

# Outsourcing Success in 2013

Best Practices, Trends &  
Strategies for Corporate Counsel



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# Finance & Accounting Outsourcing – Key Insights and Lessons Learned

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# The Value of Contract Terms: Commitments, Options and Incentives

## Commitments

- Desired services
- Quality and compliance
- Firm price

## Options

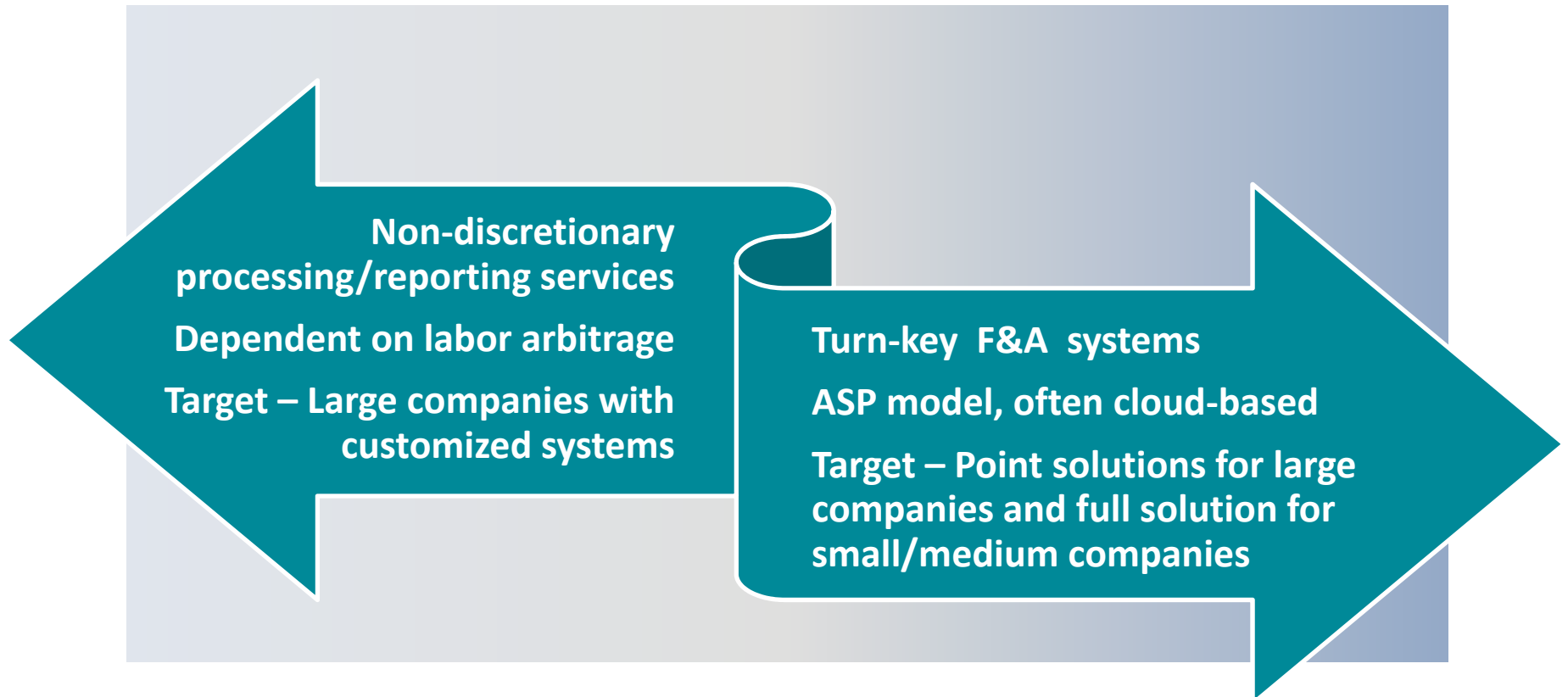
- Increase or reduce scope
- Change requirements
- Terminate

## Incentives

- Credits and liability for damage
- Gain sharing
- Termination rights



# Broad Range of FAO Offerings



Each end of the spectrum presents different legal and contractual challenges, options and trade-offs



# Common Finance and Accounting Functions

## CORE F&A FUNCTIONS

- Accounts payable
- Accounts receivable or revenue cycle
- Fixed asset accounting
- General ledger accounting
- Tax accounting/reporting
- Reporting

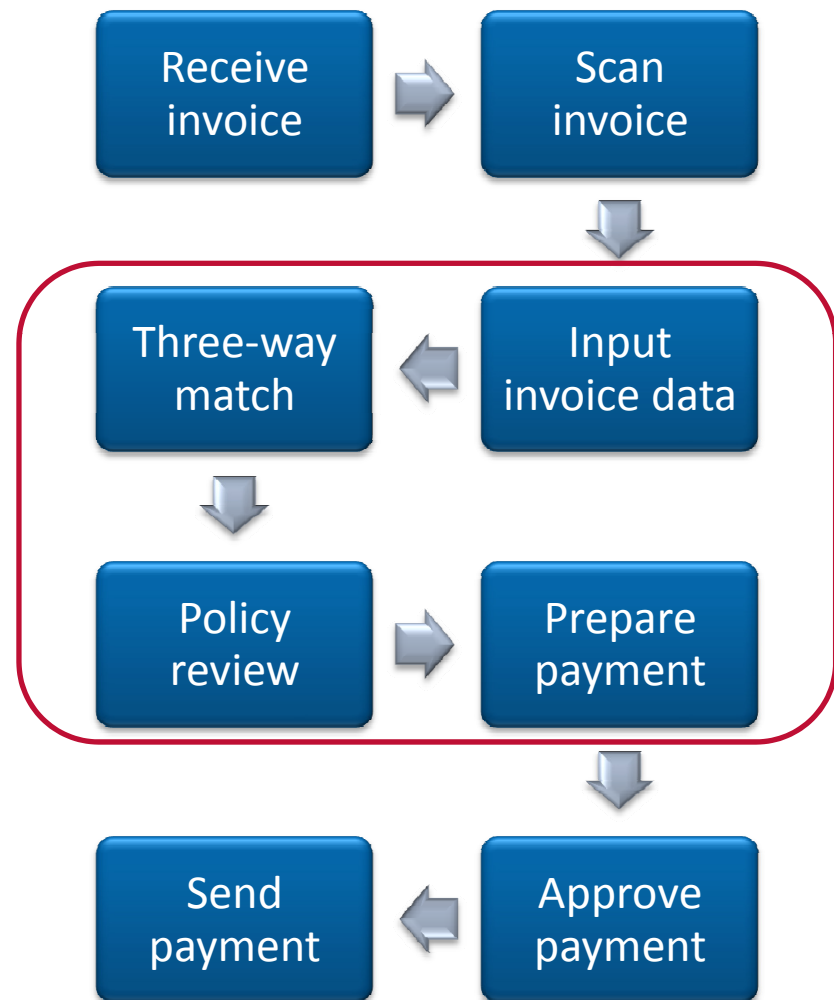
## OTHER RELATED FUNCTIONS

- Payroll processing
- T&E expense management
- Planning & forecasting
- Treasury
- Collections
- Financial Analytics



# Portions Typically Outsourced

- Sourced services are defined by accounting processes and financial systems
- Scope may differ by business unit or geography
- Sourced functions generally ministerial, at least for now
- Handoffs at points that allow control and performance measurement



# Internal Controls

- Commitment to maintain strong internal financial controls over provider's operations
- Commitment to maintain controls over FAO services that are consistent in all material respects with customer's SOX compliance requirements and accounting policies, as they may change from time to time
- Define principles in contract, but avoid imposing one-off requirements on shared delivery centers
- Provider to propose internal controls meeting principles for customer review and approval
- Provider to memorialize approved internal controls in Service Management and Governance Manual



# Audit Rights

- Standard option to conduct operational and financial audits of provider's performance of the Services, including audits by government regulators and other third parties
- Separate commitment to support audits of customer's finance and accounting functions as part of chargeable services
- Consider defining level of audit support included in base pricing, but not number of audits
  - Exception for audits resulting from provider's breach
- Right to receive unqualified annual SSAE 16/ISAE 3402 audit reports (successors to SAS 70)
  - Consider financial credits, enhanced liability and/or termination right for failure to provide unqualified report
- Recognize the limitations of traditional SSAE 16/ISAE 3402 audits





# Common Pricing Terms in FAO Transactions

- Transition and transformation: fixed fee subject to credits
- Tools and technology: fixed monthly charge
- Governance: fixed monthly charge
- Production FAO:
  - Typical approach: FTE-based pricing with rate cards
  - Higher-value approach: Transaction-based with ARC/RRC rates
  - Emerging approach: Gain sharing based on financial metrics such as days' sales outstanding
- Possible adjustments
  - FX adjustments because customer pays provider in onshore currency and provider pays its people in offshore currencies
  - Inflation adjustment sharing labor rate risk
  - Benchmarking



# Obtaining Meaningful Commitments to Savings and Productivity with FTE-based Pricing

## Problem

FTE-based pricing provides no meaningful commitment to savings

## Solution

- Create an “FTE glide path” that starts at current FTEs declines based on committed productivity improvements
- Adjust the glide path based on changes in volumes
- Provide that the charges will be based on the lesser of the actual FTEs and the FTE glide path
- Create an incentive for additional productivity by sharing the savings if the actual FTEs are less than the FTE glide path



# Obtaining an Option to Convert from FTE-based to Transaction-based Pricing

## Problem

Companies often lack adequate data to contract immediately for transaction-based pricing

## Solution

- Agree initially on transaction volume units (TVUs) such as invoices processed
- Require reporting of actual TVUs monthly
- Require reporting of FTEs by transaction type
- Include an option to convert to transaction-based pricing with:
  - Base Charges equal to current charges allocated based on FTEs for a base volume equal to actual FTEs
  - ARC/RRC rate equal to a percentage of the average cost



# Key Options for Retaining Leverage and Managing Change

- Option to obtain New Services from provider
- Option to in-source or use third parties for existing and new services
- Options to remove unacceptable personnel, subcontractors, provider facilities and Key Personnel
- Option to withhold disputed charges, including commitment by provider to continue to provide services regardless of level of disputed charges
- Option to require provider to use customer as a reference
- Option to terminate for convenience or change of control without punitive termination charges
- Option to terminate for cause upon material breach

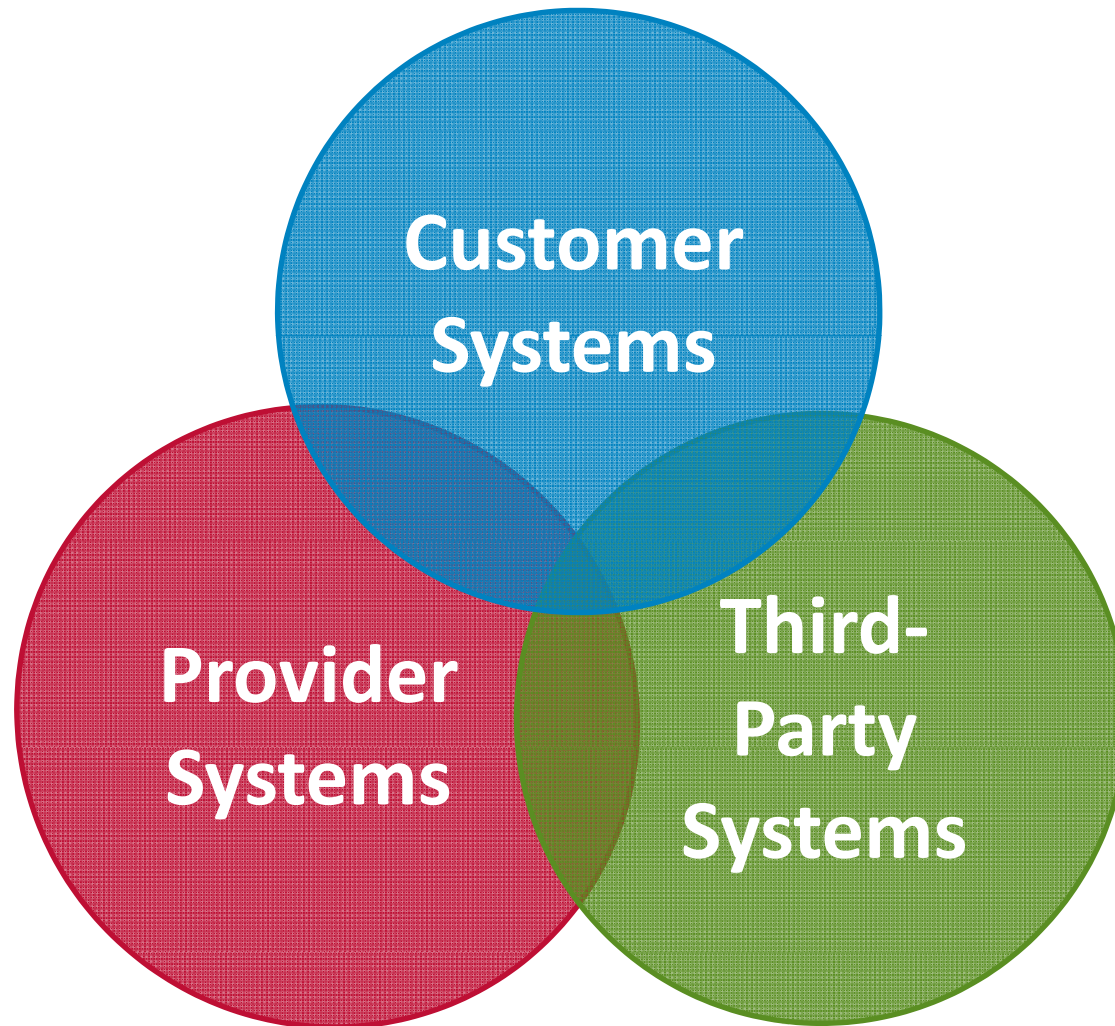


# Reducing Risk and Cost of Exercising Termination and Non-renewal Options

- Option to extend Services for up to 18 months on same terms, including pricing
- Option to obtain Disengagement Services, such as consulting and “reverse transition” services
- Option to acquire/use software, equipment and third party contracts, unless exception agreed to in advance
- Option to hire at least some Provider Personnel
- No charge for Disengagement Services if capable of being performed by existing staff
- Defined pricing if additional Provider resources required



# Provider and Third Party Technology May Be Vital to Solution and Customer's Operations



# Key Contract Clauses for Provider and Third-party Technology

- Specifications and acceptance criteria
- Allocation of cost of developing interfaces
- Option for customer to allow its employees and contractors to use technology to run customer's business
- For third-party technology, obligation for required consents and option for direct contract with third party
- Maintenance and support obligations
- Control over changes adversely affecting customer
- Commitments as required to comply with laws



# Examples of Applicable Laws

- Data privacy / data security / cross-border data transfer
- Industry-specific regulations (such as local records and licensing requirements for insurance companies)
- Export controls and restrictions
- FCPA and other anti-corruption laws
- Debt collection laws
- Payroll tax laws
- Payment Card Industry Data Security Standard
- ACH rules/regulations
- Controlling law / jurisdiction





# Commitments to Comply with Laws

- Allocating responsibility for compliance with laws requires more thought for FAO than ITO
- Avoid cookie cutter approach
- Consider the customer's (and provider's) familiarity with relevant areas of laws and applicable jurisdictions
- Consider whether liability will be waived or capped
- Watch what you ask for – this can significantly increase your price without delivering commensurate value



# How to Address Key CFO Priorities in Your Savings Calculation

Speak the CFO's language

Understand the CFO's priorities

Perform a solid, defensible financial assessment

Consider the "what ifs"

Quantify the non-financial value of the deal



# Quantifying the Value You Add Through Contract Terms

- **Commitment Example:**

- Cost of performing compliance functions that would have been retained without contract language **or**
- Probability of compliance failure multiplied by sum of cost of remediation plus fines and other costs of compliance failure

- **Option Example:** Probability of termination for change of control multiplied by discount from Convenience Termination Fee for termination for change of control

- **Incentive Example:** Probability of poor performance because of lack of customer leverage multiplied by cost of poor performance

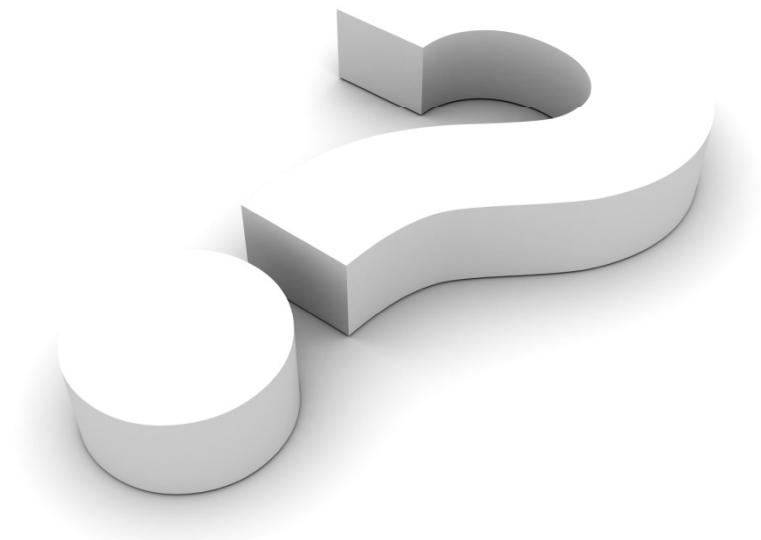


# Summary

- Finance and accounting outsourcing involves unique opportunities and risks because of the central, highly regulated role of the F&A function within your company
- The right contract terms can help to maximize value and avoid costly pitfalls
- You can estimate the monetary value of the right contract terms by focusing on commitments, options and incentives



# QUESTIONS?



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# Aligning Incentives to Drive Results in Outsourcing Arrangements

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# Agenda

- Incentive Based Pricing Arrangements
- Key Incentives for Managing Transition and Transformation Efforts
- Structuring Risk Allocation Terms to Drive Behavior
- Creating Service Level Agreements that Work



# Overview

- This presentation will focus on:
  - Influencing choices and behavior, not necessarily on addressing accidents or mistakes
  - Identifying actions and decisions of the supplier that the customer wants to influence
  - Negotiating terms that reward actions that customer wants to encourage and that discourages actions that customer wants to avoid





# Incentive Based Pricing Arrangements



# Incentive Based Pricing Arrangements

- Use incentive based pricing arrangements to drive desired performance
- Examples include:



# Incentive Based Pricing Arrangements



- Replace Fixed Fee Pricing with Shared Pricing
  - Base Fee
    - Typically cost based
    - Pass-through, fixed fee, etc
  - Incentive Fee
    - Define metrics of importance to customer
    - Incentivize supplier by tying supplier's profit to performance against metrics



# Incentive Based Pricing Arrangements



- Add Gainsharing
  - Additional element to existing pricing arrangement
  - Can be tied to revenue or savings based upon customer's desired outcome and type of deal
  - Additional compensation to supplier based on meeting or exceeding targets (percentage of improvement)
    - Obligations of each party need to be clearly defined
      - Required investments
      - Approvals
    - Clearly define parameters for payment
  - Applies only to upside; no downside risk to supplier



# Incentive Based Pricing Arrangements



- Create a Risk/Reward Mechanism
  - Same upside reward as gainsharing
  - Supplier also assumes downside risk
  - FM budget example
    - Supplier underspends budget, the parties share savings
    - Supplier overspends budget, supplier is liable for overrun



# Incentive Based Pricing Arrangements

T&M with  
Collar

- Use T & M with collar
  - T&M rates and estimated budget are agreed
  - If project is completed under budget, supplier receives a share of under budget amount or some other reward
  - If project goes over budget, rates are decreased based on amount over budget
    - (e.G., Over 100% to 105% of budget, 95% of rates apply; 106% to 110%, 90% of rates apply, and so on.



# Key **Incentives** for Managing Transition and Transformation Efforts



# Key Incentives for Managing Transition and Transformation Efforts

- Incentivize supplier to meet transition and transformation milestone dates through payment mechanisms, credits and/or holdbacks
- Use payment mechanisms to encourage timely performance
  - Tie payment to completion and acceptance of milestones
  - Clear acceptance process so that supplier understands the process and plans activities to meet required deadlines.





# Key Incentives for Managing Transition and Transformation Efforts

- Structure deliverable credits to maintain incentives for milestone completion
  - Phase in the deliverable credit
    - Increase the percentage of the deliverable credit based upon the extent to which the supplier is late in meeting the due date to maintain supplier's incentive to complete
  - Use earnback to incentivize supplier
    - Encourage supplier who has missed interim milestone dates to get on track to meet final milestone dates
- Use of at risk amount and pool for deliverable credits



# Structuring Risk Allocation Terms to Drive Behavior



# Structuring Risk Allocation Terms to Drive Behavior

Influencing supplier business decisions

- Management decisions to do or not do something (e.g., to suspend service delivery)

Influencing supplier's approach to the account and application of its resources

- Incentivize supplier to focus on areas of concern for the customer



# Structuring Risk Allocation Terms to Drive Behavior

- Influencing business decisions
  - Example: Efficient breach.
    - If the economics of a deal are sufficiently upside down, a supplier may conclude that it is more efficient for it to walk away from a deal than it is to continue performing. Customer is at risk that a supplier will make the decision to walk away even if the contract does not permit it.
    - If a supplier concludes it is more efficient to walk away from the deal than continue to perform, the results can be catastrophic to a customer if the contract is for large, critical functions.



# Structuring Risk Allocation Terms to Drive Behavior

- Change the deal economics to avoid efficient breach
  - To influence the supplier's decision of whether to walk away from the agreement, we need to change the economics of that decision
- Relevant contract terms for changing the economics:
  - Traditional service agreements have a **waiver of consequential damages** and a **cap on liability**, including **exceptions** to both
- How to structure those terms:
  - Making wrongful termination/refusal to provide services or abandonment by the supplier both an exception to the consequential damages waiver and the cap on damages



# Structuring Risk Allocation Terms to Drive Behavior

## Influencing supplier's approach to the account and application of its resources

- Shifting Risk
  - Shifting risk to the supplier for specific failures creates an incentive for the supplier to allocate resources to mitigate the risk of such failures.
- Clear supplier responsibilities
  - Shifting risk to the supplier will not work if the supplier does not understand what it is responsible for under the contract.



# Structuring Risk Allocation Terms to Drive Behavior

- Use *specific* indemnities focused on particular failures
  - Examples:
    - Indemnity for failure to comply with laws
    - An indemnity for damages resulting from insufficient training
- Designate certain damages as direct damages and not consequential
  - Examples:
    - Damages associated with recreating lost data are direct damages
- Calling out activity to highlight them and provide supplier an incentive not to breach and an opportunity to allocate resources to mitigate damages if it breaches



# Creating Service Level Agreements That Work





# Creating Service Level Agreements that Work



- Key mechanism to align the quality of supplier's performance with customer expectations
- MPSA requires supplier to perform services so as to meet or exceed the service levels
- Enhance enforcement through service level methodology



# Creating Service Level Agreements that Work

- Set effective service levels and establish clear consequences
  - Use service levels to influence behavior:
    - Suppliers will strive to meet service levels that measure the *Supplier's Performance* (i.E., Outcomes within supplier's control) to avoid penalties
    - Include service levels where Supplier has an opportunity to influence outcomes



# Creating Service Level Agreements that Work

- Allocate credits effectively:
  - Focus credits on areas of greatest concern to customer. Spreading credits across too many Service Levels can dilute the impact
  - Maintain the right to add, delete, modify (e.g., reallocate percentages) and elevate to allow customer to refocus supplier energies to address changing customer concerns and needs or supplier performance issues
- Define the measurement process and use measurement tools to drive the desired behavior



# Creating Service Level Agreements that Work

- Use credits and remedies (such as termination rights) to disincentivize supplier from undesirable results
  - Credits recognize the diminished value of the services
  - Set expected and target service levels
  - Increase credit amount for multiple defaults
  - Use significant minimum defaults
  - Include clear cut termination rights

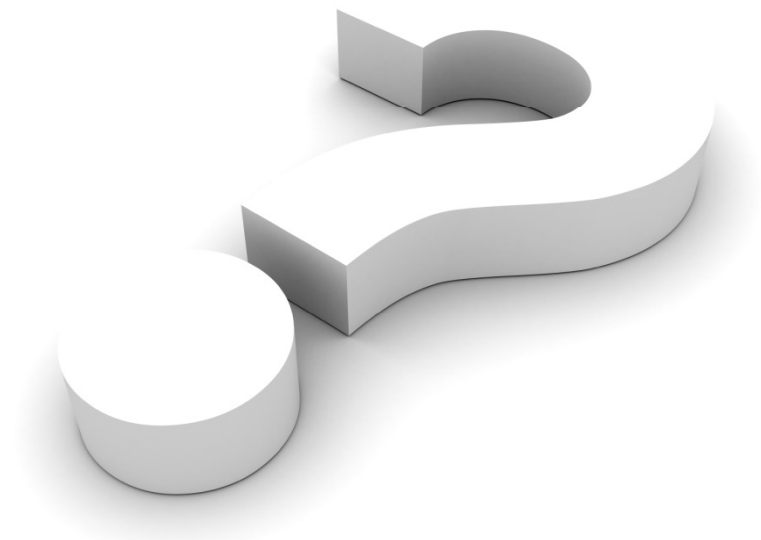


# Creating Service Level Agreements that Work

- Encourage supplier improvement
  - Create incentives for supplier to get back on track
  - Provide for earnback to reward supplier for improvements
  - Provide for continuous improvement



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# The Compliant Cloud: Practical Approaches to E-discovery, Export Control, Privacy and Other Compliance Issues

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# Program Agenda

- Developments in e-discovery and the cloud
- Understanding export control issues
- Assessing the risk of government seizure of data in the cloud
- EU data privacy influences on global cloud contracting





# Developments In E-discovery and The Cloud



# Why Cloud Computing Increases E-discovery Risks

- Data is not in the actual possession of the litigant
- Little or no control over whether and when the data is destroyed
- Potentially limited access to data
  - Access may not be sufficient or may be too slow to meet Court or regulators requirements for production
- Data may be co-mingled with that of another company or a separate corporate entity
  - Who has possession, custody and control?
- Little or no information about where the data is stored, which may create problems of access and compliance with data transfer laws



# Discovery of ESI in the Cloud

- FRCP 34 provides that discovery may be had of documents and things that are in the ‘possession, custody and control’ of a party



- This can include documents that a party has the ‘right, authority or practical ability’ to obtain from a non-party
- ‘Control’ does not require a party to have legal ownership or actual physical possession of a document
- If ESI is maintained with a cloud computing provider, consider steps necessary to access, preserve and produce such ESI
- If the cloud computing provider intermingles US and foreign data, must ALL the data be produced?



# Managing Risks Related to Electronic Discovery in the Cloud Computing Context

- Things to Articulate in the Cloud Computing Provider Contract
  - Who has ‘control’ of data
  - What are my rights to access and collect the data in a timely manner
  - Can I direct the provider to preserve specific data
  - Will it be a breach of this contract if data is not preserved at my direction
  - Will the provider indemnify me, and pay my attorney’s fees and costs, for failure to preserve or provide me access to ESI
  - What is the format of production from the provider (scope, file type)
  - Will the chain of custody be documented
  - What happens to data upon termination of contract



# Managing Risks Related to Electronic Discovery in the Cloud Computing Context

- Things to Consider When Designing a Cloud Computing Solution
  - Does the provider have policies and procedures that might impede my obligations to preserve, collect, and produce ESI during litigation
  - What are the provider's routine ESI deletion practices and protocols
  - Does the provider have the technological capability to permit me to access and collect data in a timely manner
  - In what form or format will the data be stored and returned to me for production during litigation
  - Where in the world will the data be maintained
  - Will the data be intermingled with other data
  - Will production of data from the cloud require compliance with data transfer laws



# Understanding Export Control Issues



# What is an Export?



Cross-border transmission of U.S.-origin data and software

- Does the cloud provider store your documents on (or route documents through) servers located outside the United States?

Release/disclosure of U.S.-origin technical data or source code to foreign nationals located in the United States (“deemed export”) or abroad (“deemed re-export”)

- Who has access (potential or actual) to documents you put in the cloud?



# Is Your Technology or Software “Controlled” for Export?

- Export Administration Regulations (“EAR”)
  - Dual-use items
  - Department of Commerce, Bureau of Industry and Security (“BIS”)
  - Listed on the Commerce Control List (“CCL”)
  - Reason for control and destination country
  - EAR 99 items controlled to terrorist-supporting countries (Cuba, Iran, North Korea, Sudan and Syria)





# Is Your Technology or Software “Controlled” for Export?

- International Traffic in Arms Regulations (“ITAR”)
  - Defense articles and services
  - State Department, Directorate of Defense Controls (“DDTC”)
  - Listed on U.S. Munitions List (“USML”)
  - All exports of defense articles and services are controlled
- U.S. Sanctions Programs
  - Treasury Department, Office of Foreign Assets Control (“OFAC”)
  - Prohibits activities of U.S. Persons
  - No services/goods/technology to sanctioned countries or individuals



# Who Bears the Obligation to Comply with US Export Control Laws?

- General Rule: All parties to the export transaction must comply
- EAR-Controlled Items
  - BIS Advisory Opinions (January 2009 and January 2011)
    - Providing a cloud service is not an activity subject to the EAR; the cloud provider is generally not the exporter; cloud providers do not need to obtain “deemed export” licenses for their foreign national IT administrators
    - Transmitting controlled data or software to and from the cloud is an export; the user of the cloud has the responsibility to comply with export controls
- ITAR-Controlled Items
  - No guidance issued by DDTC
  - Assume both parties bear responsibility
    - Obligation of user to disclose to the provider that data is ITAR-controlled
- No guidance issued by OFAC



# Compliance Considerations

- Traditional export control analysis – do you have “controlled” technology or software?
- Due diligence before entering into a cloud service agreement
  - How and where will data be maintained; who will have access to the data in the cloud; will the cloud user or cloud provider be exporting any software
- Consider excluding “controlled” data from the cloud or using a “domestic cloud” where the provider’s resources are located in the U.S. and administrators are U.S. citizens/permanent residents
- Develop contractual safeguards in cloud service agreements
- Train your employees to identify unique export risks related to the cloud



# Assessing The Risk Of Government Seizure Of Data In The Cloud



# How Can The US Government Seize Data?

## Available Tools

- Patriot Act options
  - National Security Letters
  - FISA Orders

- Cross-border options
  - Mutual legal assistance treaties
  - Informal requests between law enforcement

- Conventional options
  - Search warrants
  - Grand jury subpoenas



# How Can The US Government Seize Data?

## Seizure Options

- What to seize?
  - Data from a server
  - Entire server
- From whom?
  - Any entity with access to data / hardware
- Extraterritorial reach?
  - US office or “substantial and continuous US business”
  - Repatriate offshore data
  - Cross border options



# Minimizing Risk To Your Data

## Define The Risk That Concerns You

- Business interruptions / loss of use of data
- Customer relations (e.g., negative perception of Patriot Act)
- Compliance with EU or other local data protection law
- Leakage of damaging or embarrassing company data
- Loss of trade secrets
- General sense of what is fair



# Minimizing Risk To Your Data Solutions

- Jurisdiction

- Can be hard to put data beyond US reach
- May not be helpful, EU can seize data or servers also

- Contract

- Advance notice of seizures when possible
- Consider all access points
- Dedicated server?
- Backups?





# EU Data Privacy Influences On Global Cloud Contracting



# Frame of Reference – Know What You Are Buying

Customer Need	Pure Utility Cloud Contract	Dedicated Private Cloud Contract	Semi-Private, Leveraged Cloud Contract
	<p>Could be SaaS, some PaaS and pure public (fully leveraged) cloud model, networks, virtual machines, storage are fully shared, and even apps may be shared</p> <p>Lowest Cost</p>	<p>Fully dedicated, fully private enterprise cloud offering, networks, virtual machines, storage devices are not shared</p> <p>Highest Cost</p>	<p>Semi-private, leveraged offering, where networks, virtual machines, and storage devices may be shared, but are carefully logically separated</p> <p>Somewhere in Between</p>



# Privacy, Security and Compliance Issues with Cloud Computing: —Non-US

- Numerous countries prohibit or restrict the transfer of personal data out of a certain area, and require additional formalities before the data may be transferred
- Examples: EU and EEA countries, Argentina, Brazil, Canada, Dubai, Israel, Mexico, New Zealand, Uruguay



# Working Party Opinion 196 (July 1, 2012) on Cloud Computing

- The Working Party identifies concerns falling into two categories:
  - cloud clients lose control of the technical and organizational measures necessary to ensure the availability, integrity, confidentiality, transparency, isolation and portability of data;
  - lack of information processing;
    - insufficient information about a cloud services processing operations poses a risk to controllers as well as to data subjects because they might not be aware of potential threats and risks and therefore cannot take measures they deem appropriate.



# Working Party Opinion 196 (July 1, 2012) on Cloud Computing

- Contractual Safeguards for Cloud Computing must address:
  - Client's instructions (with penalties);
  - Security measures, including organizational and technical measures;
  - Subject of contract, term and extent, manner, and purpose of the processing personal data;
  - Return, destruction and erasure of personal data;
  - Confidentiality requirements, binding on provider and employees;
  - Support of data subjects exercising their rights;
  - Numerous restrictions on subprocessors, including obligation to name them and to flow down contract obligations;



# Working Party Opinion 196 (July 1, 2012) on Cloud Computing

- Contractual Safeguards for Cloud Computing must address:
  - Customer's right to monitor the provider, and provider's cooperation with monitoring;
  - Provider must inform the customer of relevant changes;
  - Logging and auditing of relevant processing operations on personal data;
  - Notification of the client about any legally binding request for disclosure of the personal data by a law enforcement authority unless otherwise prohibited;
  - A general obligation on the provider's part to give assurance that its internal organization and data processing arrangements are compliant with national and international legal requirements and standards.

Cloud Providers must be careful not to assert rights that make them a data controller instead of a data processor



# Privacy and Security Compliance Requirements Drive Contract Needs

Need for diligence on provider	Response to data security incidents	Established Contract Terms
Know where your data is processed and stored	Audit rights	Meaningful risk of provider for liability for breaches and non-compliance
Know places where your data may be transferred	Proper disposal and destruction of data	Controls on data and security standards, log files, etc.
Rights to approve of subprocessors	Change Control	Compliance issues – e-discovery, holds, government seizures, export, data subject requests, etc.



# Additional Resources and Reading

- Cloud Security Alliance – [www.cloudsecurityalliance.org](http://www.cloudsecurityalliance.org)
- National Institute of Standards and Technology, Cloud Computing Synopsis and Recommendations, Special Publication 800-146, 1 (May 2012), available at [http://www.nist.gov/customcf/get\\_pdf.cfm?pub\\_id=911075](http://www.nist.gov/customcf/get_pdf.cfm?pub_id=911075) (11 PVL 977, 6/18/12).
- NIST Special Publication (SP) 800-53 – Guide for Assessing the Security Controls in Federal Information Systems
  - <http://csrc.nist.gov/publications/nistpubs/800-53A/SP800-53A-final-sz.pdf>
- Federal Financial Institutions Examination Council, Outsourced Cloud Computing (July 10, 2012), available at [http://docs.ismgcorp.com/files/external/062812\\_external\\_cloud\\_computing\\_public\\_statement.pdf](http://docs.ismgcorp.com/files/external/062812_external_cloud_computing_public_statement.pdf).
- Article 29 Data Protection Working Party, Opinion 05/2012 on Cloud Computing, 01037/12/EN, WP 196 (July 1, 2012), available at [http://ec.europa.eu/justice/data-protection/article-29/documentation/opinion-recommendation/files/2012/wp196\\_en.pdf](http://ec.europa.eu/justice/data-protection/article-29/documentation/opinion-recommendation/files/2012/wp196_en.pdf) (11 PVL 1097, 7/9/12).
- <http://www.mayerbrown.com/Cloud-Computing--Article-29-Working-Party-Guidance-on-EU-Privacy-and-Security-concerns-07-10-2012/>
- CNIL, Recommandations pour les entreprises qui envisagent de souscrire à des services de Cloud computing, available at [http://www.cnil.fr/fileadmin/images/la\\_cnil/actualite/Recommandations\\_pour\\_les\\_entreprises\\_qui\\_envisagent\\_de\\_souscrire\\_a\\_des\\_services\\_de\\_Cloud.pdf](http://www.cnil.fr/fileadmin/images/la_cnil/actualite/Recommandations_pour_les_entreprises_qui_envisagent_de_souscrire_a_des_services_de_Cloud.pdf) (11 PVL 1082, 7/2/12).





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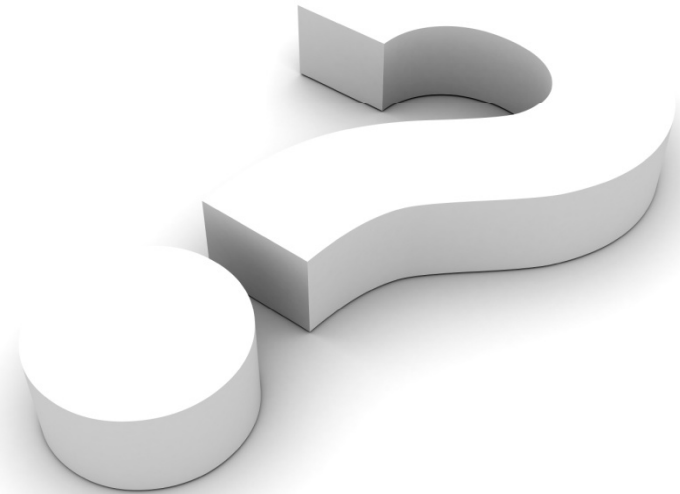
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# Lessons Learned From Litigation: Addressing Changing Needs And Poor Performance



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## State of Indiana v. IBM, Case No. 49D10-1005-PL-021451, Indiana Superior Court, Marion County, July 18, 2012

- State of Indiana terminated \$1.3 Billion transformation and outsourcing agreement with IBM based on numerous alleged breaches and sought damages (\$170 million)
- IBM counterclaimed to recover costs and termination fee (\$100 million)
- Court: “Neither party deserves to win this case.”
- Court finds that IBM substantially performed the contract so no material breach, termination for cause or damages
- Court grants IBM damages consisting of costs but denies termination fee claim, finding it to be a penalty



## Case Facts

- Termination based on quality and timeliness issues
- Some SLAs consistently breached but penalties were small
- Some complaints not covered by SLAs; considered immaterial
- Corrective action plan was agreed; notice of material breach with time-limited opportunity to cure was not sent
- IBM was making progress on the corrective action plan
- State changed project design and asked IBM to implement new design at no additional cost



## Case Facts

- Only when IBM refused to implement changed design at no additional cost did State declare material breach
- Governor Daniels praised IBM publicly at time termination for cause was announced
- State did not act consistent with claim that failure of performance constituted material breach
- State really was attempting to use a termination for cause as leverage to negotiate a favorable change order
- Termination fee included excess profit component



## Issues Arising From Indiana Case

- Poor Performance / Material Breach
- Changing Needs



# Material Breach Standard

- Contract: “[I]n order to terminate for cause, there must be a breach or series of breaches that is ‘material considering th[e] Agreement as a whole’”
- Legal standard for determining materiality:
  - Extent to which injured party will be deprived of benefit
  - Extent to which injured party can be adequately compensated
  - Extent to which party failing to perform will suffer forfeiture
  - Likelihood of a cure, taking account of circumstances and reasonable assurances
  - Extent to which behavior of party failing to perform comports with standards of good faith and fair dealing



# Material Breach Standard

- “Material breach is one that goes ‘to the heart of the contract’”
- What benefits did State receive?
- Focus on benefits received rather than impact of failures to perform
- Could IBM correct the problems?





# Material Breach Standard

- Subjective Test → Unpredictable Result
- At stake → liability for costs and profits/termination fee



# Lessons Learned About Material Breach

- Bright line tests in contract will improve predictability
- Without bright line tests, difficult to predict whether court/arbitrator will find material breach
- Supplier cannot be certain of outcome either
- Therefore, a well-supported material breach notice can create leverage for the customer to obtain improved performance or favorable exit terms from supplier



# Making An Effective Record

- Actions need to be consistent with the concept of materiality
- Customer needs to act like the breach is causing or threatening to cause major damage to customer's business, whether the damage can be quantified or not
- Where breaches create ongoing risks, notice must be prompt and customer may have to take steps to mitigate before dispute is resolved



# Making An Effective Record

- Cite section of the contract that has been breached, describe how it was breached and describe how it impacts customer's business
- Breaches whose impact may be difficult to quantify can be very persuasive grounds for termination (e.g., loss of back-up data, data security/privacy breach, loss of reputation, risk of regulatory penalties)
- Send notice according to notice requirements in the contract
- Promptly reply in writing to anything in supplier's response that you disagree with



# Making An Effective Record

- If supplier blames customer and contract contains “Savings Clause” investigate whether supplier gave sufficient contemporaneous notice to preserve defense
- If supplier failed to give proper notice, point that out in written reply so record is clear that notice was not properly given
- Written communications will reduce the cost of resolving the dispute and strengthen your position
- Written communications will summarize key facts and reduce time and cost searching emails



# Making An Effective Record

- Written communications also will improve the parties' understanding of issues leading to improved performance or settlement
- Breach communications can be written in a constructive tone to promote communication
- Breach communications should be judge/jury/arbitrator friendly



# Making An Effective Record



- Do not confuse breach-related communications with dispute resolution procedure in which communications may not be used as evidence
- Invoke the informal dispute resolution procedures in the contract only after you have created favorable record



# Litigation

- Only after record is made and supplier has failed to cure
- Mediation may be helpful
- Declaratory judgment action may be prudent before serving termination notice
- Must address ongoing risks while seeking declaration; conduct must be consistent with claim of materiality
- Consider challenging enforceability of termination fee





## Structuring Contracts – Lessons from Indiana/IBM

“This story represents a ‘perfect storm’ of misguided government policy and overzealous corporate ambition”

– *Court in State of Indiana vs. IBM*



# Structuring Contracts: Two Main Themes

Holding the supplier accountable for its performance under the contract

Preserving flexibility through change processes and pricing mechanisms



# Holding the Supplier Accountable

- Hire Services based on specific requirements rather than high-level aspirations
  - Indiana’s contract focused on high-level goals and “policy objectives” for the new welfare system
    - Example: “Self-sufficiency, programmatic savings, and administrative savings”
    - IBM’s actual role: Run legacy system, build new system, maintain new system
  - IBM negotiated express disclaimer for high-level policy objectives
    - MSA states that those goals “did not impose any contractual obligations on IBM”
    - Court agreed that the general provisions “do not create IBM contractual obligations”
  - Indiana would have been better off:
    - narrowing the scope of the contract
    - focusing on the requirements of the system, IBM’s specific obligations and IBM’s scope of responsibility on the project



# Holding the Supplier Accountable

- Establish and maintain objective performance measures
  - Indiana measured the overall state of its welfare system, rather than IBM’s actual performance
  - Indiana’s management team used ambiguous measurements like “red, yellow, green” to describe the overall project
    - General standards can work against the customer – the supplier’s performance may be “red”, even if the project itself is “green” or “yellow” (as Indiana reported throughout the project)
- Include performance standards for each phase of a project
  - “Project saw implementation issues immediately” – system down for 48 hours, “thousands of lost hours of work, tens of thousands of calls unanswered”
  - However, most of IBM’s commitments did not begin until after the system was implemented – court determined they “never went into effect”
  - Use milestones for one-time projects and service levels for on-going Services



# Holding the Supplier Accountable

- Make credits cumulative remedies – not sole and exclusive
  - Credits are not sized to approximate a customer’s losses
    - Indiana’s credits were small, and the court considered the amounts to be “a reasonable indicator of the weight the parties gave to these measures in the agreement”
  - Credits are not a substitute for damages or a substitute for performance
    - Indiana’s credits were “liquidated damages”
    - Court determined that IBM could perform under the contract by paying the contractual penalty *instead of performing*
    - “Liquidated damages were paid in lieu of performance and provided IBM with an alternative means of performance that was satisfied by payment”



# Holding the Supplier Accountable

- Avoid overly broad exceptions and warranty carve-outs
  - IBM negotiated for an express disclaimer of “uninterrupted or error-free operation”
    - Court cites this disclaimer multiple times in determining whether IBM breached in obligations or was responsible for system problems
- Separate internal governance processes and reviews from reviews concerning the supplier’s scope
  - Indiana combined its review of IBM’s performance with the review of the overall welfare modernization initiative
  - This resulted in over-politicizing what would otherwise be a straightforward review of performance:
    - timeliness, quality, achievement of specific objectives



# Holding the Supplier Accountable

- Even for complex /collaborative projects, divide supplier and customer responsibilities
  - A smaller, more targeted IBM scope would have been more accurate and more useful to Indiana than partnership-style construction of the project
  - Indiana retained operational control, general authority and responsibility for oversight, and policy-making authority
  - In seeking “policy authority”, Indiana took on responsibility for success of the project, including with respect to IBM’s role
- Supplier will not be held accountable for responsibilities that are “joint” or collaborative
  - Court refers to “the parties’ common administrative difficulties” and “the pressures that any group of companies would have experienced given the complexity and difficulty” of the project



# Holding the Supplier Accountable

- Establish meaningful “bright-line” termination rights
  - In looking to terminate for bad performance, Indiana was forced to claim “material breach” – ambiguous standard for court to consider
  - Better to include express rights for the customer to trigger termination based on specific performance criteria. Examples:
    - Missing one or more Critical Milestones
    - Missing the same SLA in multiple consecutive months
    - Paying total credits in an amount greater than X% of the at-risk amount over a number of months
  - Both parties agree in advance that the right to terminate for cause accrues to customer, without any consideration of materiality by the courts
  - Include language that makes it clear that customer also retains a separate right to terminate based on uncured material breach





# Preserving Flexibility

- Structure supplier's scope to maintain flexibility
  - Indiana contracted with IBM for a “mega-deal”, rather than a 3-part project with options for Indiana along the way. 3 separate scope components:
    - Running current “legacy” system = on-going until go-live of new system
    - Implementation of new system = one-time until system is designed and online
    - Running implemented system = on-going after new system is running
  - Indiana would have had greater flexibility by establishing checkpoints for system completion with an “option” for maintaining the system after go-live
    - Instead, IBM got a commitment from Indiana for everything up front, before the system had been created
    - System risks were known up front:
      - “No one has done this successfully, as far as we know”
      - In Texas, rollout for similar system was stopped – applications not processed
      - “considerable challenge” and “potentially significant risk in successfully implementing the recommended solution”



# Preserving Flexibility

- Establish a change process that permits customer flexibility without supplier veto right
  - Indiana used a typical “change order” approach, where every change requires negotiation and mutual agreement (this provided veto right for IBM)
  - This put IBM in the role of “doing favors” for Indiana as the project changed
    - Scope changes, re-prioritization, capacity increases, emergency disaster recovery
    - Court lauded IBM for its flexibility
    - Indiana: “It scares me because no matter how hard we try to hold the line with IBM, they are going to refuse to do some things without change orders”
  - Instead, include concept of Mandatory Change – unilateral right for customer to change scope
    - Customer retains flexibility, and the only negotiation is determining the effect of the scope change on supplier’s compensation – not on whether the change itself is mutually agreed



# Preserving Flexibility

- Establish parameters of price fluctuations related to changes
  - Require that the Parties determine the net effects of a change
    - Indiana and IBM changed the scope 11 times in 10 months , resulting in a combined increase in IBM’s price for the work by a total of \$178 million.
    - Not clear from the judgment whether reductions in scope were also contemplated to offset increases
  - Parties should measure price change by effort and resource changes, rather than perceived “value” to the customer – too subjective post-signing
  - Establish a materiality threshold where applicable to avoid “nickel and diming” and minimize administrative burden
  - Supplier delay or failure should not constitute “change” to be addressed by a change order or more money for supplier
    - Not clear from the judgment whether any “scope changes” were actually changes necessary to accommodate IBM’s failures and/or delay



# Preserving Flexibility

- If a supplier insists on a Minimum Revenue Commitment (MRC), use it to buy flexibility
  - Indiana signed up to a 10-year, \$1.3 billion deal all at once, only to be changed by change orders (to be mutually agreed by IBM) or termination (resulting in termination charges)
    - No incentive for IBM to continue to win business – IBM won the entire deal with the initial signature
  - Instead, preserve customer's right to change scope so long as MRC is satisfied
    - Rather than 100% commitment, establish revenue stream minimums (e.g., 50% of anticipated spend) and pricing brackets/thresholds
    - Permit MRC to be satisfied through separate revenue streams – other new projects or increased spending on existing projects
  - Use MRC to buy flexibility (e.g., lower rates; cheaper banded pricing)

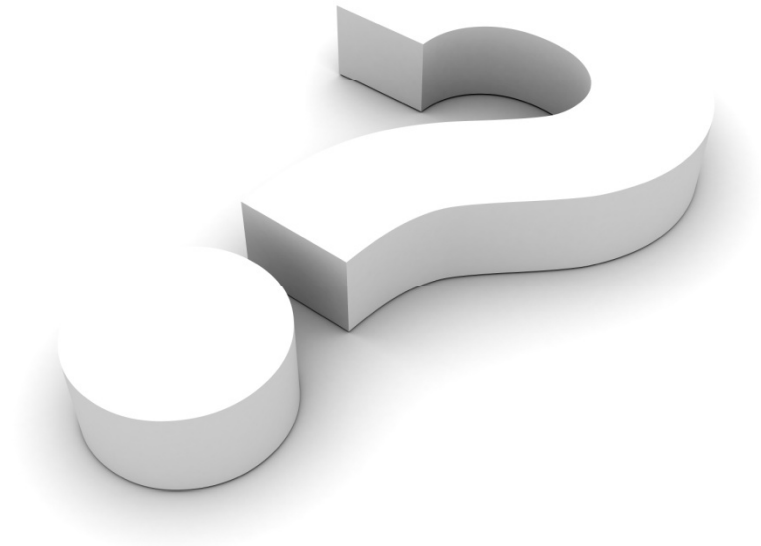


# Preserving Flexibility

- If a supplier insists on Termination Charges, make the supplier justify purpose and amount for each category
  - IBM’s termination charges were profit-based termination charges, and were determined by the court to be disproportionate in the context of the termination = disallowed as a penalty
  - When Indiana claimed “material breach” termination, risk was high if IBM succeeded (as it did) in showing that it was termination for convenience
  - Not every agreement needs to include termination charges
    - Personnel-only deals, where redeployment is feasible and no stranded assets
  - Focus on supplier’s actual costs associated with stranded assets, ramp-down of personnel, etc.



# QUESTIONS?



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# Outsourcing In Unexpected Places – Divestitures, JVs and Value-Add Agreements

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# Agenda

Where is outsourcing being overlooked?

- Corporate divestitures / acquisitions
- Joint ventures
- Value-added product / service agreements

How does outsourcing in these areas compare to traditional outsourcing?

What adaptations are required to apply outsourcing protections to these areas?





# Corporate Divestitures and Joint Ventures – What are the sourcing concerns?

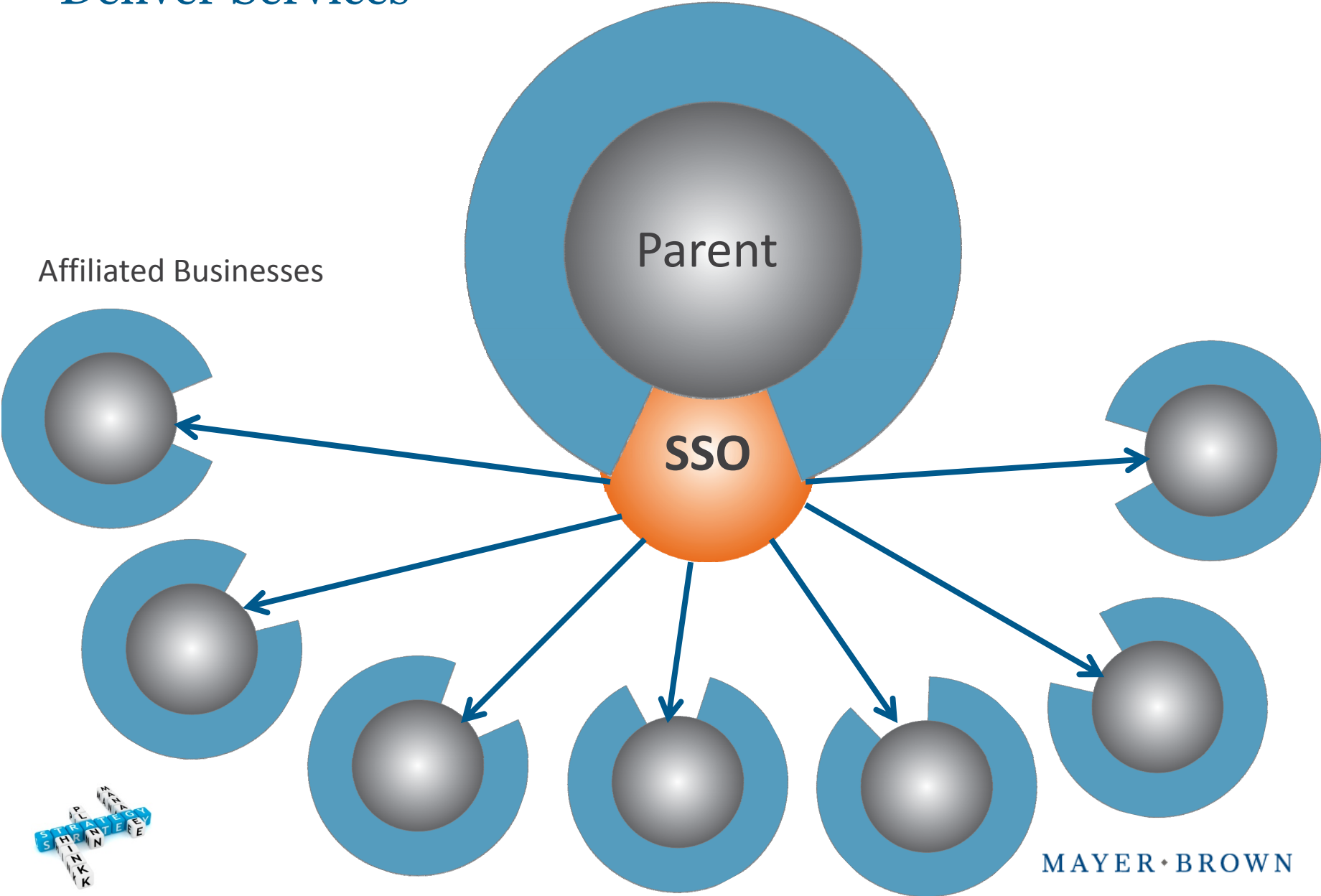
Companies have fundamentally changed how they obtain  
and deliver services



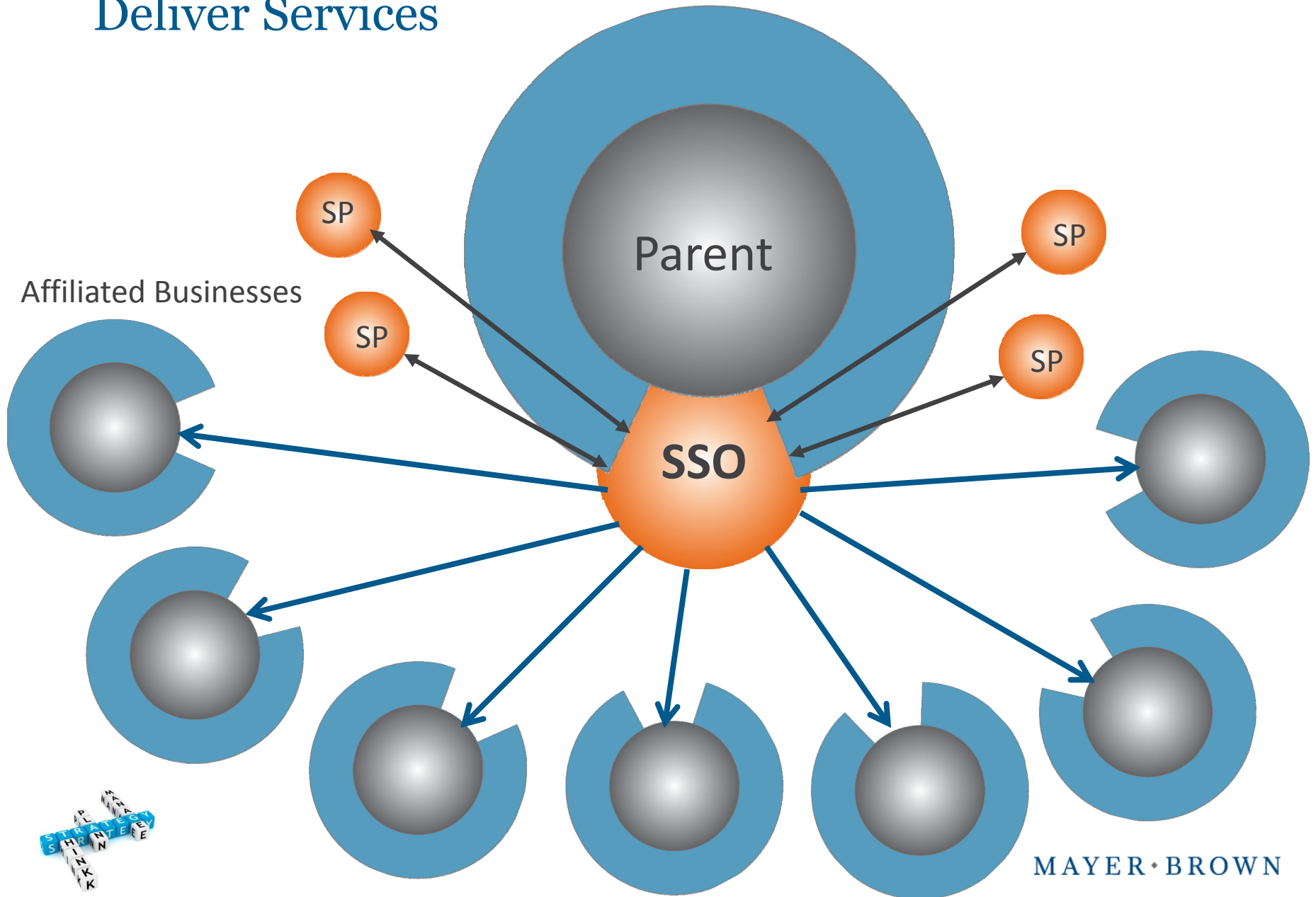
These fundamental changes impact how corporate  
transactions are done



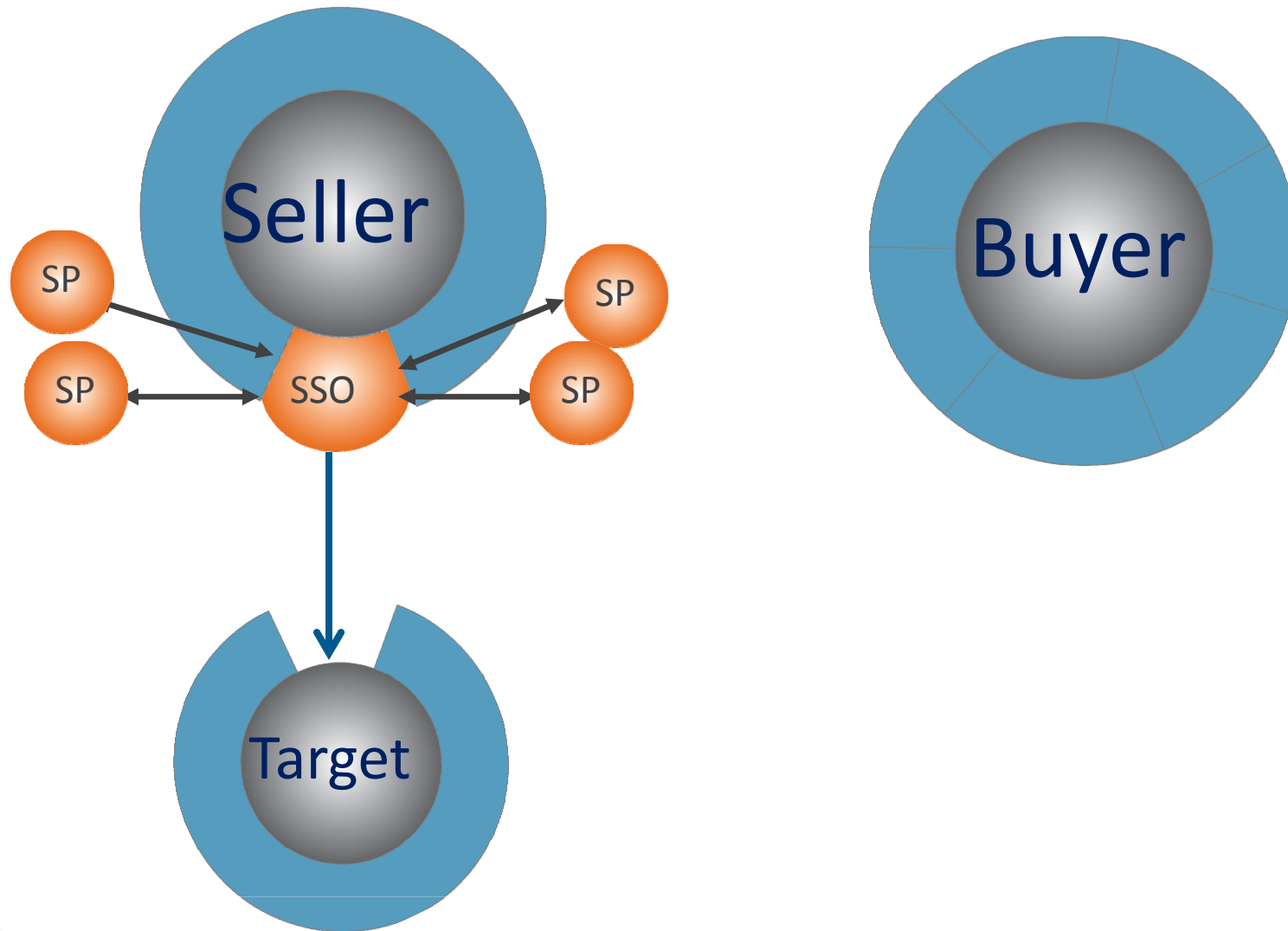
# Corporate Divestitures -- How Companies Obtain and Deliver Services



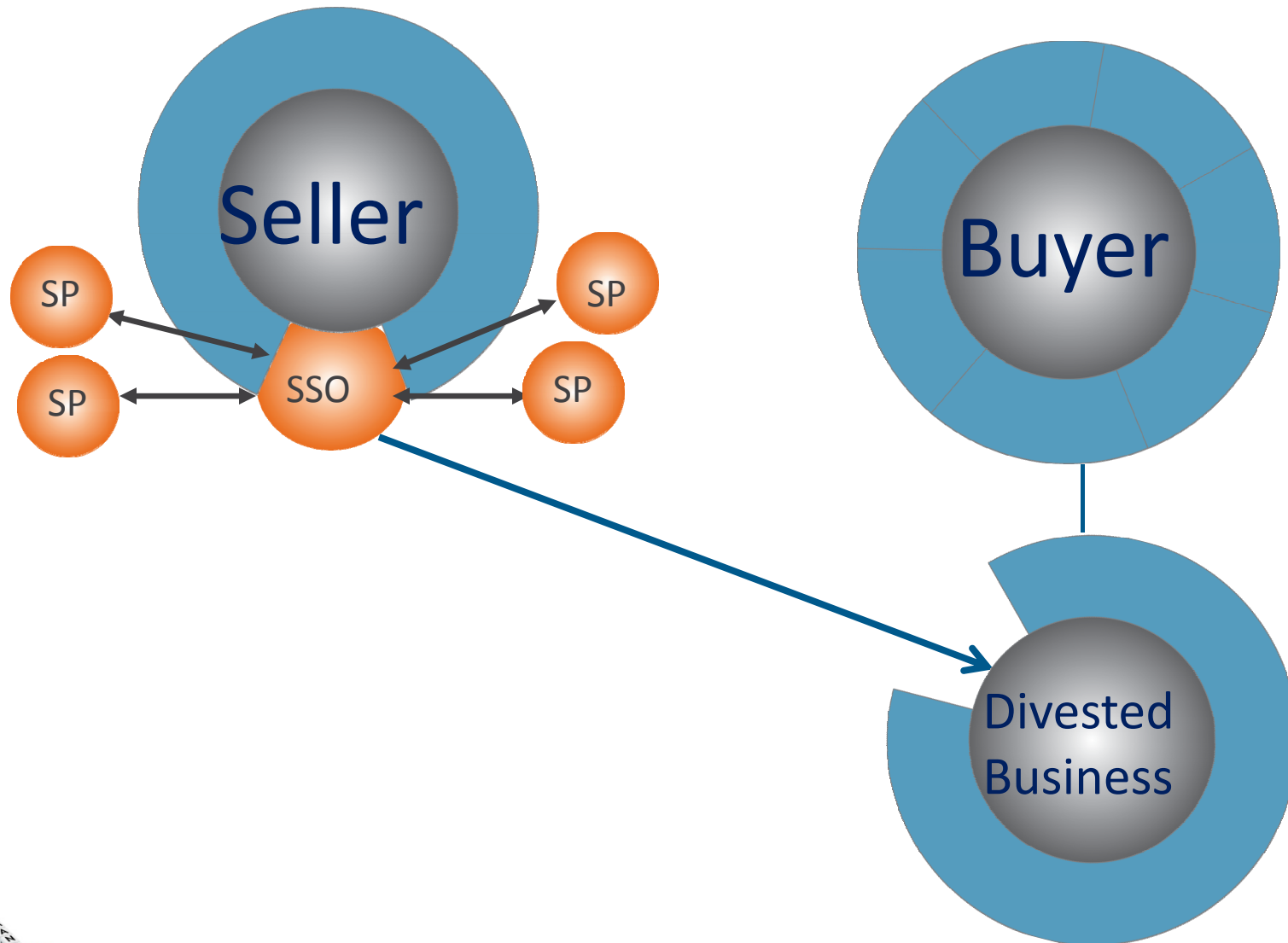
# Corporate Divestitures -- How Companies Obtain and Deliver Services



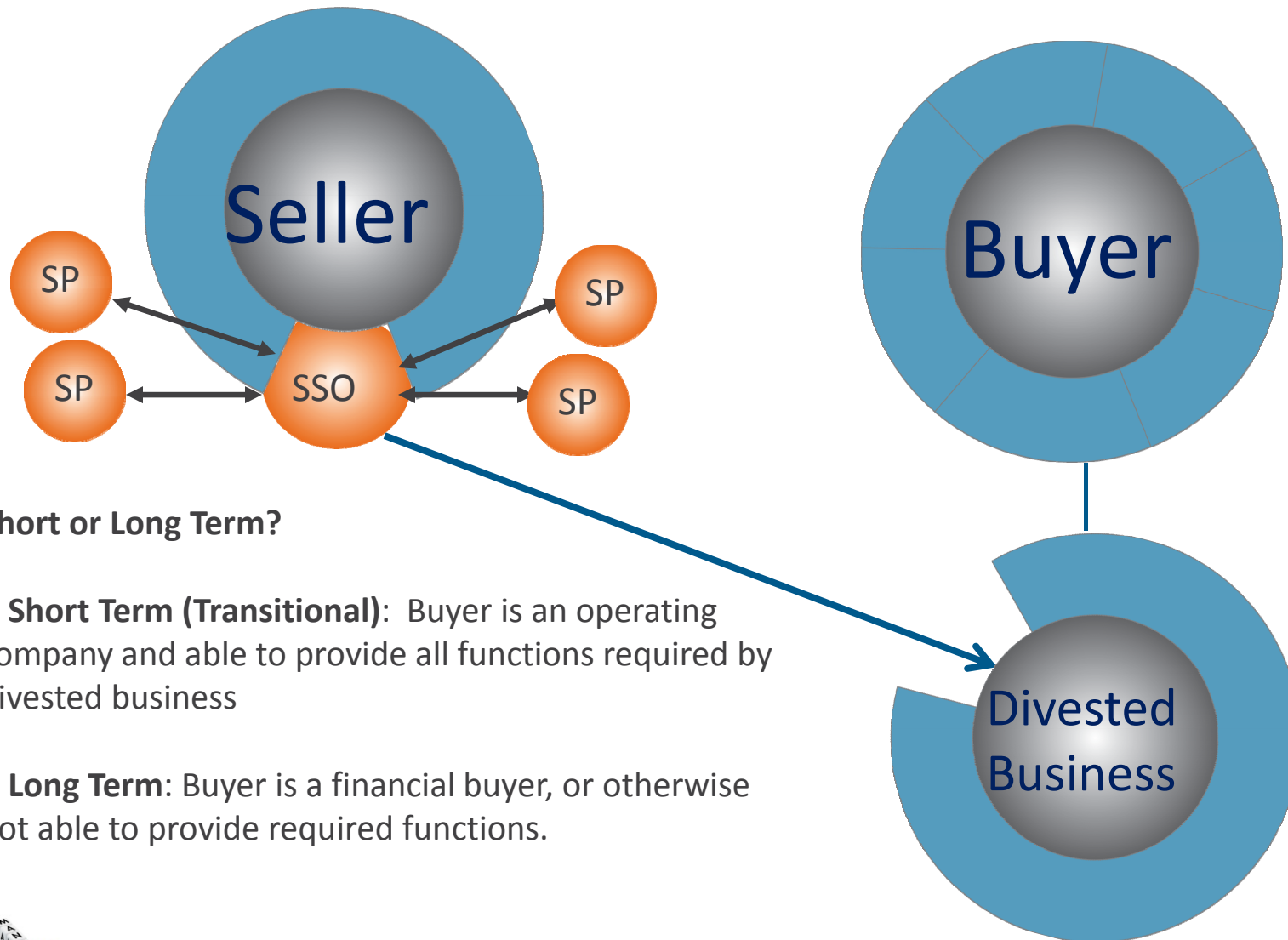
# Corporate Acquisitions – Asset Sale or Stock Sale



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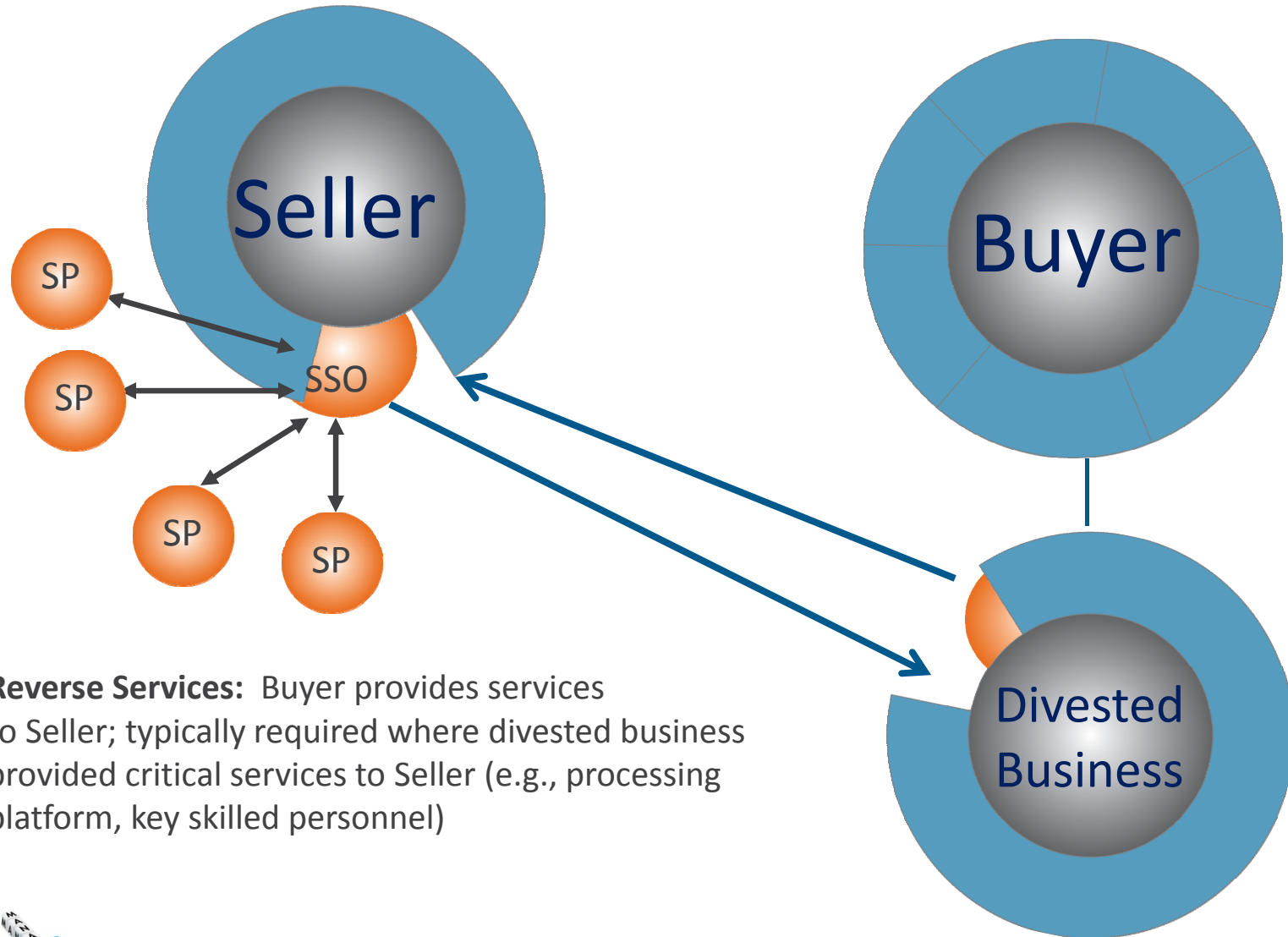


## Short or Long Term?

- **Short Term (Transitional):** Buyer is an operating company and able to provide all functions required by divested business
- **Long Term:** Buyer is a financial buyer, or otherwise not able to provide required functions.



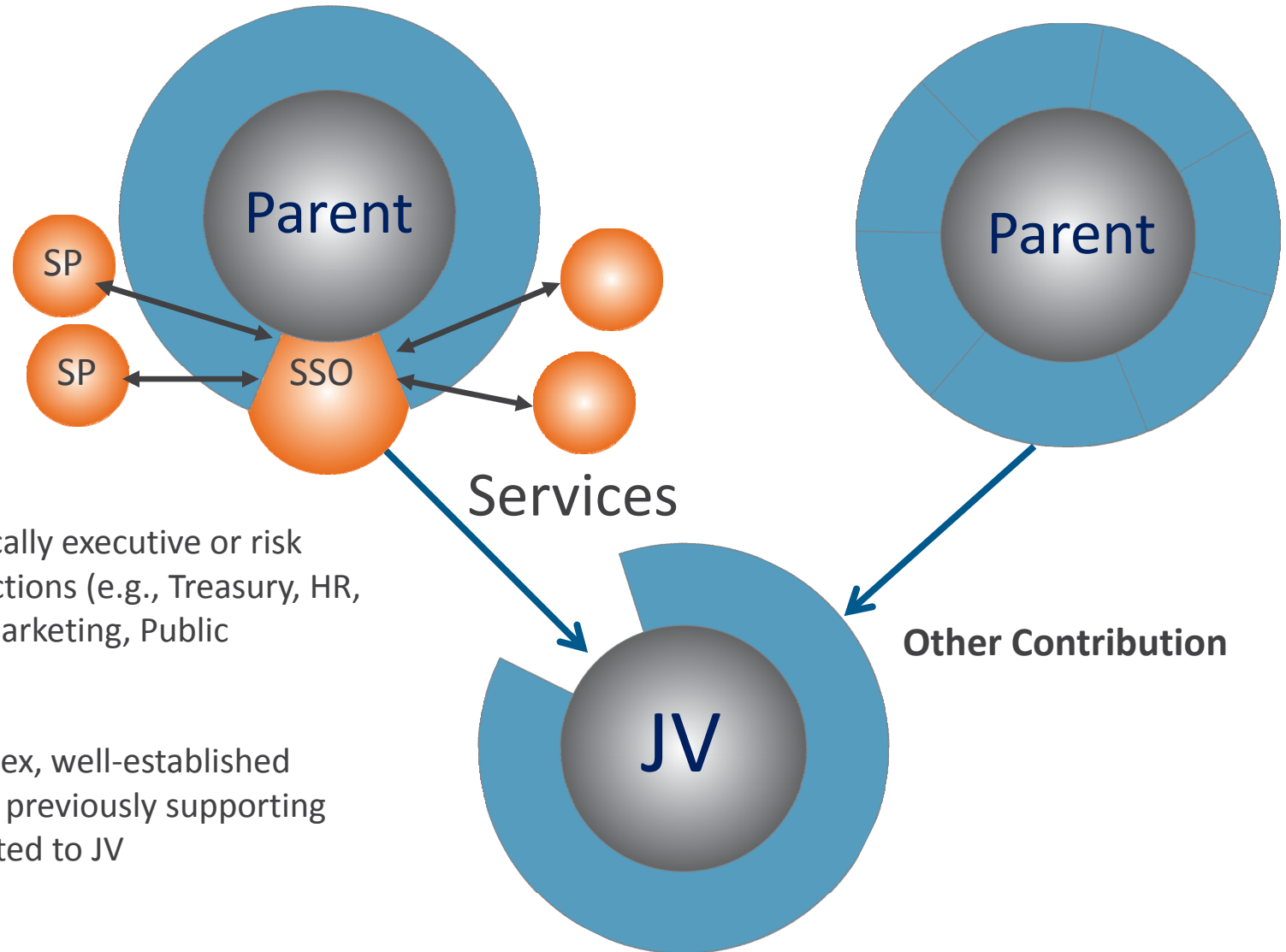
# Corporate Acquisitions – Asset Sale or Stock Sale



**Reverse Services:** Buyer provides services to Seller; typically required where divested business provided critical services to Seller (e.g., processing platform, key skilled personnel)



# Joint Ventures -- Service Arrangements



**Short Term:** Typically executive or risk management functions (e.g., Treasury, HR, Auditing, Legal, Marketing, Public Relations)

**Long Term:** complex, well-established support functions previously supporting business contributed to JV





## Value-Add Product / Service Agreements – What are the sourcing concerns?

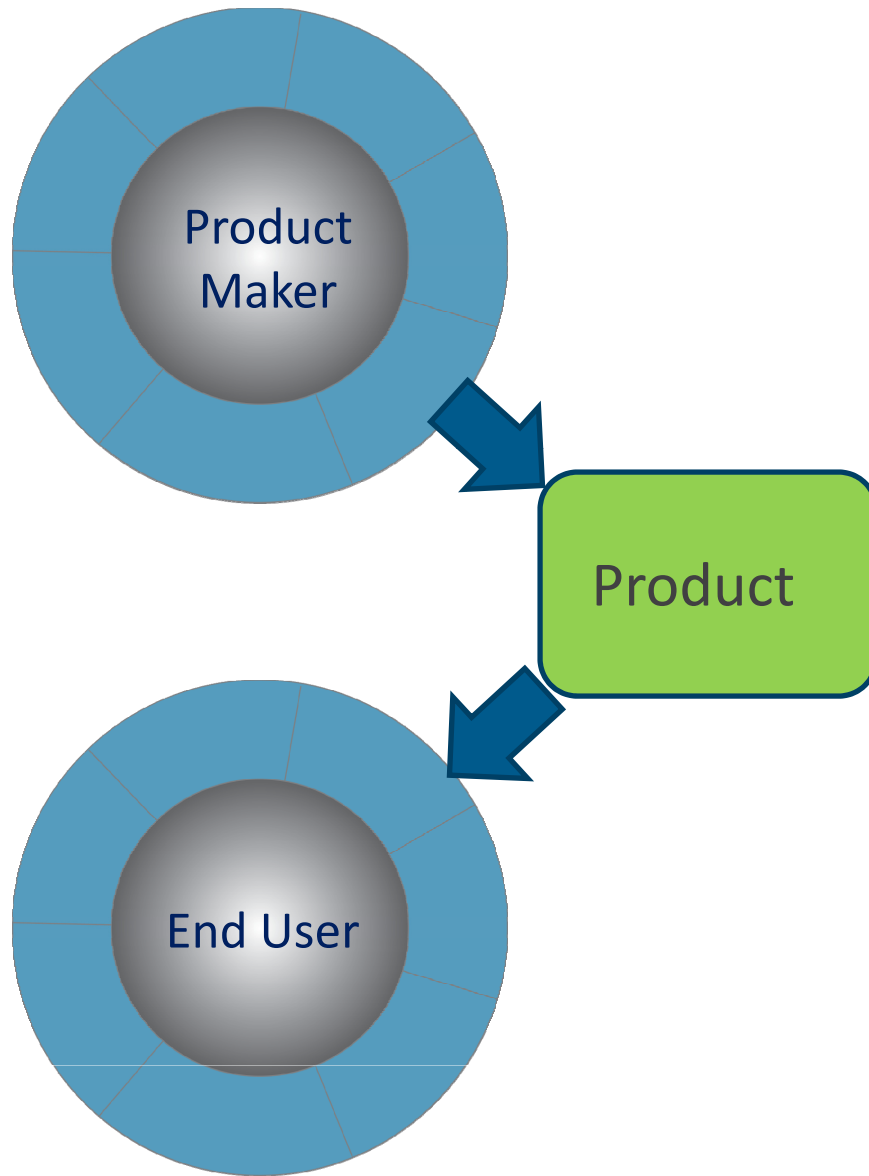
Dramatic growth in technology integration – Internet, smart phones, remote capabilities



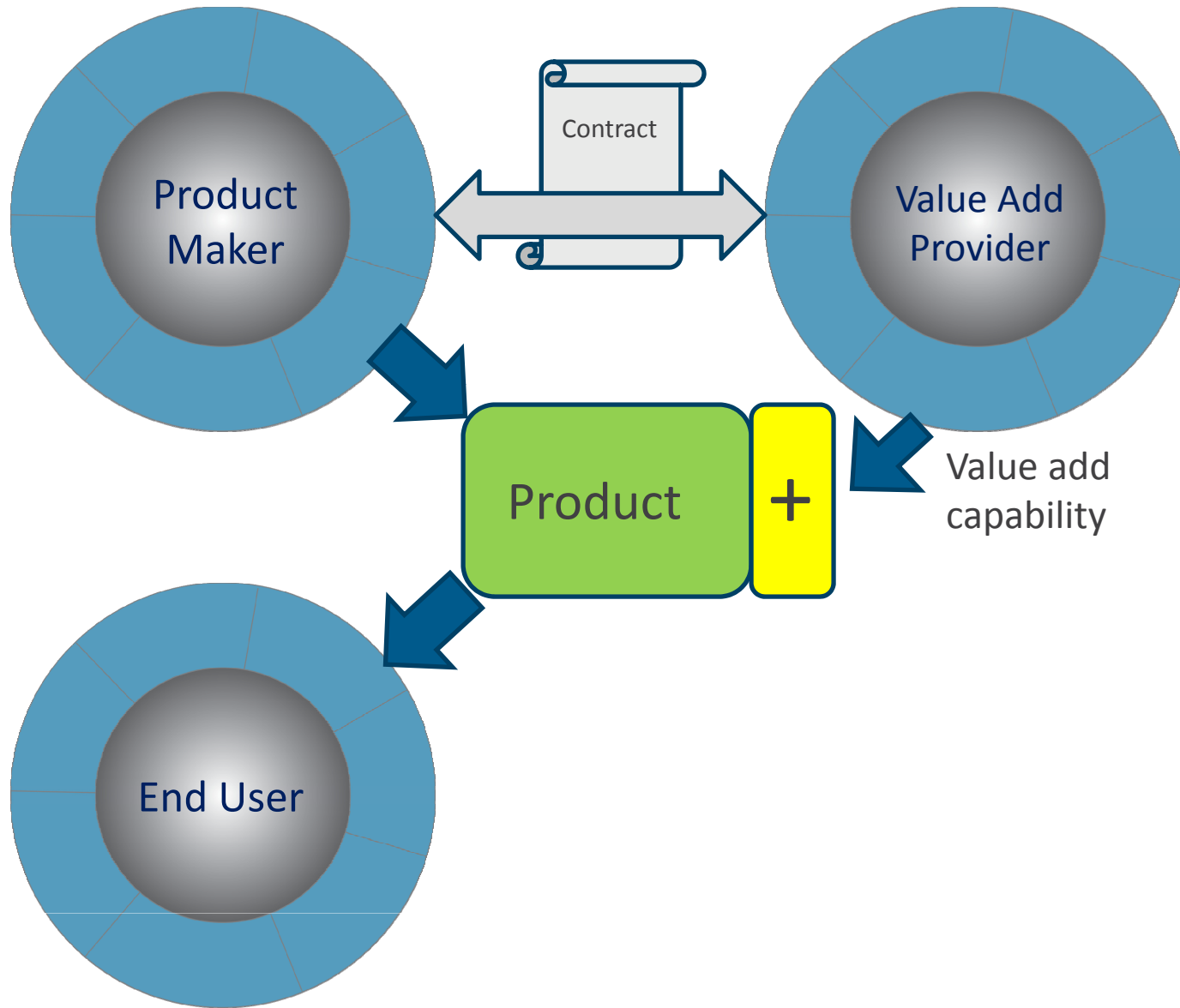
Companies are including these capabilities in their products and services to remain competitive



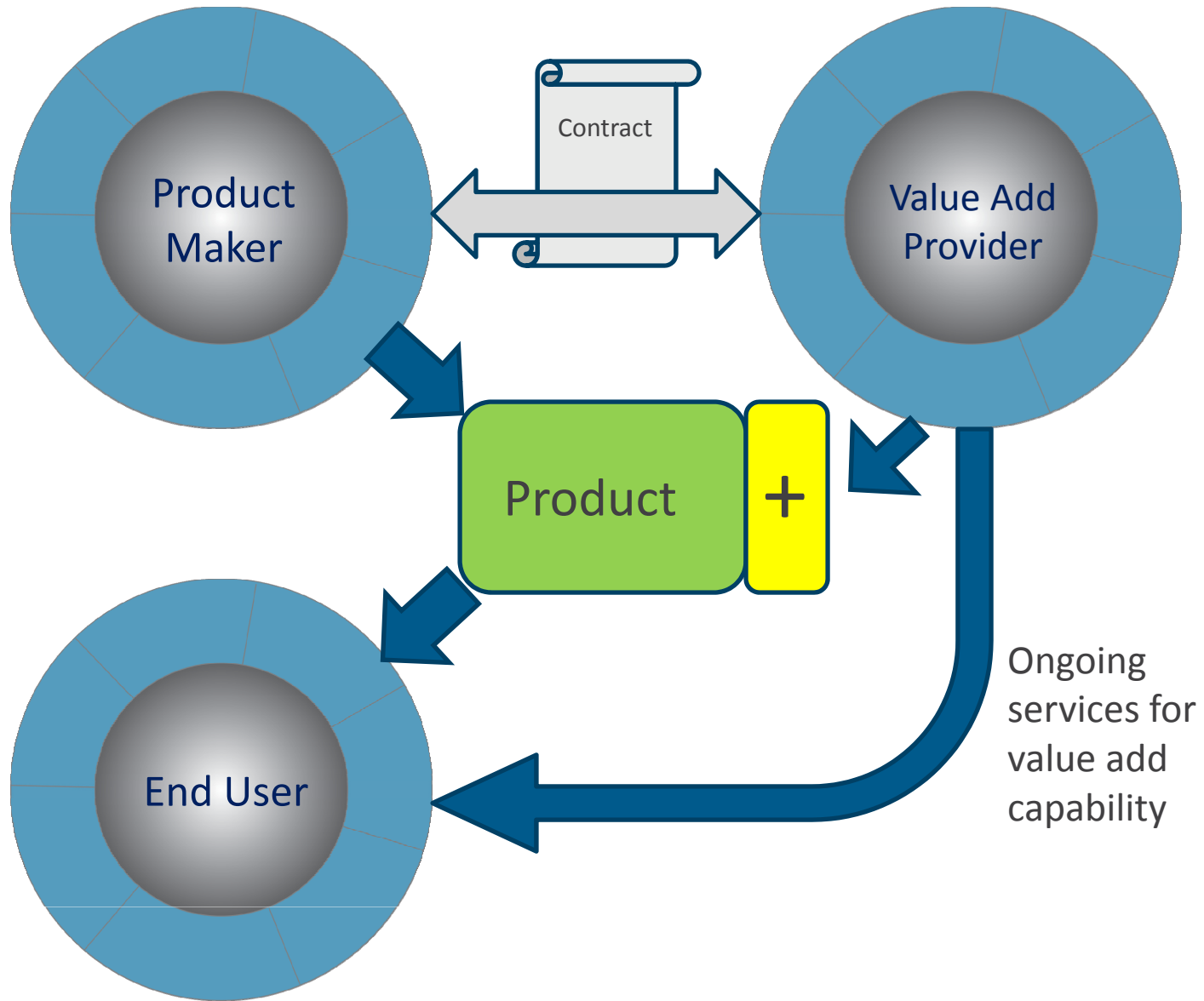
# Value-Add Product / Service Agreements



# Value-Add Product / Service Agreements



# Value-Add Product / Service Agreements



# Comparisons to Traditional Outsourcing

## — Common Benefits



Leverage capability of experienced provider



Avoid capital investments



Lower cost and increased profits



Free up management to focus on  
core business



Ability to adapt quickly



Remain competitive in the market



# Comparisons to Traditional Outsourcing

## — Common Challenges



Difficulties in defining responsibilities



Dependence on provider



Risks of managing inevitable changes  
over time



Difficult to unwind



# Comparisons to Traditional Outsourcing

## —Common Customer Concerns



Hidden costs



Lack of control



Poor service quality



Compliance gaps



Inability to adapt to changes

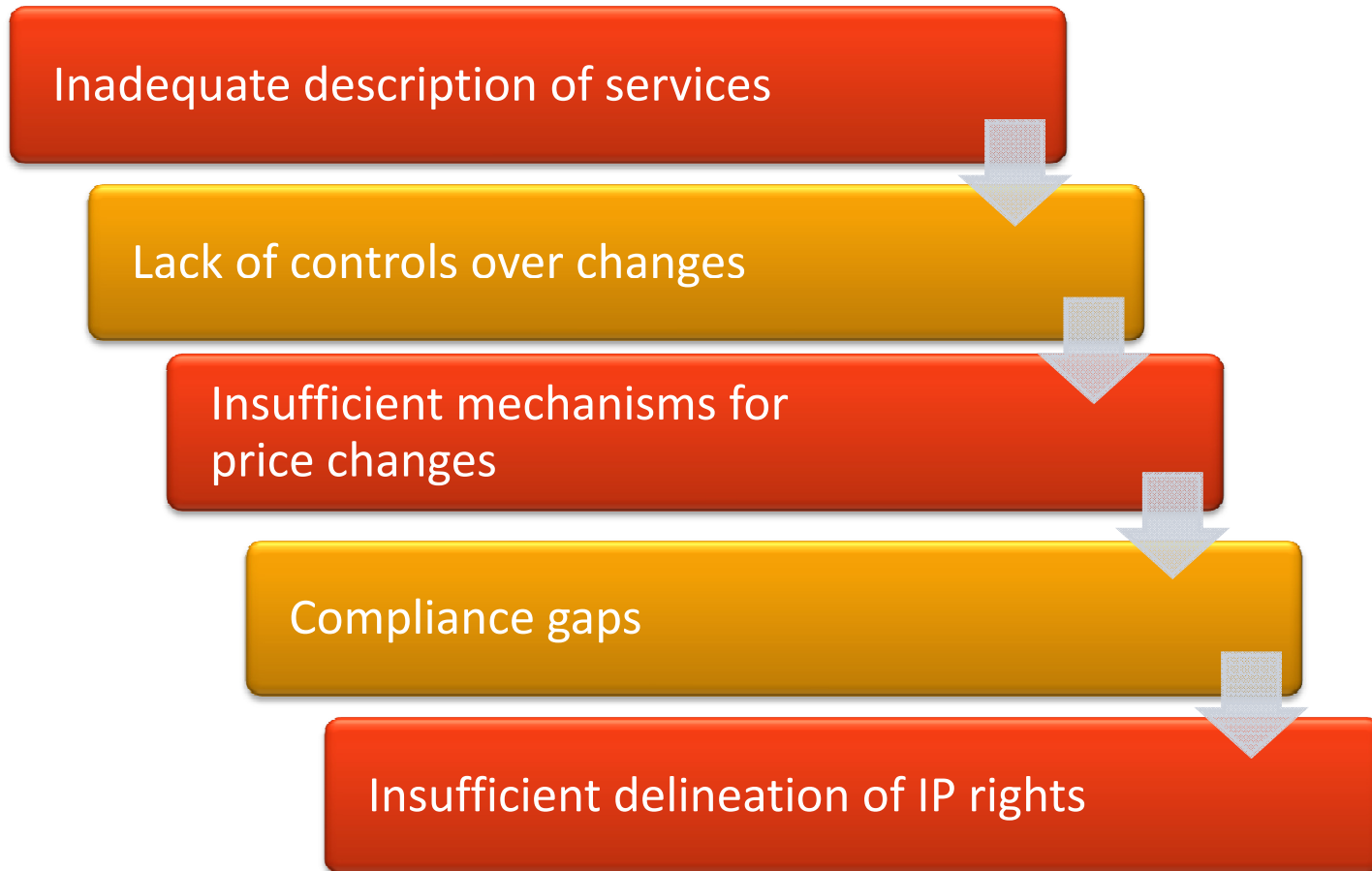


Pricing becomes uncompetitive



# Common Pitfalls When Outsourcing Principles Are Not Used

Higher risks for one or both parties from:





# Distinctions Drive Adaptations of Outsourcing Provisions - M&A and JV



Corporate Provider is not an outsourcing vendor

- Not an established commercial offering
- Contracts may restrict servicing non-affiliates
- Lack of data / tools for detailed service levels
- Lack of data / tools for resource unit pricing



Corporate Provider has limited resources



# Distinctions Drive Adaptations of Outsourcing Provisions - M&A and JV



Corporate Provider uses the same systems and services for its own business



Corporate Provider has few, if any, rights to transfer license and contract rights at expiration/termination



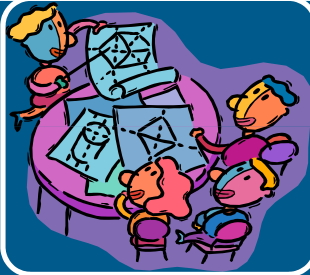
Corporate Provider cannot easily redeploy stranded equipment and people on termination of services



# Adaptations of Outsourcing Provisions For Corporate Providers in M&A and JV



# Distinctions Drive Adaptations of Outsourcing Provisions - Value Add Provider



Value-Add Provider is providing a new feature / service that Product Maker does not have

- No historical data for pricing or performance
- Data / tools for detailed service levels may not exist – may need to be created



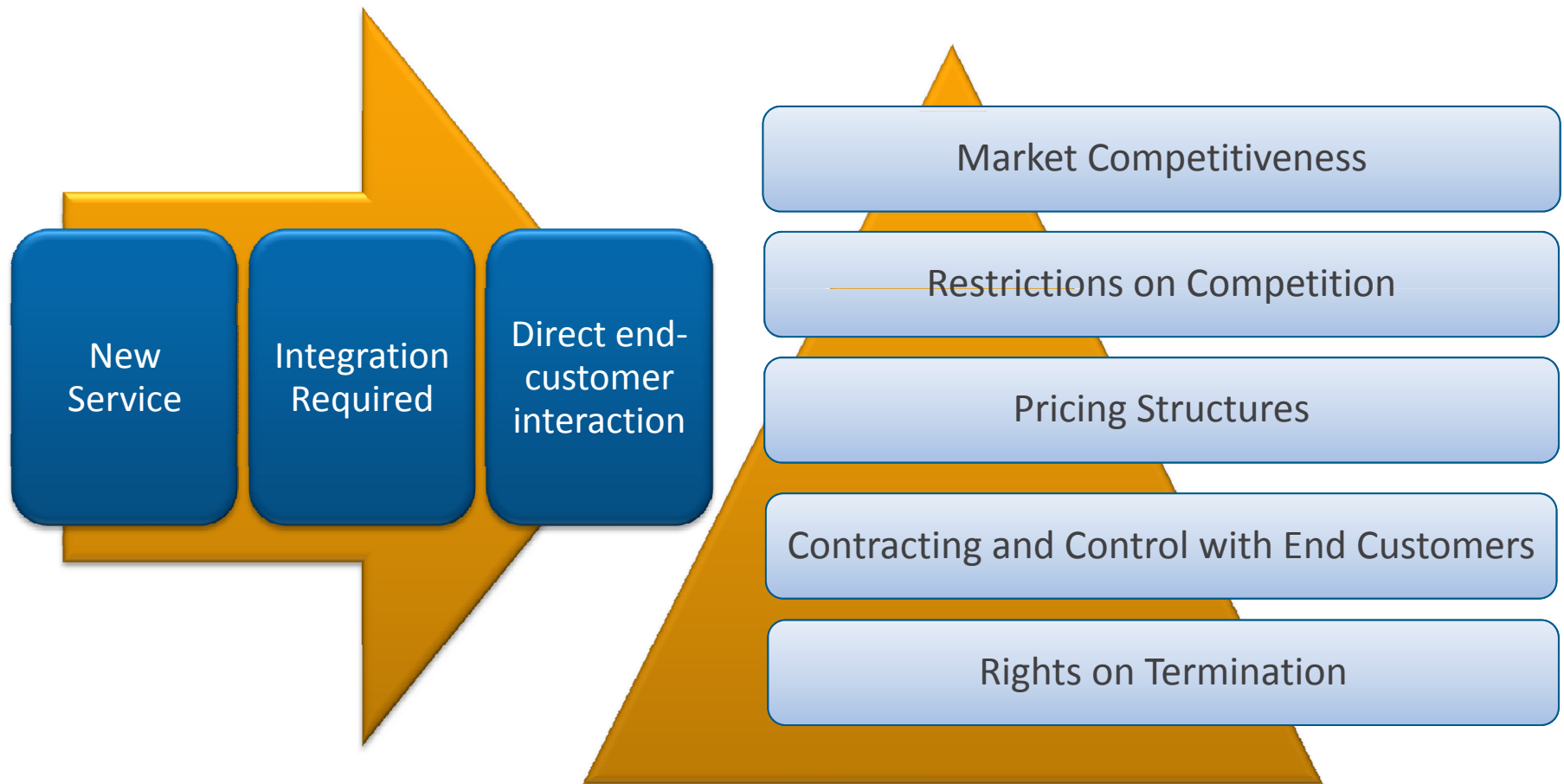
Value-Add Provider must adapt its products / services to integrate with Product Maker's products



Value-Add Provider may be providing services to both Product Maker and to Product Maker's end user customers



# Adaptations of Outsourcing Provisions For Value Add Providers



# Summary



Outsourcing arrangements are going unnoticed in common agreements



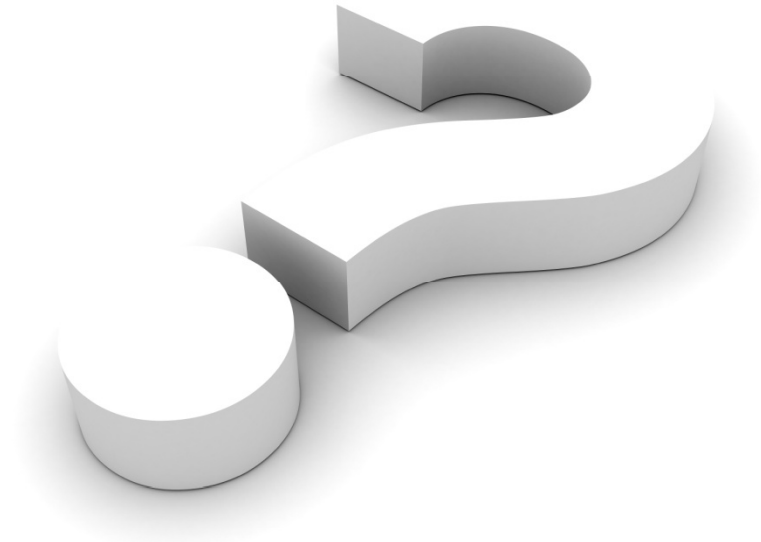
Risk increases when important contractual tools and protections are overlooked



Sourcing specialists can add value by making M&A, JV and product development teams aware of available tools and protections



# QUESTIONS?



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# Top Contracting Issues for Sourcing in Asia



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# Agenda

- Asia sourcing environment
- Compliance with laws
- Contract enforcement and dispute resolution
- Security



# Asia Sourcing Environment



- Shared services and outsourcing
- Varied landscape – provider capabilities / customer objectives
  - Mainland Asia
    - Includes China and India
  - South East Asia
- Government promotion and incentives



# Asia Sourcing Environment, cont'd

Contracting  
best practice

- Beware of false security of the foisted contract – face, form vs substance
- Emphasize built-in processes and procedures to support performance
- Language – governing contract/facilitating performance



# Compliance with Laws

- Asia's increasing regulatory environment
  - The Asia agenda – development
  - Regulatory practice in Asia
    - Civil law orientation, but often vaguely written
    - Varied interpretation / enforcement
  - Examples and challenges
    - Privacy / data protection
    - Telecommunications (including value added telecommunication services)
    - Industry specific regulation - financial services, pharmaceutical
- Don't forget home country laws



# Compliance with Laws, cont'd



- Best practice contracting approach
  - Establish clear top level commitments respecting compliance
  - Design operable practice, procedures and roles (respective responsibilities) to support fulfillment of commitments for:
    - identifying and interpreting applicable regulations (and changes)
    - Implementing necessary changes or otherwise addressing
    - Critical components for contract coverage
  - Carry through - monitor, audit, act to create environment for virtuous cycle of compliance



# Contract Enforcement and Dispute Resolution

- Enforcement environment in Asia
- First line, best practice contracting for Asia –
  - Structure contracting to reduce risk / promote compliance (self-help enforcement):
    - Due diligence, supplier selection and qualification
    - Payment schedules tied to performance, delivery and acceptance
    - Strategic scoping – retention of critical and practical controls
    - Effective use of incentives
  - Importance of performance monitoring and structured informal dispute resolution
    - Escalation and face
    - Virtuous cycle of compliance



# Contract Enforcement and Dispute Resolution, cont'd

- Choice of law and venue – foreign
  - Validity: foreign element
    - Caution about local entities (even wholly-owned)
    - Caution about false security of remote home law
    - Certain issues governed by local law in all circumstances
      - IP ownership, labor laws, land ownership, insolvency , enforcement of foreign judgments or awards
- Alternative dispute resolution in Asia
  - Mediation
  - Arbitration
- Litigation
- Enforcement of judgments and awards



# Contract Enforcement and Dispute Resolution, cont'd

- Best practice, provide for:
  - Applicable law and venue for maximum effectiveness and credibility impact on supplier
    - Consider regional alternatives (Hong Kong, Singapore)
  - For global transactions – consider “virtual choice of law” mechanisms - dispute resolution at parent level, applying global rules of contract





# Security

- Security risks – Asia environment
  - Pressures for economic development and cultural traditions
  - State roles – and capabilities
    - the elephant is not restricted to the corner
- Approach security as a process, evaluated through risk/benefit assessment (adequate)
  - Weakest link assessments – eyes open



# Security, cont'd

## Contracting Imperatives

- No contract silver bullet, but build provisions (and meeting of minds) are critical, to support responsible / credible / dynamic / comprehensive security program
  - Promote transparency, leverage support, and trust no one
- Conventional Preserve right for customer to make security driven determinations



# QUESTIONS?

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