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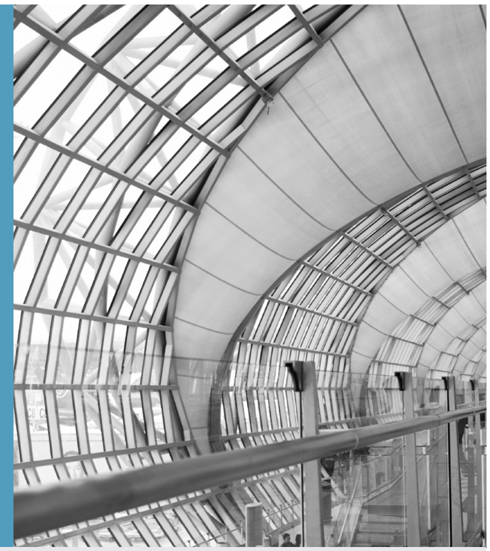
Business & Technology Sourcing Review



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Editors' Note

Welcome to the new Business & Technology Sourcing Review.

Mayer, Brown, Rowe & Maw has unified its global brand with a new short and simple name: Mayer Brown. You can see our new logo on the cover. We also are introducing a new look for our former Business & Technology Sourcing Newsletter.

Our goal is still to bring you smart, practical solutions to your complex sourcing matters in information technology and business processes. We monitor the sourcing and technology market on an ongoing basis and this review is our way of keeping you informed about trends that will affect your sourcing strategies today and tomorrow.

In this issue, we'll cover a range of topics, including:

- The European Commission's adoption of a notice that affects merger control aspects of outsourcing projects,
- A new UK court decision that alerts companies to improve clear drafting of outsourcing agreements to create a win-win situation for customer and supplier, and
- A look at using hybrid arrangements to unlock the potential of sourcing alternatives for your company.

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If you'd like to contact any of the authors featured in this publication with questions or comments, we welcome your interest to reach out to them directly. If you are not currently on our mailing list, or would like a colleague to receive this publication, please email contact.edits@mayerbrown.com with full details.

Renegotiation Success: How to Manage the Legal Pitfalls

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Companies involved in outsourcing arrangements sometimes find themselves considering termination of the agreement because the service provider's deliverables are not meeting contractual expectations. Or the current contract is nearing its expiration date and the company wishes to continue with the arrangement but with more favorable terms. Such crossroads lend themselves to renegotiation, often culminating in a reduction of services, and should be anticipated as a normal business event in today's global sourcing marketplace.

Other events that give rise to renegotiations include perceived misalignment of charges relative to the market, increased regulatory requirements, changes in technology, and other situations not contemplated or adequately addressed in the current agreement.

Timing can often play a crucial factor in negotiation discussions. A renegotiation undertaken independently of the pressure of an expiring agreement will usually yield more favorable results. If the service provider is proactively engaged, both parties can work toward a new agreement that is more closely aligned to mutual interests absent any defensive posturing. Nonetheless, the customer should ensure that the desired changes are reflected in the contract terms of the new agreement.

Contemplating Renegotiation

Any organization contemplating renegotiation should approach the situation with the same competitive outlook used to negotiate the original agreement. However, if the discussions involve only the incumbent service provider (as is often the case), then the renegotiation is more akin to a sole source, non-RFP transaction. As a result, such positioning may reduce the competitive pressure felt by the provider as compared to that felt during the original negotiation (assuming not sole-source). This may weaken the customer's leverage during renegotiation, but several best practices can aid the customer in the renegotiation process.

The use of a comprehensive agreement that contains market-tested terms and conditions can play a particularly critical role. It is important that the documentation be based upon solid industry practice and, ideally, consistent with terms and conditions familiar to the incumbent service provider. Also, in order to facilitate and expedite negotiations, the customer should present its proposed contract and critical contract schedules to the service provider with instructions that a specific, non-general response is required. This can be an important step in efficiently confirming as many basic terms and conditions desired by the customer as instructions that a specific, non-general response is required. This can be an important step in efficiently confirming as many basic terms and conditions desired by the customer as possible, so that renegotiations can focus only on transaction-specific issues and concerns. Other best practices include setting clear objectives for the renegotiation, involving appropriate parties, establishing financial baselines, and seeking external advice when necessary.

Renegotiation discussions predictably focus on pricing and scope of services, including the recalibration of service levels. The operating assumptions developed during the initial negotiation now have real historical data that can be leveraged by both the customer and the service provider for their individual benefit. Armed with this historical knowledge, customers would prefer to set the lowest possible minimum service levels, so that the guaranteed revenue accruing to the service provider is the smallest possible number, while having service providers place a greater percentage of charges at risk (but recoverable via performance incentives). It is important that the customer promotes service levels as tools for establishing the services themselves, not merely devices to measure performance. In this sense, historical service levels met by the service provider offer insight but do not determine service levels that should be adopted by the parties going forward.

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In addition to including a pre-determined expiration date, sourcing contracts typically include termination rights that allow the customer to end the relationship before the expiration date upon payment of a monetary sum. Termination rights may also allow the relationship to continue in a reduced manner while the services are "in-sourced" back to the customer or "re-sourced" to another service provider. Generally, the customer has the broader termination rights, often allowing it to terminate a sourcing agreement "for cause" or convenience, while the service provider typically has limited termination rights usually tied to either the customer's failure to pay or confidentiality breaches.

Termination rights can be extremely useful during interim (pre-expiration) renegotiation. Without such rights, the customer may face limited choices when dissatisfied with the current arrangement which is not naturally expiring: honor the existing agreement, regardless of whether or not the customer is satisfied from the services, or terminate the agreement, while risking a potential breach claim by the service provider. As a practical matter, typically neither party to a sourcing contract has a strong interest in proceeding to litigation as the parties are keenly aware of the negative repercussions, such as being branded a difficult partner. Moreover, service providers are extremely sensitive to "losing an account," so leveraging termination rights can strengthen the customer's bargaining position at renegotiation.

Preparing for Renegotiation

Once the decision to renegotiate has been made, it is critical to define a strategy and analyze the materials that support the approach. In this regard, it is important for the customer to capture any institutional knowledge gained and lessons learned as a result of the current sourcing arrangement and operational experiences.

Moreover, while the incumbent service provider has detailed operational and financial knowledge of the services underway, the customer must evaluate its rights to access or use this information. To determine whether any current operational data is accessible, the customer should consult the confidentiality provisions of the original agreement. If such provisions limit access to meaningful data, useful operational information frequently can be gleaned from current statements of work (or updated service levels) for defined services. Again, the ability of the customer to use this data may be restricted by the existing agreement.

A common theme in renegotiation often involves the customer's desire to tie the provider's performance (and financial incentives) to guaranteed and continued improvement. Sometimes, the customer simply wants to negotiate pricing to levels that are more consistent with the external market. Competitive benchmarking, and in particular "mark to the market" analysis, can be instrumental at this stage to focus the interim renegotiation on key areas where the customer can exert leverage to align pricing and service levels.

However, competitive benchmarking can be an expensive undertaking and can slow the renegotiation process. To address these concerns, many of the larger sourcing advisors are beginning to offer abbreviated competitive analyses that rely on internal databases to provide benchmark-like information with much faster turnaround.

While there may be a tendency in renegotiation to focus on an absolute reduction in pricing levels, other creative methods exist to structure more financial flexibility into a renegotiated agreement. Before engaging the incumbent service provider, the customer should consider the following inflection points to drive additional financial savings: 1) use of increased variable pricing, 2) reductions in incremental charges, 3) declining Additional Resource Charges (ARCs) commensurate with volume growth, and 4) forward-looking declining pricing that assumes productivity and technology improvements.

Another financial concession to enhance future flexibility is a reduction in "termination for convenience" costs. While it is reasonable in most circumstances to allow a service provider to recover direct wind-down costs and unamortized investments in a termination for convenience, recovery for lost profits function is a disincentive to service provider performance and should not be granted under any circumstances. Timing is another important consideration. In fairness, the customer should provide advance notice to allow the service provider the opportunity to redeploy committed resources.

Conducting the Renegotiation

Once the strategy and supporting materials for the renegotiation have been determined, the customer must decide whether to exclusively engage the incumbent service provider or to invite others to participate in the discussions. By conducting the renegotiation in an RFP-like manner, the interjection of competition can negate some of the advantages accruing to the incumbent service provider. To maximize the effectiveness of this approach, the customer must be willing (and able) to shift a portion of the outsourced work to a third party.

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The renegotiation process should yield a new agreement that addresses the customer's concerns. While financial terms are often a major focus of renegotiation, other contract terms must not be neglected. A recent trend in sourcing contracts has seen a shift towards agreements of shorter duration; although service providers will be inclined to offer higher pricing for the shortened term, the customer gains valuable flexibility.

Other issues, such as ownership and usage rights of intellectual property, data, equipment, and documentation, should be updated in light of the new agreement and statements of work. Exit strategies, such as the right to in-source or resource services, should also be revisited during the renegotiation. Finally, termination assistance services should also be restructured to reflect the operational knowledge gained from the original agreement.

Final Thoughts

Before entering into a renegotiation, the relationship must be objectively assessed. If the relationship is damaged, the customer must assess whether it is irreparable or amendable. Renegotiation is unlikely to fix a dysfunctional relationship. Lower rates and additional promises of higher levels of service will not usually alter the behavior of a service provider that has failed to meet expectations.

Switching service providers is never an easy undertaking. However, there are situations when it makes sense to forego a renegotiation and re-enter a competitive RFP process. Most outsourcing agreements allow for short extensions, so this should alleviate potential service disruptions when transitioning between providers.

Nonetheless, a successful renegotiation depends on the customer maintaining its leverage. The ability to do so usually originates from the customer assessing all viable alternatives and committing to execute an alternative option if needed.

One certain lesson learned from a renegotiation is that it will happen again to your organization. The knowledge acquired during each renegotiation should be applied to the inevitable future renegotiations, and should be institutionalized, so that personnel changes won't negatively impact your organization's negotiating position. ◆

Intellectual Property and Knowledge Process Outsourcing in India

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Protection of intellectual property (IP) is a critical concern in every knowledge process outsourcing (KPO). It is a legal concern as well as a strategic business issue because IP assets are vital in today's knowledge-based economy. Even in India, with its increasingly dependable and modernized legal system, IP ownership, infringement, and piracy concerns must be thoroughly and carefully addressed in every KPO.

A KPO often involves sharing or creating multiple types of IP rights (e.g., patent, trademark, trade secret, industrial designs, copyright, mask works), each of which is governed by its own distinct national law. Such IP rights can be further categorized depending on how the IP is shared or created, such as customer IP versus service provider IP, and this can be further sub-categorized into new or pre-existing IP.

Regardless of the KPO delivery model employed, often a US customer sourcing to an Indian service provider must necessarily make its IP – ranging from proprietary designs to business processes to chemical formulas – available to the Indian service provider (which may be a third-party vendor, a business partner, or a corporate affiliate's local workforce) so that the offshored functions can be performed effectively. In addition, new IP might be created by the Indian service provider on behalf of the US customer. This sharing and creation of IP across multiple jurisdictions creates very real legal vulnerabilities for the US customer where the host country's IP laws may control IP-related disputes. In other words, US IP laws may not, and likely will not, be applied within the host country regarding IP ownership disputes even if the operative contract between the US customer and the offshore service provider contains an unambiguous "governing law" provision calling for a specific US state's laws or US federal law to govern.

Further complicating this issue, US courts may apply foreign IP law to decide issues involving the ownership of IP created abroad, notwithstanding the operative contract's governing law and venue provisions. In 1998, in a case titled *Itar-Tass Russian News Agency vs. Russian Kurier*[1] involving copyrighted work created in Russia, the United States Court of Appeals for the Second Circuit applied the "work made for hire" doctrine under Russian law to determine the initial ownership of the copyright of the works in suit.

IP protection and enforcement mechanisms for IP rights differ in material respects on a country-by-country basis. This can affect a US customer's expectations in the offshoring arrangement and, in the absence of appropriate contractual safeguards, can potentially jeopardize a US customer's rights to its own IP or critical third-party technology. Therefore, in any KPO, a US customer must (i) thoroughly and carefully perform legal due diligence on national and local IP laws and customs, (ii) assess the possible impact on the contemplated KPO transaction, and (iii) structure measures that will adequately protect against the potential risk of losing control of IP so that the purpose of the KPO may be successfully accomplished.

India's IP Legal Framework and Enforcement

FRAMEWORK OVERVIEW

While India is perceived as providing better IP protection than the majority of the other offshore jurisdictions, such as China, Russia and Mexico, India's IP laws and enforcement mechanisms are nevertheless weak compared to western IP laws and practices. However, India is a member of the World Trade Organization (WTO) and generally complies with the minimum standards stipulated by the WTO Agreement on Trade Related Aspects of Intellectual Property Rights. India also is a signatory to major international IP harmonization conventions, such as the WIPO treaties, which include Universal Copyright Convention, the Berne and Paris Conventions, and the Patent Cooperation Treaty.

India also provides express statutory protection for patents, copyright, trademarks, industrial designs, and mask works. Most recently, India amended its patent statute to provide for statutory patents for drugs, chemicals, and agricultural products in addition to the historically available patent protection for process of manufacture. India has made substantial improvements to its IP regime in the last decade to foster innovation as well as to attract foreign investment. Despite these measures, however, some gaps remain in India's IP regime and the actual implementation and enforcement of IP rights remains weak and ineffective compared to US standards.

ENFORCEMENT OVERVIEW

In India, the enforcement system for IP rights includes civil remedies as well as criminal penalties. Most disputes in India relating to IP infringement settle out of court without trial. Civil cases historically require years to come to trial and a criminal case can similarly require a number of years before it is finally concluded in India's court system. Another discouraging factor for IP owners pursuing civil claims in India is the difficulty of proving the actual extent of damages caused by the infringement and recovering reasonable compensation. Typically, the monetary damages awarded by Indian courts are meager compared to US awards. Indian IP law provides only for compensatory damages based on the principle of restitution of the loss actually suffered. No statutorily-trebled damages or punitive damages are available, which particularly creates a less than optimal deterrent against piracy. While Indian IP law does not impose copyright or trademark registration requirements as a prerequisite to enforcement, registrations still serve a very important evidentiary function because they are deemed *prima facie* evidence of validity and trigger statutory damages in infringement suits.

Recent amendments to the Indian Civil Procedure Code, as well as more recently issued judicial precedents, however, signal an improvement in the enforcement area. In 2002, India amended its code of civil procedure to impose mandatory time limits and associated penalties on litigants to reduce delays in the civil litigation process. While these new and ambitious requirements may likely be honored more in their breach, such requirements will probably cause a more expeditious disposition of civil cases in Indian courts. Also, in 2005 the Delhi High Court opened the door for awarding punitive damages for the first time in a copyright infringement case, observing that the level of punitive damages should be commensurate with the degree of the infringing misconduct.[2]

Despite improvements, civil litigation in India remains a relatively marginal enforcement tool and foreign IP owners engaged in KPO should plan to rely instead on thorough, carefully negotiated contracts that are based, as much as possible, on rules-based performance rather than standards-based conduct. For example, rules-based service level criteria (the well-known "five nines" criteria, for example), which can be objectively measured, verified, and monitored, and which present far less room for contestable dispute, should always be selected over standards-based benchmarks such as "reasonable" or "best" efforts. Efforts should also be made in contract negotiations to create a clear basis for seeking to have disputes resolved in preferable offshore venues where stronger remedies exist.

However, as suggested above, a KPO customer in India cannot rely on the enforcement of such venue selection contract terms if challenged in an Indian venue. Therefore, the contract must be as "airtight" as possible with respect to the underlying substantive obligations so that Indian-based adjudicative bodies, whether courts or Indian-appointed arbitrators, will have objective standards to follow and verifiable evidence and data to evaluate, and subjective analysis will be minimized.

Despite improvements, civil litigation in India remains a relatively marginal enforcement tool and foreign IP owners engaged in KPO should plan to rely instead on thorough, carefully negotiated contracts that are based, as much as possible, on rules-based performance rather than standards-based conduct.

With respect to the enforcement of statutory IP rights, the most effective remedy in India to block and deter IP infringement is injunctive relief. Injunctive relief in response to breach of contract claims is available but is harder to obtain than other remedies. Other remedies, such as *ex parte* search warrants and seizure orders, known as an Anton Piller Order,[3] can also be obtained in civil actions. In India, criminal prosecution is available only in trademark and copyright cases, but not in cases involving patents or designs. More specifically, criminal remedies are available against any person who knowingly infringes or abets the infringement of a copyright or who uses or applies false trademarks and trade descriptions with the intent to defraud. Few criminal prosecutions relating to IP misconduct have emerged from Indian courts to date, but there are promising signs that Indian criminal law might become a more realistic deterrent.

Because of the weaker enforcement of India's IP laws, counterfeiting and piracy continue to be rampant and, accordingly, present a serious problem for US companies doing business in India. Such weaker enforcement presents serious challenges to the Indian government in promoting India as a destination for innovation and high-end technology development. In 2004, US companies lost over $500 million in sales due to piracy in India of copyrighted works, particularly software, sound recordings, films, popular fiction, and other books. For these reasons, in the last several years the US Trade Representative has placed India on the "Priority Watch List" as part of what is known as the Special 301 review, which identifies foreign countries that deny adequate and effective protection of IP rights and is one of the trade measures adopted by the United States to exert pressure on India to strengthen its IP laws and enforcement.

Finally, from the KPO perspective, one of the most troubling gaps in India's IP legal framework is that India does not provide any statutory protection for trade secrets or confidential information. The United States provides statutory protection to trade secrets, both at the state and federal level, with meaningful civil and criminal remedies to counter misappropriation of trade secrets, including actual and punitive damages, injunctions, attorneys' fees, but that is not the case in India.

Conclusion

While it is clear that India offers greater IP protections than the majority of the other offshoring jurisdictions, customers are still left with much to be desired. Because of the weakness in the legal and enforcement networks available, a US company sourcing to an Indian service provider should carefully construct and consider IP rights in its applicable outsourcing arrangements and should not rely on civil or criminal enforcement in such agreements. ◆

Endnotes

1 42 U.S.P.Q.2d (BNA) 1810 (S.D.N.Y. 1997).

2 *Microsoft Corporation v. Deepak Raval & Anr*, 2005 (33) PTC 122 (Del.); *Time Incorporated v. Lokesh Srivastava*, 2005 (30) PTC 3 (Del.).

3 This order derives its name from the British case *Anton Piller KG v. Manufacturing Processes Ltd.*, 1976 (1) All. E.R. 779, and is a pre-emptive ex parte injunction that aims at protecting the plaintiff against the activities of an unscrupulous defendant who may destroy or remove incriminating evidence.

The Importance of Clear Drafting in Outsourcing Arrangements

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Outsourcing arrangements inevitably involve mutual interdependence between the customer and the supplier. The supplier is unable to perform some of the services in accordance with the service level requirements unless the customer performs some obligations, just as the customer may be unable to perform its normal business activities if the supplier fails to deliver the services it is contracted to provide under the outsourcing agreement. A recent decision in the UK courts in relation to an interim injunction offers a timely reminder of the importance of clear drafting in outsourcing agreements.

Disputes between customers and suppliers in outsourcing arrangements rarely reach the courts, at least in the UK, so this decision is interesting in the way in which it shines a light on a customer/supplier outsourcing dispute.

The dispute was between Powergen, a major electricity utility in the UK, and Vertex, a supplier of finance and administration services to Powergen.

The agreement between Vertex and Powergen related to nine different types of service for which there were separate transaction documents. These included services to India, which encompassed the provision of an Indian call centre for Powergen customers, and "stay warm services", which related to end to end services to be supplied to a particular vulnerable class of Powergen customers. The agreement was originally entered into in 2002 for a ten-year term and at the time had an estimated contract value of £1.1 billion. It was a very large business process outsourcing transaction by UK standards.

It seems that the relationship was not a good one and that a series of renegotiations transpired, the most recent being in May 2005. Shortly after the May 2005 renegotiation disputes occurred over a range of issues. In relation to the "stay warm services," a dispute surfaced as to whether or not Vertex should be managing the collection of ageing debt. Powergen said it should be doing this and Vertex argued, in effect, that this activity was outside the scope of the services. The way in which Vertex was handling the Powergen personal customer data and, in particular, whether it observed adequate security measures for the purposes of compliance with UK data protection legislation also caused a dispute between the parties.

In relation to the India services, the dispute, in the judge's mind, turned on the extent to which the customer had a contractual remedy in respect of the supplier's alleged failure to meet obligations to deliver the services in accordance with "good industry practice" where there were no specific service level criteria measuring the relevant shortcomings in performance.

Powergen eventually served notice to terminate the outsourcing agreement for material breach. Vertex responded by launching injunction proceedings arguing that Powergen should be injuncted from acting on its notice to terminate the outsourcing agreement and that it should be restrained from taking steps that prevented Vertex from fulfilling its obligation under the outsourcing agreement. Vertex argued, as it had to do to obtain an interim injunction, that it would suffer irretrievable and unquantifiable losses if Powergen were not injuncted.

> The judgment on this point is an important reminder for parties negotiating an outsourcing agreement to be absolutely clear as to the specific dependence the supplier has on the customer for the performance of the services.

The Dependencies Argument

The outsourcing agreement contained a fairly standard carve out of liability for Vertex failing to perform its obligations under the agreement where the failure was due to Powergen not fulfilling its obligations. Powergen's obligations were described in quite general terms, including:

- to be responsible for the completeness, legal compliance and timely delivery to Vertex of all necessary pricing, regulatory and other information;
- to provide access to computer hardware and software owned by Powergen;
- to work with Vertex to identify new initiatives to reduce the cost to serve whilst maintaining compliance with any relevant SLA aspiring to perform the services in accordance with the agreed key performance indicators.

Vertex also argued that there was an implied term that Powergen would provide all such co-operation as Vertex required of it for the purposes of the outsourcing agreement.

The judge observed that in the complex relationship being documented in the outsourcing agreement

> it is plain that the agreement requires extensive mutual co-operation if it is to work and there is scope for real and genuine disagreement as to what is the nature of the co-operation required by Powergen in order to enable Vertex to properly perform its obligations.

The judge did not think that it was appropriate to grant an injunction, which would have the effect of compelling the parties to work together. He also took the view that the particular terms of the contract – the dependence on Powergen – were insufficiently defined to indicate to Powergen what exactly was required to not prevent or hinder Vertex from fulfilling its obligations under the outsourcing agreement. The court had to look at these types of obligations as if it would have to enforce them and provide that the party not complying with them would be in contempt of court. The judge was not prepared to impose what he regarded as an intolerable burden on Powergen employees to comply with particular obligations, pending a full trial of the issues that would not take place for months, with the potential sanction of contempt proceedings where it was not at all clear what the individual employees were required to do.

The judgment on this point is an important reminder for parties negotiating an outsourcing agreement to be absolutely clear as to the specific dependence the supplier has on the customer for the performance of the services. Although this was an interim hearing at which the issues between the parties were not argued fully, it is typical of the circumstances in which dependencies will be reviewed. By the time the matter gets to a full trial, the issues between the parties as to relative responsibilities are likely to have become completely unbridgeable. If anything, this judgment should be a warning to suppliers to be clear as to the dependencies both at the overall and individual service level and not to rely on vague general language. The dependence should be aimed at "achieving a result" rather than more general language such as "run the business". This judgement indicates that the courts, at least in England and Wales, are likely to interpret these dependency carve-outs in favor of the customer who has to perform the obligations and not generally as a shield for the non-performing supplier.

At the time outsourcing agreements are being negotiated there is often considerable pressure to sign the deal and leave minutiae to be sorted out by the business people as they implement the agreement.

Lessons for the Draftsman

Outsourcing agreements contain a mass of factual detail that is often technical in nature. At the time outsourcing agreements are being negotiated there is often considerable pressure to sign the deal and leave minutiae to be sorted out by the business people as they implement the agreement. The lessons from the Powergen case are helpful for lawyers seeking to ensure that their clients are properly protected by clear drafting.

While there were some issues around whether the supplier was in breach of its obligations and, specifically, whether it was meeting requirements – imposed on the customer – under the UK data protection legislation, a striking feature of the case is the uncertainty the parties had about central elements of the relationship. First, there was uncertainty about whether the collection of ageing debt was inside or outside the scope of the supplier's obligations. It is hard to understand why an issue like this would not be a black and white matter.

Second, there was uncertainty about the level of the supplier's obligations. What, exactly, was meant by an obligation to deliver services in accordance with "good industry practice"? This is a commonly used standard in technology services agreements and lawyers should be alert to the possibility that their clients may not be able to measure it and that it therefore amounts to little practical definition of the required quality of service.

Third, there was uncertainty about the nature of the obligations on the customer. When faced with a request to enforce uncertain obligations, the court took the pragmatic decision that the obligations were, in fact, unenforceable.

Lawyers negotiating outsourcing agreements should remind their clients of the practical difficulties down the line if the agreement is weak on definitions of scope and obligations. ◆

European Commission Provides Guidance on Merger Control Aspects of Outsourcing Projects

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On July 10, 2007, the European Commission (the "Commission") adopted a Consolidated Jurisdictional Notice (the "Notice") to provide up-to-date guidance on the Commission's jurisdiction to review transactions under Article 81 of the EC Treaty and Council Regulation 139/2004 (the "Merger Regulation"). The Notice is interesting from an outsourcing perspective, because it expressly addresses merger control aspects of outsourcing projects.

Even before the release of the Notice, there was no doubt that outsourcing projects could trigger the need for a merger filing. The Commission has been involved in a number of outsourcing-related merger filings, including those for EDS/Lufthansa (IV/M.560) and the IBM/Business Solutions/JV (COMP/M.2478). With the Notice, the Commission intends to consolidate a number of previous notices and update them in light of recent developments.

Content of the Notice

Under the EC merger control regime, the Commission has jurisdiction if there is a "concentration," which can either be a mer ger between previously independent undertakings (less relevant in the outsourcing context) or the acquisition of control. The Notice describes the circumstances under which an outsourcing arrangement might be considered an acquisition of control. The Commission recognizes that outsourcing contracts can take several forms. Where cases of simple outsourcing do not involve any transfer of assets or employees to the outsourcing services provider, the Commission considers this type of arrangement to be akin to a normal service contract. Even if the outsourcing service provider acquires a right to direct those assets and employees of the customer, no concentration arises if the assets and employees will be used exclusively to service the customer.

However, if the outsourcing service provider also takes over assets and personnel associated with the activity that was previously handled by the customer internally, a concentration may arise if the assets constitute the whole or part of an undertaking, i.e., a business with access to the market. This requires that the assets previously dedicated to in-house activities of the seller will enable the outsourcing service provider to provide services not only to the outsourcing customer but also to third parties, either immediately or within a short period after the transfer. If the transferred assets include at least those core elements that would allow an acquirer to build up a market presence in a time frame similar to the start-up period for joint ventures, a concentration may arise. If, on the contrary, the assets transferred do not allow the purchaser to develop a market presence, the Commission takes the view that the transaction will not result in lasting changes in the market structure and the outsourcing contract is again considered similar to a normal service contract.

The Notice also contains a detailed description of the circumstances under which a joint venture for the provision of outsourcing services will be considered a “concentration.” In this section of the Notice, the Commission takes the view that the joint venture typically cannot be considered to be full-function (leading to a concentration) if it provides its services exclusively to the client undertaking and is dependent for its services on input from the service provider. The same applies if any third-party revenues are likely to remain ancillary to the joint venture’s main activities for the client undertaking. At the same time, the Commission makes clear that there can be outsourcing situations where the joint venture partners, for example, for reasons of economies of scale, set up a joint venture with the perspective of significant market access, resulting in a qualification as full function.

As a second step in determining the jurisdiction of the Commission, the operation needs to meet certain turnover thresholds, contained in Article 1 of the Merger Regulation. The Notice contains detailed guidelines regarding the interpretation of the Merger Regulation, including discussions of turnover, key dates, and allocation of turnover.

Consequences

The Notice is helpful in reminding all parties involved that outsourcing arrangements can require merger filings in the EU. One also must keep in mind that there could be national filing requirements if the thresholds of the Merger Regulation are not met. Merger filings impact the timing of the project and should therefore be taken into consideration as early as possible. ◆

Adapting Offshoring to Your Business

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Frequently, companies that are considering offshoring find themselves conforming their sourcing strategies to existing alternatives offered by service providers rather than constructing alternatives more suited to their unique requirements. While the evolution of sourcing has certainly led to an expansion of available options, a lot more can be done to reach the full potential of sourcing alternatives.

The traditional choice between creating an offshore captive and outsourcing to a third party leaves a company to select between alternatives with starkly different risks and benefits. Creating a captive can offer the promise of control, labor cost savings through disintermediation, elimination of exit risks, protection of competitively sensitive information, and preservation of company culture and brand. However, in comparison to outsourcing, the captive approach requires greater investment and local country expertise, may forfeit leverage and flexibility, and takes longer to realize savings. The importance of these factors in a company's choice depends on the attributes of the function being offshored and the goals and attributes of the company itself. The attributes that have to be considered include the competitive sensitivity or strategic importance of the function, the domain-specific knowledge required, and the size and scale of the operation being outsourced. The relevant goals and attributes of the company can include factors such as organizational readiness to make a long-term commitment, the need for process improvement, time sensitivity, available skills in creating and managing an offshore enterprise, and the relative strength of the company's brand in drawing labor resources in the local market. Very often, the combination of these attributes and goals do not match up neatly with either the captive or the outsourcing option. If the mismatch is significant, the results can be disappointing. For example, a company may wish to create a captive to house a competitively sensitive or strategic function but have insufficient scale or local country expertise to realize the savings potential.

There are some well-established alternatives, such as joint ventures and build-operate-transfer (BOT), which, by combining features of both captives and outsourcing arrangements, can address some of the limitations of the traditional choices. But these alternatives come with their own drawbacks. Joint ventures offer companies the promise of greater control and visibility to costs, but they are complex structures that require extensive planning and documentation to address governance issues, capital contributions, dilution of interests, exit rights, and competition restrictions. BOT arrangements offer the advantages of outsourcing with the downstream prospect of ownership, but experience has shown that BOTs are often nothing more than outsourcing deals stripped of the usual customer protections and with no realistic likelihood of any transfer. This outcome is generally the result of insufficient customer planning and a strong service provider incentive to keep the outsourcing arrangement going.

Companies are finding ways to combine traditional choices in hybrid arrangements to give them the flexibility to adjust their outsourcing strategies as they go. These arrangements typically leverage a third party supplier's skills and experience while retaining greater control and more options for the company. For example, a company could use a third-party outsourcer as a vehicle for rapidly establishing an offshore service center while planning to migrate the outsourced function to its own captive center at a future date, thus giving the company time to construct its own center and wait for the offshored services to be stabilized. This arrangement also allows the company to begin realizing labor arbitrage savings immediately. In this model, the transfer of functions to a captive center need not be inevitable. It may very well happen that the company will discover that for some functions, or parts of functions, continuing the outsourcing arrangement is preferable to transferring them to a captive center. Hence, the real strength of hybrid arrangements is that they can be constructed to give the company the flexibility to adapt its offshoring approach over time.

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Another option is to construct hybrid-like arrangements within the contractual outsourcing by varying the degree of the company's control over such factors as employee selection and hiring, the sharing of space and infrastructure, technology requirements, third-party contracts, and how services are delivered. By adjusting these factors, the company can exert captive-like control over the outsourcing services provider with or without the option to migrate services to a captive center. For instance, a company that is concerned about sensitive information could require that an exclusive work force be housed in a dedicated portion of the service provider's facility, operating on an entirely separate data processing and telecommunications infrastructure.

Of course, more control comes at a higher cost, so finding the right balance is essential to preserving the cost advantages of using a third party. In addition, it is important to give sufficient control to the service provider to make it accountable for the services and to give it sufficient incentive to properly manage them. For instance, the company's control should not be so thorough as to absolve the service provider of its responsibility for achieving service levels and operating within cost parameters. After all, the reason for using a service provider in the first place is to leverage its expertise and obtain the cost advantages of having it provide the services.

While not necessarily complex, because these hybrid arrangements are neither standard nor common, advance planning is essential to a successful outsourcing. As anyone who regularly negotiates contracts knows, straying from precedent can be challenging, if for no other reason than it takes people outside of their comfort zone. Consequently, to employ a hybrid arrangement, a customer must be deliberate and explicit in its requests for proposals, rather than treating these arrangements as an afterthought or attempting to retrofit them onto existing deals. Success also relies heavily on developing a pricing strategy that counteracts the innate tendency of service providers to extend the term of their revenue generating services. One such strategy is to build in success fees that reward the service provider for achieving the customer objectives, such as transferring the function to customer operations.

Offshoring is an embedded part of most major companies' sourcing strategies, but the structures being used for offshoring are continuing to evolve as companies seek to adapt offshore alternatives to their businesses, goals, and strategies. The well-worn paths of traditional outsourcing and captives, and even alternatives of joint ventures and BOTs, sometimes do not lead to optimal results. However, by exploring the creative and challenging options afforded by hybrid arrangements, companies can design offshoring arrangements that more closely match their needs. ◆

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