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# Business & Technology Sourcing
## REVIEW

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Mayer Brown's Business & Technology Sourcing (BTS) practice is one of the global industry leaders for Business Process and IT Outsourcing as ranked by Chambers & Partners, The Legal500 and the International Association of Outsourcing Professionals (IAOP). With more than 50 dedicated lawyers—many having previous experience with leading outsourcing providers and technology companies—the practice has advised on nearly 300 transactions worldwide with a total value of more than $90 billion.

# Editors' Note

Welcome to the Summer edition of the Mayer Brown *Business & Technology Sourcing Review*.

Growing global environmental concerns coupled with our efforts to enhance efficiency have now led us to reach our readers primarily by electronic distribution. We are excited about this new format, as it allows you the option of downloading from your email a complete PDF version of the Review or accessing each individual article via web links. However, if your preference is to continue to receive a printed version, please do not hesitate to email us at *marketing@mayerbrown.com*. Finally, as always, we welcome your thoughts and comments and invite you to contact us with your feedback.

# Troubled Outsourcing Arrangements: Strategies and Tips for Managing Difficult Issues

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## Overview

There are a number of practical steps that outsourcing customers can take when an outsourcing relationship develops serious problems that cannot be solved through normal governance processes. By using a step-by-step framework for managing disputes, customers can get their outsourcing relationships back on track. Alternatively, they may use these steps to pursue other alternatives (such as removal of affected scope) in an organized, minimally disruptive manner.

## How Did We Get Here?

Problems develop in outsourcing relationships from a variety of unfortunate circumstances, such as: (1) mismatched expectations between the customer and the supplier; (2) changes that were not anticipated at the time of contract formation; (3) competing internal goals of the customer (for example, transformation versus cost savings); (4) poor performance by the supplier; (5) value not being delivered by the supplier;

By using a step-by-step framework for managing disputes, customers can get their outsourcing relationships back on track.

(6) below-market supplier compensation; and (7) mistakes of fact in contract formation. Many of these problems can be managed and resolved through a dispute resolution process that supplements governance. Some more serious problems may require assistance through more formal dispute resolution procedures.

## Immediate Steps: Managing a Dispute While Day-to-Day Business Must Continue

When a dispute becomes serious, there are a few steps you must take to protect your company:

- Consult an attorney regarding attorney-client privilege, which protects confidential oral and written communications between lawyer and client. Subject to certain

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limitations, the privilege is intended to exclude discussions between lawyers and clients from discovery by the other party, and from introduction into court. Your attorney can help you to issue guidelines to your team about what documents should be marked as privileged, and what practices should be followed to protect and maintain that privilege.

- Put your consultants under an appropriate engagement letter in an effort to protect privilege. The letter should create a new engagement and provide that the consultant is working at the direction of counsel and is engaged in assisting with analysis of the dispute.
- Make sure that you follow the dispute resolution process spelled out in your contract (for example, escalate issues through the governance process, provide required notices, and observe any time frames required to preserve your contractual rights).
- Create a customer dispute control group that will interact with the supplier regarding the dispute. This control group takes on the job of managing the dispute, and relieves those who are trying to manage the day-to-day affairs in the outsourcing relationship. Customer and supplier representatives who are managing the day-to-day services can then interact more constructively on those services, without the direct tension that resolving a dispute can bring.
- Clamp down on any dispute-related communications (such as through email) occurring outside the control group.
- Institute a customer-only daily or weekly checkpoint call to give day-to-day managers guidance on how to proceed so there is minimal disruption to business.

In addition to these unilateral actions that a customer should take, you should consider requesting that the parties enter into a "non-use" agreement or a "standstill" agreement. Non-use agreements prevent settlement discussions from being used in future litigation or arbitration. Standstill agreements are similar to non-use agreements, but they also "stop" time periods from running, and preserve the parties' rights while they work to resolve their disputes. These agreements can permit more open and constructive communication between customer and supplier during dispute resolution.

## Framework for Managing Disputes

After you have completed these initial steps, you will need a proven method for managing and resolving the dispute. The following framework outlines a series of actions to take before you engage in further discussions with the supplier. These steps will ensure that you properly understand the scope of the dispute and will help you reach the best possible outcome for your company. *All of these steps should be completed under the supervision, and at the direction, of your legal team to best preserve attorney-client privilege, and to best define your rights and obligations.*

Identify all open issues and disputes in the relationship, and gather relevant facts and data.

## Frame the Issues

Step one is to identify all open issues and disputes in the relationship, and gather relevant facts and data. Investigate and verify the facts you have been given by interviewing employees, and by organizing a written record of the dispute's progression as documented in emails, notes from governance meetings, correspondence and other materials. The complex subject matter of many outsourcing deals can result in information gaps that you will need to fill before proceeding. Circumstances may have changed significantly since the contract formation, so make sure that you have current information.

After gathering all the relevant information, develop answers to the questions that really matter:

- Does the dispute create a serious monetary or operational impact on your business, or is it just a source of irritation that can be tolerated?
- Even if the dispute does not seriously impact business today, could it set a damaging precedent for future issues?
- How soon must the dispute be resolved?

After going through this process, state the issues in writing, and make sure that your customer team agrees with your statement of the issues.

## Assess the Issues

After you have defined the issues through the framing step, you need to assess each issue to ultimately develop your position. Review the agreement and evaluate your strengths, weaknesses and contractual remedies. Remedies may include termination, litigation, arbitration, partial termination, damages, indemnity, injunctive relief or some combination of these steps. Review the parties' positions in any similar (or related) disputes. Identify disputes that will be harder to resolve because they are more important to one or both sides.

Before escalating any issue, you should evaluate the "value" of the dispute in comparison to the value of the outsourcing agreement as a whole. Monetize each matter in the dispute and assess whether it is worth spending additional time and resources to resolve. Some issues may be conceded or "traded" for an issue that is more important to your company.

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Determine the outcome that you want to achieve in dispute resolution.

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Determine where you may have leverage to encourage a favorable resolution. Many outsourcing agreements allow customers to in-source or re-source work to other providers, which can create effective leverage in discussions with a supplier who wants to keep the work. Determine whether the supplier's behavior is the type that is excluded from contractual caps on liability (willful misconduct being one example) and how that might influence the supplier to cooperate in a resolution. Consider exercising rights that you have by contract but that you have not exercised, as these may spur constructive changes. Examples include customer audit or benchmarking rights.

You also need to understand the supplier's leverage points. For example, the supplier could reduce the quality or timeliness of service without committing a breach of the contract. Improper withholding of invoiced amounts could trigger supplier rights under an agreement to require escrow of disputed charges, or even to terminate for non-payment under certain circumstances. An understanding of the economic/strategy drivers behind the supplier's position is vital to a full grasp of the situation. In particular, it is important to assess whether the supplier is performing at a loss, because that will be a key driver of its negotiating positions.

The final step in the assessment process is to write a Customer Position Paper. This paper should state (1) the framed issues, (2) the customer arguments and leverage points and (3) the supplier arguments and possible leverage points. The Customer Position Paper should also evaluate the strengths and weaknesses of the customer's positions, and prioritize the issues based on their value and the business goals they impact.

## Define a Successful Outcome

With the Customer Position Paper in hand, the next step is to determine the outcome that you want to achieve in dispute resolution. This desired outcome must take into account the relative strengths, weaknesses and business priorities that have been defined in the assessment phase. Your contracting team (including your attorney) should develop a Term Sheet that proposes how to resolve the issues in accordance with the customer's desired outcome. The Term Sheet process is somewhat like the process of contract negotiation. You must remember your desired ending point and structure a Term Sheet that allows room for compromise and movement on issues so that you end at or near your desired outcomes on the issues that most matter to your company.

As part of the Term Sheet, to better guide amendment or restructuring discussions, classify the agreement terms and schedules based on how much change (if any) they will need. Potential classifications could include:

- "Remain the Same" (no changes necessary)
- "Refresh/Refine" (such as list schedules to be updated)
- "Renegotiate/Restructure" (where negotiated solutions or changes need to be made in the contract and schedules)
- "Remove through Termination" (for example, where scope will be removed, and the contract must reflect that scope change).

In putting together the Term Sheet, it is important to remember that for many disputes, the party "at fault" is not always entirely clear. If a customer approaches every issue as if the supplier is completely wrong, or attempts to put every financial burden associated with an issue on the supplier, it may not solve the disputes and problems in the long run. A bad (uneconomical or impractical) deal for a supplier will ultimately become a bad deal for the customer. The supplier will not, or will be unable to, perform, and the customer will not achieve its business goals. When that occurs, both parties possibly face a lengthy and expensive dispute resolution.

In outsourcing deals, however, where the parties have to work together cooperatively for many years, solving disputes by negotiation rather than litigation or arbitration is by far the better path.

## Plan the Negotiation

Develop an overarching Negotiation Plan, distinct from the internal Customer Position Paper discussed previously, that will govern discussions with the supplier. First, establish the process to be followed for dispute resolution (similar to the negotiation process used to enter the deal originally), and detail the time frames for resolution. Create a meeting plan with dates, topics, participants and meeting objectives. Map the desired communication points between customer and supplier (which may vary depending on the issue). Without compromising negotiation strategy, if it is possible to state the desired end result with the supplier (such as amendment to the contract, termination of the contract or another solution), make that result clear to the supplier.

## Engage

Having followed the preparation steps listed above, your team should now be well prepared to engage the supplier in dispute resolution discussions. You should share a copy of the Term Sheet and the Negotiation Plan with the supplier. Solicit feedback and comments from the supplier and modify the Term Sheet and Negotiation Plan as necessary. Come to agreement on the plan, especially regarding changes to the agreement and schedules, and determine (if possible) what would be a mutually successful outcome. Ultimately, when you come to agreement on the Term Sheet, the dispute is well on its way to resolution.

## Conclusion

Overall, customers need to remember that business goals should drive dispute behavior, rather than dispute behavior driving the business outcome. In “escalated” executive dialogue and mediation, the parties define the issues and control how they are resolved. In arbitration or litigation, judges or arbitrators, along with litigation counsel, define the issues and control how they are resolved. There are disputes where litigation or arbitration may be the only practical means of resolution. In outsourcing deals, however, where the parties have to work together cooperatively for many years, solving disputes by negotiation rather than litigation or arbitration is by far the better path. Following the framework approach set forth above helps customers identify their business goals, sets the framework for proper behavior before and during negotiations, and defines an effective path for ultimate resolution of the dispute. ◆

# Best Practices in Due Diligence on Existing Contracts

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Many an outsourcing deal has foundered on third-party contracts. Signings have been put off for weeks. Business cases have dissolved at the eleventh hour. Surprise costs have shown up during transition or even after the ongoing services have commenced. Even worse, executive management has wondered how facts that have been in written contracts for years could pop up so late.

Fortunately, none of that needs to happen. You can complete due diligence review in an efficient and cost-effective way well in advance. Doing so can tell you what you need to know to assess risk, gauge costs and contract for issues. If you start with a good process, you are well on the way to a good result. This article provides an overview of best practices.

## Create a Team

The first step is to assign a team responsible for the due diligence effort. The team at a minimum will include a lawyer with enough experience to make judgment calls on the meaning of the contract language in the third-party

> Completing due diligence review can tell you what you need to know to assess risk, gauge costs and contract for issues.

contracts. In addition, such a team often includes other contract reviewers, members of the procurement group familiar with the contracts, and members of the deal team familiar with how third-party technology and services will be used. A team leader should be named to manage the review project, because it will generally involve hundreds if not thousands of separate steps.

## Getting Started

On the customer side, the team leader's first goal is to get copies of the contracts that will need to be reviewed. This may be harder than you would expect. The contracts may be spread across business units, filed in a manager's office, or discarded when the negotiator left the company. The only clues that a contract should exist might be accounts payable records and lists of software running on systems.

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The team leader also should work to understand the customer's contracting history. Did the customer try to include outsourcing-friendly provisions? If not, they aren't likely to turn up. Did the customer have form agreements? If so, the review might be simplified by examining the base form to know where the key provisions might be. If the customer's practice was to try to obtain outsourcing-friendly provisions in separate amendments, reviewers can look first for amendments before reviewing the entire contract.

## Record Summary Information Consistently

It is important to ensure that every member of the review team uses the same words, acronyms and phrases to describe the same contractual provisions. This permits multiple reviewers to produce work product with a commonly understood meaning.

The best practice is for the team leader to prepare review instructions that outline the expectations and guidelines applicable to each team member's review. Quality assurance on initial work product early in the review process will identify problems in the instructions, which should then be corrected immediately to avoid re-work at the end of the due diligence review.

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The review should produce work product that efficiently answers all of the questions that the negotiation teams will raise.

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## Tailor Review to the Deal

The review instructions should be tailored to the peculiarities of the deal. Ideally, the review should produce work product that efficiently answers all of the questions that the negotiation teams will raise. Thus, it is helpful to review the instructions with members of the negotiation team (including technical, business and administrative members) before providing them to the review team.

## Use the Right Software

Reviewers should record information in a standard format using the same software package. This will allow them to produce a single computer file containing all of the collected information. In selecting a software package, you should consider the following:

- Number of contracts
- Training for reviewer
- The software's current availability on the customer's and service provider's desktops
- The software's query, reporting, and mail merge capabilities
- The software's ease of use as a tracking database

## Review Deal Terms with Review Team

At the outset, the team leader should take the time to familiarize the review team with the key terms of the deal, such as the nature of the outsourcing arrangement and who and what will be transferred to the service provider. In addition, the team leader should lay out the key questions to be answered, which may include questions regarding what counterparty consents will be required, what the customer's outstanding financial obligations are and what fees would be triggered by the deal. Dedicating this time at the start of the project will make it less likely that a reviewer will miss an important item of information due to a lack of familiarity with the deal.

## Streamline the Process and Separate the Wheat from the Chaff

A successful due diligence process does not require gathering every minute piece of information from each customer contract. You can streamline the process and cut costs by working with the business and technical teams to focus on the contracts that matter and exclude those that don't. Here are a few helpful tips to keep in mind:

- Companies rarely purge old contracts. As a result, their contract file will likely contain a number of terminated contracts that may not need to be reviewed. A report of payments over the past two years from the customer's accounts payable system can help determine whether a contract has expired and how important it is.
- The technical team may be able to provide a list of software to be accessed by the service provider. If this list is available before due diligence begins, reviewers can use it to avoid wasting effort on reviewing contracts for software that will not be affected by the deal.

- The service provider may have relationships with vendors that provide broad consents or licenses. Such relationships may cover all the rights needed in order to complete the deal.
- Consider having a reviewer create a high-level contract inventory by performing a quick "first pass" review. Provide this inventory to financial, technical and administrative experts to identify important contracts and those that do not require review.
- Cut costs by finding out what databases already exist. For example, the vendor's address for notices might already be in the customer's accounts payable system.
- Only use experienced lawyers to perform a second-level review of key contracts and to perform quality assurance.

## Be Wary of Hard-Coded Cost Information

The cost information hard-coded into a contract should be treated with suspicion. A variety of cost adjustments, such as changes in annual maintenance prices, are generally not reflected in a customer's contract file. Hard-coded cost information should be validated by reviewing the customer's accounts payable system or contacting the business expert responsible for administering the contract.

## Consider Assuming the Worst

You may consider simply sending letters to all contract vendors requesting each vendor's consent to all of the contemplated outsourcing activities. The review team would then only need to review contracts for vendors that refuse to give consent. This approach may make sense if (i) few contracts are expected to permit the deal; (ii) the cost of obtaining consents would be less than the cost of finding contracts that require consent; (iii) the deal isn't confidential; and (iv) the review is not intended to gather other valuable information. In the right circumstances, this approach can dramatically reduce due diligence costs.

## Separate Legal Judgment from Fact Gathering

The initial review team should simply gather well-defined facts. The legal analysis of these facts should be conducted as a separate exercise. This will cut costs by allowing the review effort to be conducted by individuals with low hourly rates. Here are a few helpful tips to illustrate this point:

- You might instruct a reviewer to determine whether a contract is silent with respect to assignment. However, reviewers should not be required to make a legal judgment on whether such silence means that assignment is permitted or prohibited in the context of the contract.
- A reviewer who is uncomfortable interpreting or understanding certain language in a contract should mark the section for further analysis by a second-level reviewer and move on to another section.

Hard-coded cost information should be validated by reviewing the customer's accounts payable system or contacting the business expert responsible for administering the contract.

## Set Standards to Allow Second-Level Quality Assurance

Reviewers should collect sufficient supporting information to allow for an efficient second-level review if the contracts will not be readily available after the initial review. This can be accomplished by having the key pages of each file scanned electronically or by typing the exact contract language that supports a summary or conclusion into the relevant contract summary.

## Increase Value by Collecting Data for Multiple Reasons

It takes time for a reviewer to understand a contract well enough to answer questions about it. Consider leveraging that time to produce a useful database for vendor management, for future contracting or for verifying vendor invoices. For example, the model instructions referenced above require the reviewer to determine the renewal terms for the various contracts. ◆

# How to Establish Service Levels Without Historical Data

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One of the most important issues to consider when entering a new outsourcing arrangement is how to define the level of service performance the outsourcing provider will be obligated to deliver. Absent a transformational shift in service provisions, a frequent approach to establishing initial service levels is to base them on the customer's historical performance. A basic value proposition of many outsourcings is that the provider will commit to providing the customer with at least the same level of service to which the customer is accustomed, but will do it at a better price. From this starting point, the provider may then set about improving the process of service delivery and the customer might expect incremental service level performance improvement over the term of the agreement.

But how can the contracting parties establish service levels when the customer has no historical performance data, or the data is insufficient to support the customer's desired metrics? One possibility is for the customer to establish historical data as soon as it has the sense that it may enter into an outsourcing engagement by quickly implementing the required measuring tools. But this can be expensive, and gathering enough data to establish baselines with integrity takes time. In the current economic environment, the imperative is to cut the time and expense in getting to an agreement—a directive generally at odds with building solid internal metrics. So what are the alternatives?

> Some service levels, particularly ones related to governance, are squarely within the control of the provider from the first day of the engagement.

## Use Industry Standards and Provider Experience

If the customer has given the service provider a reasonable opportunity to conduct inbound due diligence prior to contracting, the provider may be in a position—based on its experience with its other customers and applicable industry standards—to commit to defined service levels despite the absence of client historical data. If, for example, the customer can show that it has properly maintained off-the-shelf applications that have not been greatly customized, the provider may commit to an industry-recognized availability metric for the application layer. However, the client's environment obviously can be much more complex and it may present the supplier with a greater challenge in properly sizing the risk of committed service levels.

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## Carve Out Metrics that Are Not Dependent on Historical Performance

Some service levels, particularly ones related to governance, are squarely within the control of the provider from the first day of the engagement. For example, metrics measuring the customer's ability to complete projects on time and on budget, or that speak to its ability to retain key account personnel, are not relevant since these are now the very processes the supplier brings to the table. Consequently, providers should be able to commit to these types of metrics independent of the customer's historical performance.

## Baseline Performance Post- Signing

For those service levels that cannot be defined prior to contracting, parties often baseline the provider's level of service performance for a period of time (e.g., six months) after the provider assumes responsibility for steady state service delivery. During this measurement period, the provider is typically not subject to credits for poor performance unless temporary minimum service levels have been agreed upon. At the end of the measurement period, the service levels are automatically established based on the data collected during the baselining period. For example, the final service level might equal the supplier's average monthly performance during the measurement period.

This approach is problematic on at least two fronts. First, and most obvious, if the provider's ultimate contractual performance obligations will be based on its own level of performance during the baselining period, the provider has little incentive to perform well. If the provider performs poorly during the baselining exercise, that's exactly where the final contractual bar is placed. Second, regardless of the provider's motivations, the level of service performance is often degraded in the first few months after transition as processes are stabilized. So if, as is often the case, the parties start to measure performance on the "go-live" date, the baseline will include a few months of data where performance may be inherently lower than typical steady state.

There are a number of tactics for improving the traditional baselining approach that may serve the customer and the provider well.

- **Set targets.** If there are no targets for the provider to meet during the baselining period, the parties have no barometer for success. The parties should establish service level targets during the measuring period and the provider should be obligated to use reasonable efforts to meet them. While there is no credit for the provider's failure to meet a target during the baselining period, at least the parties have defined the goal.
- **Review performance regularly.** The parties should meet early and often to review the provider's performance against the target metrics. This is an excellent opportunity for the parties to identify problems, collaborate on process improvements and develop performance improvement action plans.
- **Define minimum final service levels.** The customer should be hesitant to enter into the engagement without a safety net. Before contracting, the parties should be able to identify the worst case scenario for final metrics.
- **Consider performance trends.** As already discussed, the product of a typical baselining exercise is an automatic equation involving the provider's performance in each month of the measurement period. Rather than taking, for example, the average performance level over the period, the parties should review whether the performance trends are clearly demonstrating that higher final service levels are achievable. This is essential in avoiding the hiccups that may come right after transition.
- **Identify alternatives.** If the target metrics were not achieved by the conclusion of the measurement period, the parties should be in a better position to identify the cause for failure at this point in the relationship (they may have spent a year or more together from the beginning of transition through the end of the baselining period). They should then be able to identify the process changes required to meet the customer's desired metrics and should have a clearer view of the field of possibilities to implement those changes, with or without additional cost to either party.
- **Consider the consequences.** Although clearly not the norm, the customer should consider a scenario where, despite both parties' best efforts, the final metrics are not acceptable to the client. An array of contractual protections (e.g., the right to reduce scope or terminate all or part of the agreement without penalty) may lessen the sting of disappointing results. ◆

# Increased Obligations under the HITECH Act Revisions to HIPAA: A Brief Overview

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The American Recovery & Reinvestment Act of 2009 (ARRA), signed into law on February 17, 2009, includes significant changes to the Health Insurance Portability and Accountability Act of 1996 (HIPAA). Specifically, Title XIII of ARRA, known as the Health Information Technology for Economic and Clinical Health (HITECH) Act, greatly expands the HIPAA obligations of "Covered Entities" and "Business Associates."

Prior to the HITECH Act, Business Associates—persons who perform any function or activity involving the use or disclosure of Protected Health Information (PHI) on behalf of a Covered Entity—were not directly liable for HIPAA violations. Instead, Business Associates handed the potential for contractual liability to Covered Entities through contracts known as Business Associate Agreements. The HITECH Act now imposes direct civil and criminal penalties on Business Associates for certain security and privacy violations under HIPAA.

The majority of the HIPAA Security Rule now directly applies to Business Associates in the same manner as it applies to Covered Entities. For example, Business Associates will now be required to implement and maintain certain security policies and procedures, appoint a security officer and provide related training.


The HITECH Act now imposes direct civil and criminal penalties on Business Associates for certain security and privacy violations under HIPAA.


In addition, the HITECH Act imposes new Privacy Rule-related obligations on Business Associates. More specifically, the HITECH Act provides that Business Associates may use and disclose PHI only to the extent that such use or disclosure complies with certain requirements in Business Associate Agreements Effectively, by way of this statutory tie to certain contractual provisions, Business Associates must directly comply with aspects of the Privacy Rule.

Finally, the HITECH Act specifically requires that Business Associate Agreements be modified to incorporate the new Security Rule and Privacy Rule requirements.


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## New Notification Requirements

Under the HITECH Act, Covered Entities and Business Associates alike will be subject to new notification requirements. For example, within 60 calendar days of discovering a breach of "unsecured" PHI (including breaches that should reasonably have been known), Covered Entities must notify:

- Individuals with respect to a breach of their information;
- "Prominent media outlets serving a State or jurisdiction" if more than 500 residents of such State or jurisdiction are affected; and
- The Secretary of the Department of Health and Human Services (Secretary).

The Secretary will post a list of each Covered Entity involved in a breach of "unsecured" PHI concerning more than 500 individuals on the Department of Health and Human Services' web site. Business Associates are required to provide notification to Covered Entities within 60 calendar days of discovering a breach of "unsecured" PHI (including breaches that should reasonably have been known).

Expansion of enforcement rights to state attorneys general may subject Covered Entities and Business Associates to more extensive scrutiny.

On the other hand, if PHI is "secured" by an approved methodology (e.g., data encryption), these notification requirements should not apply to Covered Entities and Business Associates. The relevant authorities are just beginning to provide guidance relating to the appropriate methods for securing PHI. For example, the Secretary recently issued guidance specifying that PHI may be secured by data encryption or data destruction practices and referencing the technical publications of the National Institute of Standards and Technology on this subject. Covered Entities and Business Associates should carefully review all current and forthcoming guidance related to securing PHI.

## Enforcement Expansion

The HITECH Act empowers state attorneys general to bring civil actions in federal court if they have "reason to believe" that "one or more of the residents of that State has been or is threatened or adversely affected" by a violator for injunctive relief or statutory damages as well as attorneys' fees. Previously, HIPAA enforcement actions could only be initiated by the Centers for Medicare & Medicaid Services (for Security Rule violations) or the Office of Civil Rights (for Privacy Rule violations). Expansion of enforcement rights to state attorneys general may subject Covered Entities and Business Associates to more extensive scrutiny.

## Increased Penalties and Compensation for Harmed Individuals

The new legislation also significantly increases the existing civil monetary penalties for each violation. Civil penalties now generally range from $100 to $50,000 per violation, with caps of $25,000 to $1.5 million for all violations of a single requirement in a calendar year. The severity of the penalties increases based upon the cause of the violation and the violator's level of knowledge regarding the violation:

**Low Penalty:** Violator had no knowledge (and by exercising reasonable diligence would not have known) of the violation

**Medium Penalty:** Violations due to reasonable cause

**Higher Penalty:** Violations caused by "willful neglect" that were corrected

**Highest Penalty:** Violations caused by "willful neglect" that were not corrected

The Secretary is required to investigate and impose penalties for "willful neglect" violations.

## Effective Dates

The effective dates for the HITECH Act changes to HIPAA vary. For example, the increased penalty provisions are effective immediately. By contrast, other provisions will be effective within a year of the legislation (i.e., February 2010), two years after enactment of the legislation, or after related regulations are published.

There are many other provisions of the HITECH Act that will affect the HIPAA obligations of Covered Entities and/or Business Associates. Organizations subject to HIPAA will need to carefully review the HITECH Act and establish a comprehensive strategy for complying with its expanded obligations by the relevant effective dates. ◆

# Unique Risks in Contract Manufacturing Arrangements

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A contract manufacturing arrangement typically involves a customer engaging a contract manufacturer to manufacture consumer products, which will then be sold by the customer into the market. Several unique risks can arise out of such a relationship, which are distinct from the issues present in other sourcing transactions. In large part, these risks arise from the fact that the customer's core business is the sale and distribution of these products and that the products are being distributed into the marketplace, which increases the number of persons who could suffer harm from the products and increases product visibility. This article highlights a few key risks unique to contract manufacturing arrangements.

**Delivery of the Products.** The purpose of the contract manufacturing agreement is for the supplier to manufacture products for the customer to deliver to the market. The customer's business and reputation depends on its ability to supply product to meet its contractual obligations and market demands. Thus, the risk that the supplier does not deliver products in a timely way could have substantial consequences to the customer. The customer should give consideration to the remedies and penalties to attach to any such breach by the supplier, and protections for the customer to alleviate the potential consequences.

The customer's business and reputation depends on its ability to supply product to meet its contractual obligations and market demands.

**Regulatory Requirements, Specifications and Quality Measures.** The customer will want to market and distribute products that appeal to consumers and that meet or exceed industry standards for quality. In addition, the customer will want to ensure that its products are safe. Many consumer products are subject to regulatory requirements, which are typically imposed for consumer safety. The customer should build the obligation to meet regulatory requirements into the specifications for the products and include warranties from the supplier that the *products* will meet all legal requirements (in addition to warranties that the supplier will *perform* the services and its other contractual obligations in accordance with laws). The supplier should warrant that the products will conform to the specifications and meet or exceed industry quality measures, where appropriate. The customer

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should have inspection rights to confirm that the supplier is meeting quality standards in the manufacturing process, as well as to confirm the quality of the products themselves.

Commercialization Risks. There is always the risk that the customer will not be able to successfully commercialize the product. This could result from, among other things, the failure of the customer to successfully market the product or a failure of the supplier to timely deliver products meeting contractual requirements. Consideration should be given to how to allocate this risk and the rights and remedies available to the customer where the risk results from supplier's default.

Product Liability Risks. One of the paramount risks associated with contract manufacturing relationships is product liability. Product liability claims can arise from the failure of products to meet regulatory requirements, specifications or quality measures or otherwise from defective products that lead to personal injury or death. Because of the potential significant costs associated with these claims, product liability indemnities are particularly important and it is essential that appropriate insurance be mandated by the contract and put in place. It is key for the insurance requirements to be appropriate for the particular industry and product.

Recalls. Depending upon the type of product to be manufactured, warranties may be extended to the ultimate consumer of the product, and inevitably consumer warranty claims can arise. In addition, the manufacture, sale and distribution of consumer products give rise to the potential for product recalls, both voluntary and mandatory. The contract manufacturing agreement should define the responsibilities of the parties for these costs, and, perhaps as important—where the supplier is to bear the responsibility and liability—include appropriate mechanisms to ensure that the customer can collect from the supplier where it is responsible for these costs.

Intellectual Property Risks. The distribution of products into the marketplace increases the potential risk for intellectual property claims. Appropriate and customary indemnification provisions should be built into the contract to protect the customer against third-party infringement claims. In addition, the customer will want to assess the ability of the contract manufacturer to bear the costs associated with such risk, and establish contractual protections to ensure that the supplier can fulfill its indemnity obligations.

The distribution of products into the marketplace increases the potential risk for intellectual property claims.

Post-Termination Risks. The ability of the customer to continue to meet market demand and to have a smooth transition of the manufacture of the products post-termination is essential. The contract should contain appropriate post-termination assistance obligations and, in particular, depending upon the industry, should include an obligation for the supplier to continue to supply product for a period of time post-termination and/or to continue to supply service parts for the products to permit the customer to continue to meet its post-termination consumer warranty obligations and consumer demand generally.

Contract manufacturing arrangements relationships are complex. Each contract will raise issues unique to the parties and circumstances involved, and specialty areas of the law will likely be implicated. While parties may decide to allocate risks differently from that suggested above, our goal is to highlight some of the common risks unique to contract manufacturing arrangements in order to generate thoughts on the structure of the relationship. ◆

# Human Resources and Personnel Issues in Chinese Sourcing Transactions

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For many years China has been developing into one of the world's leading manufacturers of goods. More recently, it has become intent on becoming a leading global provider of services.[1] While labor conditions in manufacturing have raised some significant issues of international social concern,[2] buyers of Chinese-sourced products have had relatively little occasion to focus on basic human resources and personnel issues associated with their suppliers' employees. As China seeks to attract international businesses to source services from China, however, human resources and personnel issues associated with the supplier employees will take on a new immediacy for buyers of Chinese services.

Human resources and personnel issues are inherently significant issues in any services sourcing transaction. This focus is driven by the obvious fact that the output of a services outsourcing is largely comprised of the performance (of services) by the supplier's employees. Whether a sourcing of services from China is undertaken through a captive (owned-affiliate) entity or through a contractual outsourcing arrangement, buyers of Chinese services are directly and immediately impacted by employment and labor laws and practices in China. This impact includes the ability to enforce (and exercise) certain rights expected by buyers of services, as well as risks associated with exercising such rights, including the risk of attracting liability as an employer.

> As China seeks to attract international businesses to source services from China…human resources and personnel issues associated with the supplier employees will take on a new immediacy for buyers of Chinese services.

This article provides a general overview of employment law in the People's Republic of China, with a focus on how such laws affect the sourcing of services from China. For purposes of facilitating a fuller discussion, this article will largely utilize a hypothetical outsourcing transaction between a Chinese customer and a Chinese supplier. Specifically, this article will utilize a classic outsourcing

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formulation in which the customer actually transfers responsibility for a scope of its operations (the "Services"), such as information technology or business processes previously performed by its employees in its facilities in China, to a Chinese supplier that takes over responsibility for the Services and maintains their performance, at least in part, at such customer facilities. Many foreign buyers of Chinese services will not face all of the issues arising in this hypothetical transaction (particularly those associated with the customer's incumbent employees outside China who are performing the services transferred to the supplier, which may give rise to issues under the local law of such employees' location but not China). Using such a hypothetical Chinese customer for this discussion will allow for a broader review of the issues under Chinese law and practice.[3]

> The past 10 to 15 years have seen dramatic developments in Chinese employment law.

## Overview of the PRC employment law

The past 10 to 15 years have seen dramatic developments in Chinese employment law. The foundation for labor and employment laws in China are the Labor Law (the "Labor Law"), enacted on January 1, 1995, and the Labor Contract Law (the "Labor Contract Law"), which came into force on January 1, 2008. The Labor Law focuses on general rights of employees, such as employment, promotion and training, collective contracts, work hours, wages, social security and benefits, and occupational safety and health. The Labor Contract Law focuses on the more specific aspects of the contractual arrangement associated with the engagement of an individual as the employee of an employer. These laws are generally applicable to any employment relationship established in China.[4]

## General

A few important threshold considerations associated with employment contracts in China should be noted.

### REQUIREMENT OF WRITING

An employer is obligated to enter into a written labor contract with any employee within one month from the date of commencement of employment. Failure to do so results in the employer being required to pay to the employee twice the amount of the agreed remuneration as salary.[5] This obligation most likely continues through the period of continuing failure to enter into a written contract.

### EMPLOYMENT TERM

An employer and employee can agree on the term of employment, which may be definite (defined period), indefinite or piecemeal (dependent upon completion of work assignments). Importantly, however, an indefinite term is deemed to exist in any of the following circumstances:

- Employment under an oral contract that has subsisted for one year or more (following the January 1, 2008, effective date of the Labor Contract Law);
- The employer and employee have entered into a fixed term labor contract twice successively and the parties intend to renew such contract upon its expiry (unless the employee has requested a fixed term); or
- The employee has worked for an employer continuously for 10 years or more (unless the employee has requested a fixed term).[6]

Further, if the employer fails to sign a written indefinite term labor contract with the employee when the term is or becomes indefinite, the employer becomes obligated to pay twice the amount of salary otherwise payable from the date the employment term became indefinite.[7] As noted below, an employer cannot terminate an employee without cause, irrespective of what the labor contract provides, making the term (especially an indefinite term) highly significant.

### RIGHTS OF TERMINATION OF EMPLOYMENT

An employee has the unilateral right to terminate his or her labor contract without reason, subject only to 30 days' advanced written notice. This notice period is reduced to three days during any probationary period stipulated in the labor contract (which can be up to six months in the case of an indefinite term or greater than three-year-term labor contracts). No prior notice is required if the employer has breached the law or labor contract (for example, failed to timely pay wages or social insurance contributions).

On the other hand, an employer has no unilateral right to terminate its employees. Termination of employment by an employer can legally occur only in two broad circumstances. First, in the case of definite or piecemeal term employment, termination can occur when employment in fact ends with the natural expiration of the employment contract (that is, expiration or completion, as the case may be). However, premature termination of employment can occur only in the following limited situations:

- Employee fault;[8]
- The employee suffers from a disease or from non-work-related injuries, and is unable to perform his/her original job or any other job arranged by the employer after the medical treatment period;
- The employee is incapable of performing the job assigned, and remains incapable after being provided with the relevant training or being assigned to another position; and
- The labor contract is no longer executable due to "material changes in the objective conditions" existing at the time the contract was originally entered into, and both parties fail to agree on any variation to the original contract.

Even in cases of permissible termination (other than those based on employee fault), 30 days' prior written notice (or relevant payment in lieu of such notice) is required, and severance is payable upon the termination of employment, unless the termination is for employee fault.[9] These limited employer termination rights highlight the significance of indefinite term employment.

### REINSTATEMENT FOR WRONGFUL TERMINATION

If an employer wrongly dismisses an employee, the employee is entitled to reinstatement to his or her job position, or if the employee does not request reinstatement or the contract is no longer capable of being performed, the employer is obligated to pay twice the severance otherwise payable to the employee as damages.

### OTHER LABOR STANDARDS AND ENTITLEMENTS

There are a number of laws establishing various labor standards and employee entitlements, especially at the local levels. These include statutory benefits for employees, such as minimum wages, maximum work hours, right to overtime payments, public holidays, statutory leave and social insurance. Local standards are subject to variation.

## Specific HR and Personnel Considerations for Outsourcing Transactions

Over the life of an outsourcing transaction, a number of events or activities impacting the supplier's employees can occur that may carry significant implications under Chinese law. Although a number of these events or activities can occur at multiple times over the course of an outsourcing, their incidence is often associated with a particular phase of the outsourcing—namely, the inception or beginning of the transaction (sometimes referred to as the transition); the period of ongoing performance (sometimes referred to as steady-state), and the termination or end-phase of the outsourcing. The following discussion identifies some of the more significant activities or events associated with these phases and describes the likely treatment under Chinese employment law.

There are a number of laws establishing various labor standards and employee entitlements, especially at the local levels.

### TRANSITION PHASE: TRANSFER OF CUSTOMER EMPLOYEES TO SUPPLIER

A first generation services outsourcing involves the transfer of Services performance from customer employees (each an "Incumbent Employee") to supplier employees (each a "Supplier Employee").[10] In some cases (where Incumbent Employees transition to the supplier), these Incumbent Employees and Supplier Employees are the same individuals. Typically, the customer and the supplier will have relatively well-developed objectives respecting what should occur with respect to Incumbent Employees. Of course, each Incumbent Employee also will have legitimate interests (and in some cases, concerns) about the impact of the outsourcing on his or her job. From a transition end-game perspective, an Incumbent Employee will either become a Supplier Employee, or not; and if not, the Incumbent Employee will either remain an employee of the customer, or not. Getting to the actual result is impacted and in some cases driven by the actions of the parties in the context, and through the application, of employment law.

Even in mature outsourcing markets familiar with outsourcing transactions, labor issues are often significant during the transition phase, and the human resources teams of both the customer and the supplier are integral transaction participants. It should not be surprising then, that given the relatively recent adoption of the applicable employment laws in China as well as the general immaturity of the service outsourcing market in China,[11] there is uncertainty about exactly how some of the activities and events of the transition phase will be treated. Fortunately, customers and suppliers can draw on lessons learned from many years of sourcing experience in other environments, although application of the laws of China will undoubtedly produce some unique aspects for Chinese outsourcings.

Ideally, the outsourcing agreement should expressly define the extent to which the supplier is obligated to make offers of employment to Incumbent Employees.

Ideally, the outsourcing agreement should expressly define the extent to which the supplier is obligated to make (or prevented from making) offers of employment to Incumbent Employees. Sophisticated suppliers have developed significant experience in recruiting and hiring employees from customers, and in many cases a large percentage of supplier personnel consist of employees successfully transitioned from customers. Notwithstanding such defined objectives, however, this is an area where employment law plays a particularly significant role in defining the respective responsibilities of the customer and the supplier.

For purposes of this discussion, two potential scenarios involving an Incumbent Employee during the transition phase will be analyzed:

Scenario One: The customer does not want to retain the Incumbent Employee but also does not want the Incumbent Employee to become a Supplier Employee (that is, does not want the Incumbent Employee to continue performing the Services) (the "Released Employee"). This scenario frequently arises from an accommodation of the supplier's interest that the Incumbent Employee not become a Supplier Employee (as when the supplier has sufficient employees to provide the Services without the Incumbent Employee).

Scenario Two: Where the customer wants the Incumbent Employee to become a Supplier Employee (and presumably continue performing the Services) but the Incumbent Employee does not want to become a employee of the supplier and seeks to remain an employee of the customer (the "Resistant Employee").

## Scenario One: Released Employee

In this scenario, the customer's objective is termination of the Incumbent Employee. Absent fortuitous timing under an employment contract of definite or piecemeal duration coinciding with the outsourcing, the most likely permissible ground for the customer's termination of the Incumbent Employee would be the "material change in objective conditions" ground described above. For this, the customer would argue that the objective conditions for the Incumbent Employee's employment (namely, the operational mode whereby the customer was performing its own services through its own employees, including the Incumbent Employee) have undergone a material change by virtue of the outsourcing, making it impossible to continue to perform the original employment contract (the Services no longer existing with the customer). Although the Incumbent Employee would likely not succeed in a claim for reinstatement of employment with the customer, he or she would be entitled to the notice and severance payments described above.

Significantly, however, it is possible that the Incumbent Employee may seek to maintain that he or she should be entitled to employment with the supplier—that is, that he or she should become a Supplier Employee, despite the intentions of the customer (and presumably the supplier) to the contrary. Such an argument would likely be based upon Article 34 of the Labor Contract Law ("Article 34"), that provides the following:

In case of any merger, spin-off, or like circumstances of the employer, the original labor contract shall remain valid and shall continue to be performed by the employing entity which succeeds to the rights and obligations under such contract.

Under this provision, the Released Employee might argue that his or her employment has transferred to the supplier, because the outsourcing transaction constituted a "merger, spin-off, or like circumstance of the employer." In fact, such treatment would not be dissimilar to the treatment of customer employees under European laws implementing the Acquired Rights Directive.[12] The counter-argument of the supplier (as the party against whom the Incumbent Employee would most likely be making such a claim) would be simply that an outsourcing transaction is not a "merger, spin-off, or like circumstance of the buyer," but rather a mere change of business operational mode and therefore not a transaction to which Article 34 protections apply. The treatment here remains uncertain; the law is simply too new and untested. Similar periods of uncertainty existed under European laws and this is an example of an area where the customer and the supplier may draw on the experiences of customers and suppliers in other uncertain situations to acceptably allocate associated risks.

## Scenario Two: Resistant Employee

In scenario two, the customer (and presumably the supplier) desires that the Incumbent Employee transfer his or her employment to the supplier, but the Incumbent Employee seeks to remain an employee of the customer. Depending on the circumstances, the customer and the supplier may benefit from application of Article 34 to this transaction, as described above. However, irrespective of the application of Article 34, the Incumbent Employee cannot be required to remain a Supplier Employee, and would be entitled to terminate his or her employment, subject only to required written notice of termination. Nonetheless, if Article 34 were applicable so that the employment contract transfers to the supplier, the Incumbent Employee would risk losing severance payments if he or she voluntarily resigned.[13] Such risk would likely encourage the Incumbent Employee to continue performance under the supplier, even if only temporarily.

The Incumbent Employee's objective of remaining an employee of the customer, however, would almost certainly be unsustainable. To succeed in such an effort, the Incumbent Employee would need to successfully characterize the outsourcing transaction (and associated transfer of employment to the supplier) as an illegal variation or breach of the original employment contract. Such an argument would seem wholly inconsistent with the very existence of the "material change in objective conditions" ground for termination. Particularly where an entire function of the customer is outsourced so that no job remains for the Incumbent Employee, it would seem highly unlikely that any arbitrator or judge applying Chinese law would uphold such a contention. This would seem even more unlikely where (as in this scenario) the "same" job is available to the Incumbent Employee with the supplier.

### CRITICAL SERVICE PROVIDER PERSONNEL

It is common practice in outsourcing transactions where Incumbent Employees have become Supplier Employees that the supplier is contractually committed to retain a core group of identified Incumbent Employees for a designated period. Customers seek such commitments from suppliers as a means of reducing overall transaction risk, by seeking to ensure that the supplier has the benefit of employees with known experience and knowledge of the customer and Services, especially during the Services' initiation period. Typical minimum retention periods are 12 to 18 months, beyond which the retention obligation expires and further retention of such Supplier Employee is within the discretion of the supplier, subject to applicable employment laws.

Certain employee benefits under Chinese employment law are affected by the length of an individual's employment.

One important aspect of minimum retention obligations is that the retention commitment runs from the supplier to the customer, and not to the employee. Such arrangements would seem entirely consistent with Chinese employment law.

### SERVICE PERIOD CREDIT

Certain employee benefits under Chinese employment law are affected by the length of an individual's employment.[14] Thus, in the case of an Incumbent Employee becoming a Supplier Employee, it can be important whether such Incumbent Employee is credited with the period of his or her prior employment with the customer. In this area, credit often will be given, under authority of an Implementation Rule of China's State Council, providing as follows:

> Where an employee has been arranged by an employer, otherwise than for the personal reason of such employee, to work for a new employer, his/her service period with the original employer shall be added in the calculation of his/her past service period with the new employer.[15]

This crediting rule could be significant to an employee's entitlement to an indefinite term labor contract for continuous service of 10 years or more. Attaining an indefinite term contract through such a 10-year period of continuous service, whether through actual years worked for the supplier or with credit given for prior years as a customer employee, would preclude the supplier from terminating such Incumbent Employee without statutory cause.

Often the personnel provisions of outsourcing agreements expressly define circumstances for which Incumbent Employees hired by the supplier should be given credit for years of service with the customer. While the necessity for and functionality of such a provision is lessened with the interpretative ruling, best practice and clarity would support clear documentation in any event.

#### TERMS OF EMPLOYMENT WITH THE SUPPLIER

Although not entirely clear, in circumstances where Article 34 applies to effect the transfer of an Incumbent Employee's employment to the supplier, the terms of employment with the supplier will most likely be those of the pre-existing labor contract with the customer. Even if otherwise desired, suppliers seeking to hire and maintain Incumbent Employees would be hard-pressed to reduce salary and other employment terms, risking that Incumbent Employees might seek to resist (or terminate) employment with the supplier.

> It is typical in outsourcing agreements that the customer and the supplier allocate between themselves responsibility for employee-related liabilities.

#### INDEMNITIES

It is typical in outsourcing agreements that the customer and the supplier allocate between themselves responsibility for employee-related liabilities (for example, responsibility for payment of wages and social insurance contributions during the period of employment with the respective party). Often this allocation is effected through indemnities for the various liabilities from the party allocated responsibility. It is also likely that during periods of uncertainty around the treatment of Incumbent Employees under Chinese law (notably, for example, with respect to applicability of Article 34), the parties will likely provide for an allocation of the uncertainty risk between them through the use of tailored indemnities. This is an area where customers and suppliers can draw on many years of prior experience of (other) customers and suppliers in mature outsourcing jurisdictions.

## Steady State Phase

#### RIGHTS HELD BY CUSTOMER

During the steady state phase of an outsourcing, a number of continuing employee-related issues may give rise to employment law considerations. Among these are a number of customer rights frequently contained in outsourcing agreements that require or direct certain conduct by, or treatment of, Supplier Employees, including:

- The right to require the supplier to replace an individual Supplier Employee in the performance of Services if the customer deems such replacement to be in the customer's best interest;
- The requirement that Supplier Employees comply with customer rules and practice requirements (for example, code of conduct or customer site rules such as substance abuse policies); and
- The right to give input on Supplier Employee compensation (for example, through satisfaction survey input and the like).

Another set of rights involve "flow down" rights that the supplier is obligated to make directly enforceable against the Supplier Employees by the customer. These may include:

- Obligations respecting confidentiality of customer information accessed or created by Supplier Employees, where the customer may feel that contractual responsibility of the supplier alone is not sufficient; and

- Restrictions on the performance of services for competitors of the customer.[16]

Finally, outsourcing agreements frequently contain a clear commitment by the supplier of responsibility for the acts of Supplier Employees, even if those acts constitute negligence, willful misconduct and/or fraud. Such a clear specification can be important where (as may be the case under Chinese law) the supplier may have the ability to claim that wrongful actions of the Supplier Employee are outside the scope of responsibility of the supplier.

Major outsourcing agreements often contain a number of reciprocal obligations and rights related to supplier and customer employees. One of the more significant of these is the prohibition against hiring employees of the other, unless expressly permitted (including as exceptions the activities associated with the transition of employees to the supplier and at the termination or expiration of the outsourcing).

The ultimate enforceability of these provisions is not clear under Chinese law, especially those that can be viewed as placing restrictions on the individual employee's ability to work. As in most jurisdictions, contractual restrictions on employment are not viewed favorably; however, to the extent these restrictions are applicable between the supplier and the customer (and not to individual employees) they are more likely to be enforceable. Future developments in the law will certainly clarify these issues.

### DISCLAIMER OF CO-EMPLOYMENT

Customers in outsourcing transactions must take care respecting the risk of being considered an employer (most likely co-employer) of Supplier Employees. This risk typically arises in connection with the customer possessing (and exercising) rights over Supplier Employees performing the Services, including rights such as those described above. This risk is sometimes exacerbated by the fact that for some Supplier Employees day-to-day work activities may have changed relatively little from when they were Incumbent Employees. In such circumstances, the risk is that employer status may arise and result in the Customer having employer responsibilities and liabilities, such as for wages or underpaid social insurance contributions. Outsourcing agreements typically expressly disclaim co-employer status on the part of the customer; however, because any such claim would likely be made by individual Supplier Employees who are not party to the outsourcing agreement, such a declaration may have limited impact on an employment-related claim by the Supplier Employee. Consequently, outsourcing agreements typically also include a supplier indemnity for the benefit of the customer against any such Supplier Employee claims. In some cases the risk is viewed as sufficiently great by the customer that it agrees to reduced rights directly related to Supplier Employees under the outsourcing agreement.

## Termination Phase

The final phase of an outsourcing transaction is termination or expiration. As with the other phases of an outsourcing, certain labor issues or considerations arise in connection with the activities occurring or undertaken during this phase, or in connection with the rights possessed and exercised by the parties during this period.

> To the extent treatment is uncertain given the developing law in this area, express allocation of risk between the customer and the supplier…would be appropriate.

One of the first issues is the potential follow-on applicability of Article 34 to the re-sourcing or in-sourcing of the Services. Such treatment would presumably be similar to that applicable in the transition phase, as discussed above. Again, this is an area where the customer and the supplier may draw on the experience of outsourcing in jurisdictions with laws similar to those required by the Acquired Rights Directive. To the extent treatment is uncertain given the developing law in this area, express allocation of risk between the customer and the supplier through inclusion in the outsourcing agreement of appropriate indemnities between the customer and the supplier would be appropriate.

Even without applicability of Article 34, an important right often required by the customer in outsourcing agreements is the express right to hire (or allow its successor supplier to hire) Supplier Employees engaged in the performance of the Services at the end of the term. Frequently, the customer seeks to include within this right Supplier Employees who performed Services within the final year under the agreement, in order to avoid the risk of the supplier evading the obligation by assigning its most desirable employees away from the customer account. Such a clear customer right may be unnecessary if no-hire provisions are in fact found unenforceable in China, but best practice on part of the customer would call for seeking to include such a clear right in the outsourcing agreement.

## Conclusion

China is experiencing dramatically swift change and development in both its law and its commercial practices, and this is very much evident within its services outsourcing industry. Employment law is a critical area for all service outsourcings and it will be important for customers and suppliers of Chinese services to carefully evaluate their undertakings in light of continuing developments in the law. As these developments unfold, parties to Chinese service outsourcing transactions can look to how such issues have been handled in outsourcing transactions over the years in other jurisdictions, particularly during periods of development and clarification in applicable laws. The outsourcing business model has developed and been proven over many years and through periods of uncertainty, providing guidance that can be applied to the benefit of customers and suppliers of Chinese services. Ultimately, however, there is little doubt that the law and commercial practices in China will develop in ways that support the successful sourcing of services. ◆

## Endnotes

1 See "Going to China", Business & Technology Sourcing Review, Mayer Brown LLP, Issue 11, Q1/Q2 2008 and republished in Asian Counsel (May 2008).

2 Excluding concerns associated with important issues such as child labor and working conditions that are beyond the scope of this article.

3 It should be noted that this hypothetical transaction would include the case of a foreign-owned captive entity in China transferring its operations to a Supplier. Such a scenario will likely become an increasingly frequent one as the Chinese services sector matures.

4 In addition, local regulations and rules issued by provincial, municipal and other lower level authorities are only applicable in the relevant local regions. These laws involve a variety of matters, including minimum wages, calculation of wages, application of special work hour systems and social security contributions.

5 Articles 10 and 82 of the Labor Contract Law.

6 Article 14 of the Labor Contract Law.

7 Article 82 of the Labor Contract Law.

8 Employee fault for this purpose includes:

- The employee is proved not to fulfill the requirements of recruitment during the probation period;
- The employee seriously violates the labor discipline or the work rules and regulations of the employer;
- The employee is in serious breach of his/her duties, or engages in misconduct that has caused material loss to the employer;
- The employee has entered into an employment relationship with another employer which materially affects the completion of his/her tasks with the (first) employer (and the employee refuses to rectify the situation after the matter is brought to his/her attention by the employer);
- The employee enters into the labor contract by means of fraud, threat, force or exploitation; or
- The employee is prosecuted for criminal liability.

9 Severance in connection with employment termination is provided for under Article 47 of the Labor Contract Law and the relevant local labor contract regulations and generally involves a payment of one month's salary for each year of continuous employment with the employer.

10 In the case of a successor outsourcing (sometimes referred to as a re-sourcing) or a repatriation of the services to the Customer (sometimes referred to as an in-sourcing), the Incumbent Employee would be the employee of the incumbent Supplier. Such transactions occur with relative frequency in mature outsourcing markets, and the applicable considerations should be generally consistent with an initial outsourcing.

11 See "Going to China" referenced in footnote 1 above.

12 That is, the implementing legislation of member states under the Council of European Communities Directive 77/187 of 14 February 1977 (the "Acquired Rights Directive").

13 Under Article 46 of the Labor Contract Law, an employee is not entitled to severance in the case of voluntary resignation.

14 Employment benefits affected by length of employment include annual leave entitlement and severance entitlements.

15 Rule 10 of the PRC Labor Contract Law Implementation Rules by and effective from September 18, 2008.

16 The Supplier may enter into confidentiality and non-compete covenants with a Supplier Employee restricting him or her from providing Services to competitors of the Customer during the term of employment. However, if such restriction is to be effective even after the termination of employment between the Supplier and the Supplier Employee, such non-compete period cannot exceed two years following such termination, and the Supplier is obligated to pay compensation to the Supplier Employee within such post-employment restrictive period.

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We are noted for our commitment to client service and our ability to assist clients with their most complex and demanding legal and business challenges worldwide. We serve many of the world's largest companies, including a significant proportion of the Fortune 100, FTSE 100, DAX and Hang Seng Index companies and more than half of the world's largest investment banks. We provide legal services in areas such as Supreme Court and appellate; litigation; corporate and securities; finance; real estate; tax; intellectual property; government and global trade; restructuring, bankruptcy and insolvency; and environmental.

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