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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 $100 billion.

Editors' Note

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Welcome to the Winter 2012 edition of the Mayer Brown *Business & Technology Sourcing Review.*

Our goal is 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 cover a range of topics, including:

- Estimating the value for contract terms in sourcing agreements;
- The emergence of "As-A-Service" offerings beyond cloud computing;
- The European Union's Article 29 Working Party guidance on privacy and security concerns for cloud computing;
- Benchmarking clauses in outsourcing agreements;
- The ramifications of using supplier capital in the outsourced manufacturing framework in China;
- Aligning sourcing and tax principles in contact manufacturing;
- Transferring software licenses even when they say they are "non-transferable;" and
- Material breach in outsourcing contracts.

You can depend on Mayer Brown to address your sourcing matters with our global platform. We have served prominent clients in a range of sourcing and technology arrangements across multiple jurisdictions for over a decade.

We'd like to hear from you with suggestions for future articles and comments on our current compilation or if you would like to receive a printed version, please email us at BTS@mayerbrown.com.

If you would 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. ◆

An Innovative Approach to Collaborative Contracting

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Companies regularly work with technology providers on collaborative projects. In collaborative projects, the customer and the technology provider each bring key resources and expertise as they work together to, for example, implement a complex new computer system. The customer's goals are generally to obtain the intended results on time and within budget. Unfortunately, the provider has conflicting incentives to have the project be larger and cost more. All other things being equal (including price), each party would like the other to do more of the work.

In collaborative projects, the customer and the technology provider each bring key resources and expertise as they work together to, for example, implement a complex new computer system.

Contracts for collaborative projects often produce poor results. Systems implementation projects, for example, are notoriously late and over budget. One possible reason is the mindset that contracting lawyers bring to these projects. Because collaborative projects involve services, they are documented as services agreements. The critical role of the customer in providing resources and expertise is expressed in broad "assumptions" that regularly turn out to be incorrect as the project unfolds. The contract may require the technology provider to pay "credits" for failing to meet "milestones," but those credits are often not payable because of incorrect assumptions.

We have been working with clients on what we believe to be an innovative approach to collaborative contracting.

On a parallel path, a team of technologists is often documenting a project agreement that works well and is called a "project plan." The project plan assigns each party the responsibility to perform activities and deliver results, such as software that works well. The project plan recognizes the role of collaboration by indicating that a party's level of involvement may range from responsible to assisting to consulted to informed. The project plan is often designed and managed by certified project management professionals. Regrettably, the project plan often has little to do with the legal agreement. Also, the project plan lacks the force of law.

We have been working with clients on what we believe to be an innovative approach to collaborative contracting. The approach consists of the following steps:

STEP 1:	Determine Deal Structure
STEP 2:	Determine Project Stages
STEP 3:	Define Activities and Deliverables
STEP 4:	Allocate Responsibilities
STEP 5:	Establish Milestones
STEP 6:	Link Compensation to Milestones
STEP 7:	Link the Collaborative Contract to the Project Plan

In this new approach, the legal contract reflects the project plan in allocating responsibilities for activities and deliverables to the parties. This approach has three advantages. First, it gives legal force to the project plan, which is a substantial benefit to project leaders who often have few tools beyond pestering and escalating. Second, it allows the customer personnel who will be running the project to take lead roles in defining the contractual obligations through a well-organized template. Finally, it creates a contract that is used, delivering actual value, instead of being put in a desk drawer and becoming increasingly irrelevant as reality diverges from the contract assumptions.

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In our brief experience with this approach, it appears to provide surprisingly good results. Collaborative project customers tell us that they have more control over their projects and more ability to obtain their desired business outcomes. The providers tell us that they find this approach reduces risk and builds stronger relationships.

We are writing this article to share what we hope to be valuable insights and to solicit thoughts from our readers on how we might improve these ideas and their usefulness.

Step 1: Determine Deal Structure

First, determine a structure for the project by asking such questions as:

- What is the scope of the project?
- When should it be completed?
- Who is responsible generally for what parts of the project?
- What constitutes completion? How will progress be measured?
- How will the amounts payable to the provider be determined?

The pricing for collaborative projects is often designed to create an incentive for timely, on-budget completion of deliverables. Common structures include fixed fees, fee caps, holdbacks, milestone credits (payable by the provider for failure to meet project milestones) and discounts that increase as the price rises.

Step 2: Determine Project Stages

Second, determine the high-level stages for the project. For example, these are typical stages for an enterprise resource planning (ERP) implementation project:

- Design or blueprinting
- Build or development or realization
- Test or verification
- Rollout or deployment
- Support or maintenance

Other collaborative projects may have other stages, such as “Project Kick-Off.” As lawyers, we find that the customer’s project manager generally knows the stages well and, if not, there likely are “best practices” available that define the stages.

From a contracting standpoint, it helps if stages are designed so that completion of one stage will be a "stage gate" (what we lawyers might call a condition precedent) to beginning the next stage. In any event, stages should be defined based on when they start, the activities and deliverables to be completed, and when they end.

From a contracting standpoint, it helps if stages are designed so that completion of one stage will be a "stage gate" (what we lawyers might call a condition precedent) to beginning the next stage. In any event, stages should be defined based on when they start, the activities and deliverables to be completed, and when they end.

Step 3: Define Activities and Deliverables

This third step is where the collaborative contracting approach diverges from the traditional services contract approach. Traditional services contracts tend to describe each of the stages identified above, as well as the associated activities, deliverables and milestones, by fitting them into a narrative description, often in no particular order and using varying terms for the same concepts. This results in a contract that is confusing, too long, internally conflicting and difficult to amend to reflect the natural evolution of the project. So it often ends up in a desk drawer instead of being an effective tool to deliver business outcomes.

In step three, we recommend that the parties identify the activities required to complete the project, without regard to which activities will be performed by the supplier as "Services." As the parties identify activities, tangible outputs of those activities are also identified and described as deliverables. For each activity and deliverable, the parties agree on completion criteria. In this effort, the customer's business and technical teams provide the substance and the legal team documents that substance at a contract-level of clarity.

Each activity and deliverable is assigned a capitalized defined term that can be used in the remainder of the document. Those defined terms are then listed on an Activities Exhibit and a Deliverables Exhibit.

These defined terms are the fundamental building blocks for later stages and create a modular approach that is easier to modify and easier for the drafters and reviewers to manage—most typically the engineers who will be completing the project or living with its consequences upon completion. For example, the contract might use the term "Module X Specifications" as follows:

- **In Stage 1:** Interview persons listed in Exhibit Q to obtain data required for Module X Specifications.
- **In Stage 2:** Develop Model X Specifications and obtain customer's approval.
- **In Stage 3:** Develop Module X such that it complies with the Model X Specifications in unit testing.
- **In Stage 4:** Test integrated system, including verifying that the integrated system complies with the Model X Specifications.

Dividing the activities from the deliverables creates a cognitive discipline and contractual rigor that forces the parties to address up front what they both expect will be included in the scope of the project.

Not all activities will result in a deliverable. For example, testing may result in a post-test report, but it is the test itself that the implementer is being paid to perform. Activities can be divided between those of "intrinsic" value (those that are an end in themselves) and those of "instrumental" value (those that are a means to result in a deliverable). Dividing the activities from the deliverables creates a cognitive discipline and contractual rigor that forces the parties to address up front what they both expect will be included in the scope of the project.

Step 4: Allocate Responsibilities

The activities are not all "services" to be performed by the implementer. In a typical services agreement, the descriptions focus on what the provider will do for the customer, with the customer's sole responsibility being paying for services. Some customer negotiators take a general approach that customer obligations are to be avoided.

In collaborative projects, the customer, by definition, makes meaningful contributions to completing the

project. There may be independencies and overlapping requirements that the supplier cannot manage and complete on its own. Further, even if the supplier can complete an activity on its own, doing so may not be practical or economically efficient. Thus, by failing to describe customer obligations, or by simply making assumptions about what is required by the customer, the traditional approach fails to capture the complete scope of the project.

In collaborative projects, the customer, by definition, makes meaningful contributions to completing the project. There may be independencies and overlapping requirements that the supplier cannot manage and complete on its own.

In a collaborative project contract, we define activities in the same way, regardless of whether the customer or provider will perform them. We then create a matrix showing, for each defined activity, which party will be "Responsible" and whether the other party will be "Assisting," "Consulted" or "Informed." Each of those terms should be defined. For example, the definitions might clarify that a Responsible Party manages, executes and completes; an Assisting Party provides commercially reasonable assistance to the Responsible Party; a Consulted Party is involved in discussions to provide guidance but not assistance; and an Informed Party merely receives progress reports. In practice, the customer might be Responsible for end user testing, but the provider might be classified as Assisting by, for example, providing guidance on testing methods and software attributes. Specific types of assistance can be defined if known when contracting, but the nature of collaborative projects makes it difficult to do so comprehensively.

This approach works better than the common alternative of assigning responsibilities to both parties or making them joint responsibilities. Joint responsibilities fail to establish a contractual commitment, because neither party can be in breach.

This approach also works better than the traditional approach in which the customer seeks to impose broad obligations on the supplier and the supplier seeks to evade them by including broad "assumptions" in a footnote or at the end of the document. For example: "This price assumes that Client will provide resources and information as needed for completion of the project." Using such assumptions creates a number of problems:

- The assumptions are removed from the context and the chronological order of the particular stage and thus often work poorly in practice.
- The assumptions are often poorly defined, without a way for either party to establish or confirm that the activity has been completed.
- Such vagueness causes disputes that delay the project and harm the working relationship between the customer and provider.

Step 5: Establish Milestones

In this approach, a milestone is the date when the Responsible Party must complete a specified set of activities. We recommend defining milestones after defining activities and deliverables for the project and allocating responsibilities for completing those activities and deliverables. Under the traditional approach, defining milestones involves difficult, relationship-challenging negotiations, with tortured language describing the qualifications and establishing exceptions, limitations and assumptions. We believe that this occurs because the parties attempt to define milestones before completing the hard work of defining activities and deliverables and allocating responsibilities. Providers are sensibly averse to promising to complete an undefined portion of an undefined task by a time certain, particularly without a commitment from the customer to timely do necessary work. Contentious milestone discussions are only a symptom of the larger problem that the project goals and scope have not been clearly defined and documented.

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Under the collaborative contracting approach, the parties can reference the applicable activities and deliverables and make achievement of the appli-

cable milestone contingent on completion of those activities and deliverables. Because there are defined terms for each activity and deliverable, milestones can be defined in a way that is both simple and accurate using those defined terms. The milestone should clearly point to the elements that make up the desired completion stage-gate, including the intrinsic and the instrumental activities.

The milestone definitions will appear in an exhibit that describes the entire scope of the project, from beginning to end, as a series of achievements in a certain order, each vetted and agreed upon by the parties. Each milestone gets its own capitalized defined term for easier reference when documenting pricing and follow-on milestones, as well as for use in future amendments and operational "Milestone Submission" and "Milestone Completion" notices. Rather than fitting the entire description of a milestone into a single cell of the date table, the name points to the building block description, which in itself is derived from activities and deliverables.

Step 6: Link Compensation to Milestones

Customers who see value in sharing schedule and delivery risk with the provider or providing a monetary incentive for the provider to achieve desired business outcomes can do so by linking the provider's compensation to the milestones.

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For example, fees might be payable in whole or in part only when a Milestone Completion Notice has been signed by the customer. Alternately, the provider might be required to grant or pay "milestone credits" for late achievement of milestones or might be able to charge only limited amounts for work connected with particular milestones. Here again, the documentation is simplified when there are defined terms associated with each milestone.

Step 7: Link the Collaborative Contract to the Project Plan

The definitions of activities, deliverables, responsibilities and milestones become the skeleton of the project plan. The project plan will include numerous sub-activities, such as allocations of work activities to named people, and interim deliverables, such as initial drafts of deliverables.

The definitions of activities, deliverables, responsibilities and milestones become the skeleton of the project plan.

To link the project plan to the contract, the project plan should be built using the defined terms and milestone dates from the contract. Then, when those aspects of the project plan evolve, the parties agree to modify the contract to reflect the changes.

Better project plans, because they are built on well-defined terms, mitigate the risk of misunderstanding and dispute that comes from trying to capture difficult concepts in small cells on spreadsheets or project plans.

The value of linking the project plan to the contract includes:

- Better understanding of the contract obligations, because those are integrated into the plan that the teams use every day.
- Legal, financial, procurement and management personnel review of key changes to the project plan (because related changes are needed to the contract).
- Enabling the project team to use the legal rights in the contract as tools to motivate the provider to make the project plan successful.
- Better project plans, because they are built on well-defined terms, mitigate the risk of misunderstanding and dispute that comes from trying to capture difficult concepts in small cells on spreadsheets or project plans.

We believe that the approach described here is a significantly better way to document a collaborative contract, because it reflects the necessary collaboration and fits with the way these projects are actually run. Particularly when used with the templates that we have developed for this approach, we believe that it takes less time overall and less legal cost, because it allows project managers to take a leading role.

Conclusion

We believe that the approach described here is a significantly better way to document a collaborative contract, because it reflects the necessary collaboration and fits with the way these projects are actually run. Particularly when used with the templates that we have developed for this approach, we believe that it takes less time overall and less legal cost, because it allows project managers to take a leading role. We look forward to discussing it with clients and friends. ◆

The Emergence of "As-A-Service" Offerings That Are Not Cloud Services

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There is a growing category of outsourcing services that we are encountering that have many of the characteristics of cloud services but are, in fact, not cloud services. While this category of service offerings (which we refer to as "XaaS" for this article) does not fit into the definition of cloud services, it is also very different from standard outsourcing services: it includes offerings such as backup and restore as a service, voice as a service and hosting as a service.

In this article, we will describe this category of service offerings and discuss how it differs from standard cloud computing and outsourcing offerings. We will also look at the implications of these distinctions for contracting purposes.

In many cases, XaaS offerings are promoted by new entrants and suppliers in the outsourcing arena, particularly equipment and software providers that are adding service offerings as a means to ensure a continued market for their products among customers who are increasingly attracted to buying services rather than investing in capital assets. These new entrants are oriented toward sale of their products and associated support services, and they approach the contract terms for their XaaS offerings from the standard of a standard product sale, which can place them at odds with customer expectations.

There are a number of important similarities and differences between XaaS offerings and typical cloud services. The XaaS offerings include standardization of architecture and leveraging common processes, tools, release schedules and resources, which allow the supplier to more easily scale the solution. However, XaaS falls short of cloud computing where it relies on an embedded, largely dedicated infrastructure, which imposes fixed costs on the supplier. As a result, the XaaS supplier cannot offer the elasticity and on-demand features of cloud services, and, instead, may require exclusivity or a term or volume commitment as a means of ensuring the supplier can cover its costs and earn a reasonable return.

The particular terms for these XaaS offerings can vary significantly. Each supplier's offering has to be assessed very carefully for not only the stated cost of the services, but also for the exit costs and risks associated with the service. There can be some substantial compromises required with XaaS offerings for which many customers are not fully prepared.

Some of the factors that have to be weighed in the decision of whether to use these services include (i) the ability of the customer to move to an alternate service provider, (ii) the competitive sensitivity of the outsource function,

(iii) the criticality of the outsourced function and (iv) the customer's reliance on the vendor's IP and knowledge for support of the outsourced function.

Cloud services suppliers will only commit to their standard service offering, which the supplier reserves a right to change from time to time. XaaS suppliers will commit to a more detailed description of its services, and those services are often adapted to meet the particular customer's needs.

Service Commitments. As noted above, the supplier's investments often require it to obtain a customer commitment for a minimum term or revenue, which is markedly different from true cloud contracts. We find that this is often less of a concern in practice, since a customer often needs a corresponding commitment by the supplier for continuity of services to ensure the availability of mission-critical support services and sufficient time to plan the transfer upon termination to an alternate provider. This means that the customer will require a corresponding term commitment by the supplier to continue providing services under the same terms. True cloud contracts, by comparison, typically allow the supplier to discontinue the services and change the terms under which the services are offered on little notice.

Cloud services suppliers will only commit to their standard service offering, which the supplier reserves a right to change from time to time. XaaS suppliers will commit to a more detailed description of its services, and those services are often adapted to meet the particular customer's needs. Indeed, the extent of adaptability of the offering often determines the customer's ability to use the XaaS service.

Service Quality Protections. With cloud services, there is typically no testing or acceptance process, since the service is a standard offering that does not vary by customer. XaaS, on the other hand, typically includes customer-specific features or functions and, therefore, includes testing of key transition milestones and deliverables against agreed-upon criteria. Cloud services often come with only a few service levels and no service level credits. However, even when service level credits are included, they are generally nominal or accompanied with unrealistic hurdles for obtaining them. The service levels for XaaS are designed for the supplier's technology architecture, which means they are naturally constrained by the capabilities of that architecture, but the customer can obtain meaningful service level credits. This is important because XaaS often relies on infrastructures or environments that are dedicated to the customer. Consequently, an XaaS provider cannot rely on the typical cloud provider's claim that "service level credits are unnecessary as a quality incentive, because the provider's failure to maintain high quality would have an equal effect on all of its customers."

However, unlike cloud arrangements, XaaS solutions often allow specialized configurations and customer-selected third-party software to be integrated into, or interfaced with, XaaS solutions.

Customer Control Rights. Standardization of basic architecture is central to XaaS offerings, so the customer will have little to no control over that. However, unlike cloud arrangements, XaaS solutions often allow specialized configurations and customer-selected third-party software to be integrated into, or interfaced with, XaaS solutions. In this respect, XaaS offerings allow more control than true cloud offerings.

Similarly, where a cloud provider retains the right to change its architecture with limited notice or consent from a customer, XaaS offerings include more constraints that require some change control process to protect the customer. An XaaS provider retains the right to update its offering to current versions of the technology, but those changes are contractually required to be implemented with notice, testing and assurance that they will not have a material adverse effect on the customer.

Compliance Obligations. A cloud provider's standard service comes with no commitment to comply with any particular laws. With XaaS offerings, the provider's flexibility may be limited by its architecture, but the discussion regarding compliance with laws does not significantly differ from those in other outsourcing agreements: Suppliers generally resist commitments to comply with any customer-specific laws but will agree to laws applicable to their delivery of services to the customer. Customers of XaaS offerings typically receive audit

rights to allow the customer to verify that the service meets the contractual requirements. Cloud offerings seldom include such an audit right.

An important distinction between the typical XaaS offering and cloud services is the customer's increased ability to obtain data protection assurances.

Data and Security Protections. An important distinction between the typical XaaS offering and cloud services is the customer's increased ability to obtain data protection assurances. With cloud services, data may be processed and stored anywhere, the customer has no right to approve subcontractors, supplier controls are not subject to review or approval, and there is no guaranty that all data will found and erased or returned. With XaaS offerings, data location is fixed in the contract, there are agreed-upon limitations on subcontractor access to data, the level and type of security is often a customer-selectable option, and the contract includes assurances regarding the return or destruction of data.

Intellectual Property Protections. With cloud services, the supplier retains ownership of all IP, the only exception being the customer's ownership of the data it provides. XaaS suppliers are equally concerned about retaining ownership of their standardized solutions, but there are sometimes exceptions for customer-specific adaptations. However, the XaaS supplier's concern about protecting the flexibility of its "solution" may result in a joint ownership or a license option in lieu of sole ownership of those adaptations by the customer.

Service Continuity Protections. Cloud service contracts contain no commitments regarding continuity of personnel, allow the supplier to interrupt services for suspected violation of usage rules and contain no business continuity commitment. The picture is much different with XaaS arrangements, which lend themselves more easily to some personnel continuity commitments, interruptions of service are limited to protecting service integrity and are limited in scope and time; and business continuity is often available as priced options based on the amount of protection required.

Termination Assistance. Termination assistance with cloud contracts often amounts to no more than a commitment to return the customer's data; the customer has no rights to continue using any of the supplier's IP following expiration or termination of the services. XaaS contracts often include a commitment to assist the customer with the transition of services back to the customer or to another supplier, including the customer's right to extend the period of the services as needed to ensure a smooth transition.

[T]he XaaS supplier's concern about protecting the flexibility of its "solution" may result in a joint ownership or a license option in lieu of sole ownership by the customer.

Post-Termination Rights. Post-expiration or termination rights vary with the nature of the services. For XaaS suppliers that are also in the business of selling their hardware and licensing their software, the customer generally has the right to purchase or license the components for continued use. In addition, where customized changes or configurations are made to allow integration with the customer's environment or customer-selected third-party software, it is not unusual for the customer to obtain a license to continue using those customizations.

XaaS offerings do not provide all of the on-demand and elasticity features of cloud services. However, they do offer many of the benefits of standardization without many of the pitfalls that stymie the adoption of cloud services by large companies concerned about protecting their important functions and sensitive data.

XaaS offerings do not provide all of the on-demand and elasticity features of cloud services. However, they do offer many of the benefits of standardization without many of the pitfalls that stymie the adoption of cloud services by large companies concerned about protecting their important functions and sensitive data. XaaS may well be the bridge for companies to eventually design their processes and systems to allow them to migrate many of their systems to cloud computing in the future. ◆

Cloud Computing—Article 29 Working Party Guidance on EU Privacy and Security Concerns

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The Article 29 Working Party established under the EU data privacy legislation published an opinion on 1 July 2012 addressing the data privacy compliance concerns associated with the use of cloud computing solutions.

The Working Party identified the concerns as falling into two categories:-

- **Lack of Control:** Cloud clients lose control of the technical and organisational measures necessary to ensure the availability, integrity, confidentiality, transparency, isolation and portability of data;
- **Lack of Information Processing:** Insufficient information about a cloud services processing operation poses a risk to controllers as well as to data subjects, because they might not be aware of potential threats and risks and, therefore, cannot take measures they deem appropriate.

The opinion is a reminder of the key contractual safeguards that must be put in place between the controller and the cloud service provider. The cloud service provider must agree to follow the instructions to the controller and must implement technical and organisational measures that are adequate to protect the personal data being put into the cloud-based solution. Among the particular provisions specified by the Working Party are:

The opinion is a reminder of the key contractual safeguards that must be put in place between the controller and the cloud service provider.

- an obligation by the cloud provider to supply a list of the locations in which the data may be processed;
- a general obligation by the provider to give assurance that its internal organisational and data processing arrangements (and those of subprocessors) are compliant with applicable national and international legal requirements and standards.

These two requirements are sometimes problematic for the customer, and the fact that they are specifically referred to in the opinion will strengthen the negotiating position of controllers wishing to put in place arrangements for the processing of personal data by cloud service providers.

Working Party recommendations include:

- a controller should select a cloud service provider that guarantees compliance with the EU data privacy regime by agreeing to the specific contractual protections referred to below;
- where (as is almost inevitably the case) a cloud service provider

subcontracts processing to subprocessors, this should only be permitted where the identity of the subprocessor is disclosed to the data controller and the cloud service provider flows down its contractual obligations to the data controller to its sub-processors so that the controller has some contractual recourse in the event of breaches by subprocessors.

The specific contractual protections include:

- only authorised personnel to have access to the data;
- subcontractors must be identified and the controller must have a right to terminate the contract in the event of changes;
- cross-border transfers of data shall only be permitted where lawful—for example, because the recipient has executed the EU model terms—and the cloud provider must guarantee the lawfulness of cross-border transfers;
- the controller must have the right to audit the processing activities.

The opinion also raises the possibility that independent verification or certification of compliance with the requirements specified in the opinion could be provided by an independent third party, such as ISO, the IAASB or the Auditing Standards Board of the American Institute of Certified Public Accountants.

Data controllers who deploy or plan to deploy cloud computing solutions should review the Working Party recommendations and treat them as a checklist of the issues to cover in any cloud services contractual arrangement.

Action

Data controllers who deploy or plan to deploy cloud computing solutions should review the Working Party recommendations and treat them as a checklist of the issues to cover in any cloud services contractual arrangement. ◆

Benchmarking Clauses in Outsourcing Agreements: Keys to Success

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John Lytle is Consulting Director at Information Services Group, Inc. With more than 30 years of experience as an IT executive, John provides hands-on global leadership to ISG clients, and has specific expertise across IT business alignment and optimization, sourcing strategy and rationalization, and infrastructure strategy development as well as network administration, software development, vendor management, and e-commerce.

Benchmarking clauses in outsourcing contracts are an established mechanism to gauge the competitiveness and quality of service delivery. A benchmark review can help a client and service provider determine if services are aligned with market standards for price and quality, define adjustments that can and should be made, and identify additional opportunities for improvement or innovation.

Despite these potential benefits, benchmarks have gotten a bad rap in some quarters. One reason is that, in fact, traditional benchmark reviews have often wrongly focused on the pricing of discrete slices of operational performance, neglecting the big picture of service delivery and overall business objectives. When that happens, the review process can degenerate into a standoff between the client and service provider, with one side demanding immediate price adjustments and the other challenging the validity of data and comparative references.

Effective benchmark clauses and benchmark outcomes are characterized by a transparent process involving the client, service provider, and third-party advisor, with data and comparative references agreed upon upfront. The terms of the clause must be clear, specific, actionable, and realistic.

Here are some specific keys to success and pitfalls to avoid:

- **Challenge a provider who insists on excluding a certain benchmark partner from consideration.** That could indicate a past case of being "caught with their hand in the cookie jar." All of the major players in the contract benchmarking market have well-established and defendable methodologies. Often the issue is finding the benchmark partner who best fits the client's scope, scale and complexity. Since only a finite number of deals are reviewed each year, no single benchmark firm can have the deepest insight into all environments.

- **Insisting on a specific "percentile" outcome may in fact not be reasonable based on the scope, scale and complexity of the deal.** Do not let the partner dictate the process used to execute a benchmark, as this is not their core competency.
- **Since the deal's original intent often gets lost with time, changing business pressures and current operational or strategic needs, early documentation must be preserved for consideration in future benchmarks.** Regardless of the alignment of the agreement, determine what will be benchmarked: the contract, the services being requested by the client, or the services being delivered by the service provider.
- **Use the benchmark results to define clear, actionable and time-boxed activity.** Resist attempts to soften the next steps by inserting "best effort" language, as that can effectively leave you with no clear way forward.
- **Do not put the onus on improvement solely on the service provider.** Rather, identify potential actions for the *client* organization as well. For example, are client processes inefficient and cumbersome, and can they be rationalized to allow the service provider to leverage economies of scale? Are the client's reporting requirements unnecessarily cumbersome and can they be streamlined?

Applied in this manner, the contractual benchmark can be a win/win for both parties. ◆

Unprotected Tooling: High-Risk Practices in Chinese Manufacturing

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Former Mayer Brown attorney, Thomas Keenan, contributed to this article.

As a result of globalization and the ability of consumers to purchase products at the lowest cost, manufacturers in China have become an integral part of the supply chains of many consumer product companies.

With the high level of integration of consumer product companies and their overseas manufacturers in China, there is an increasing reliance on manufacturers to finance, fabricate and manage customer tooling for plastic injection, metal stamping or die casting—the core equipment components in the manufacturing process.

With the high level of integration of consumer product companies and their overseas manufacturers in China, there is an increasing reliance on manufacturers to finance, fabricate and manage customer tooling for plastic injection, metal stamping or die casting—the core equipment components in the manufacturing process.

During the last 15 years, many product companies viewed the use of manufacturer capital for tooling as "free money" and subsequently lowered their own financial thresholds for moving forward with a project—and, in doing so, did not fully appreciate the issues that emerge when the proper safeguards are not in place. The value of the tooling involved is not small, and it is not uncommon for a manufacturer to hold and manage millions of dollars of customer tooling at any one time.

Managing the issues relating to tooling assets remains one of the more difficult elements of manufacturing arrangements. Unclear apportionment of rights and responsibilities, including use of underlying intellectual property, repair, misuse and "end-of-life" issues, can give rise to a number of issues. This article will look at the most common issues relating to Original Design Manufacturer (ODM) and Original Engineering Manufacturer (OEM) supplier-managed tooling and will discuss some solutions that should be incorporated in any manufacturing agreement that contemplates a manufacturer's use and management of customer tooling.

Managing the issues relating to tooling assets remains one of the more difficult elements of manufacturing arrangements.

Tooling: An Integral Part of the Outsourcing Process

Manufacturing agreements often include provisions for the handling of customer-supplied equipment (including machinery, jigs and fixtures) but do not adequately cover

the manufacturer's responsibilities across the full tooling life cycle from fabrication, use, maintenance and end-of-life. Due to the potentially severable nature of a piece or set of tooling from the overall manufacturing process, it is best practice to incorporate all terms relating to tooling in a separate tooling agreement so that the unique issues that arise with respect to tooling are less likely to impact the other manufacturing activities.

Unclear apportionment of rights and responsibilities, including use of underlying intellectual property, repair, misuse and "end of life" issues, can give rise to a number of issues.

Manufacturer-customer relationships differ significantly according to the nature of the manufacturer, the provenance and ownership of the product design, the incorporated intellectual property and the ownership of and rights in the tooling in question. A common mistake many customers make is to incorporate blanket terms in their purchase agreements, stating that they own the exclusive rights to all tooling used in the manufacture of their products, regardless of ownership of the toolings.

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Purchase agreements where the customer will not own the tooling (for ODM products) should also contain basic warranty clauses that provide that the manufacturer owns and has an unencumbered use of the toolings to manufacture the products. These agreements should also include manufacturer indemnity clauses that protect the customer against future infringement actions taken by others claiming that the products infringe their intellectual property rights. Absent outright ownership of the tooling, a customer cannot move its manufacturer's tooling in the event the customer wants or needs to change its source of supply. In the case of an ODM manufacturer, the customer typically purchases a product "off-the-shelf," and the tooling will have already been designed, financed and fabricated by the manufacturer, and the customer's rights to the underlying toolings will be accordingly limited.

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Tooling Financing and Ownership

Tooling financing and ownership are the most difficult tooling issues because of the intersection of title, use and equity liens on tooling in the possession and use of a manufacturer in China. If a customer has agreed that the manufacturer will fabricate tooling (tool-up) a product or purchase it from a third-party tooling house, then issues of funding must be settled. Under ordinary agreements, if a manufacturer is to finance the tool, it is common practice for the manufacturer to quote for tooling at up to several multiples of the actual fabrication cost/subcontractor quotation to account for interest on the capital employed and to hedge against possible non-recovery of some portion the amortized value of the tool.

Most manufacturers employ a simple tooling amortization mechanism based on a proportion of the expected commercial life requirements, not physical life-cycle capabilities, in production shots of the tooling. In a traditional tooling arrangement, the customer has provisions that allow for the manufacturer to finance the purchase or fabricate the tooling and charge back the customer on a per-piece (amortized) basis as the finished products or components ship. However, unless title is specifically vested in the customer at the outset (first production), title will remain in the manufacturer until the end of the amortization period, despite any payments that the customer already made. This is important because, unless properly structured, tooling agreements can leave the customer hamstrung and married to a supplier that jeopardizes its supply chain if the relationship

turns sour. This leaves the customer to consider financing a second tooling with a second manufacturer and running the risk of leaving partially paid-for tooling with the first manufacturer.

Common Problems

A common problem with manufacturer-financed toolings is that it is often difficult for the parties to track the number of "usable" shots from the tooling that have been charged back to the customer through the amortization process. Unless the customer remains vigilant, it is likely that the manufacturer will continue to charge for tooling amortization well after actual amortization is complete.

A common problem with manufacturer-financed toolings is that it is often difficult for the parties to track the number of "usable" shots from the tooling that have been charged back to the customer through the amortization process.

Another common problem is the use of the tooling for "second shift" production: production of product for the local market, or for a customer in another market, beyond the first customer's knowledge. Tooling agreements need to specifically allow for conditioned use of the tooling, as well as licensed use of any customer intellectual property in the tooling. Further, the provisions that outline those restrictions need to survive the agreement. Revocation of the license to use the intellectual property in the tooling is a means of restricting the supplier from legally using the tooling or creating another set of tooling with the intellectual property.

Customers should have the right to dictate the fate of the tooling used in their products at the end of product life cycle and, importantly, must maintain the discipline to take action at that moment—for a variety of reasons.

Tooling agreements should also contain a manufacturer guarantee that requires the manufacturer, as the fabricator or commissioner of the tooling, to replace a broken or defective tooling during the useful life of the tooling equipment. To avoid difficulties, it is often advisable to require the manufacturer to take out insurance to cover the cost of replacing the tooling. Additionally, as the tooling is in the supplier's use, control or possession during its useful life, the supplier should be required to clean, repair and maintain the tooling according to industry norms. The manufacturer should further be required to engrave (not tag) the customer's asset number into the tooling with a statement to the effect that the tooling belongs to the customer. This should help to give notice to a potential buyer that title in the tooling is vested in the customer and not the manufacturer.

Customers should have the right to dictate the fate of the tooling used in their products at the end of product life-cycle and, importantly, must maintain the discipline to take action at that moment—for a variety of reasons. The first reason takes the offensive—maximizing useful life value of the equipment. As mentioned above, many toolings are amortized over their expected "commercial" life rather than their physical life—meaning that a piece of hardened steel tooling equipment may be fully amortized over 200,000 pieces yet have an actual useful life of more than 1 million pieces. Thus, while the product cycle for one market may be completed, there actually may be much more life in the tooling (value), and it is possible for the tooling to have a highly productive "second life" for years after its "completed" initial use. This situation is compounded when there are multiple cavities and sets of the same tooling created to meet initial market requirements.

Ideally, a customer should be able to dictate what happens to all tooling for its products throughout the equipment life.

The second reason the customer should hold the right to dictate the fate of the tooling is defensive. If the fate of tooling equipment is not entirely in the hands of the customer, the manufacturer may be motivated to make independent use of the toolings, whether to recover any remaining payments or merely seeking to optimize the manufacturer's return. Ideally, the customer should be able to dictate what happens to all tooling for its products throughout the equipment life. A good customer tooling management agreement includes clear

end-of-life provisions, including collection to a central customer-controlled repository or certified destruction on site.

Tooling in the Real World

In order to analyze the risk associated with manufacturer-owned and -managed tooling, it is useful to consider two different real world scenarios: (i) where the customer needs to move production to another manufacturer and (ii) where the product life-cycle ends before the end of the amortization period.

A good customer tooling management agreement includes clear end-of-life provisions, including collection to a central customer-controlled repository or certified destruction on site.

In the first scenario, although the customer has effectively paid for a portion of the tooling value through production payments, such amortization gives rise to any clear customer title or rights to the toolings. With title remaining vested in the manufacturer, the manufacturer has a number of options (provided the tooling does not contain any of the customer's intellectual property); it can use the tooling for its own purposes (production and sales), sell it to a third party or destroy it.

If the tooling contains the customer's intellectual property, then the manufacturer can legally hold or destroy the tooling, but cannot use it for its own purposes or sell it. However, it is not uncommon in a situation where relations have broken down between the parties that a manufacturer would use or sell a tooling that contains the customer intellectual property to recover any remaining value of the tooling.

To avoid this problem, the customer should insist that title to the tooling vests in the customer at first production and that the tooling is then subject to a bailment arrangement. In essence, such an arrangement has the customer lending the tooling to the manufacturer for the customer's use. This bailment arrangement is coupled with a financing agreement—essentially a mortgage agreement with the tooling as mortgaged collateral, but with the important distinction that the customer has legal title to the tooling and an equitable right to redeem the mortgage and reclaim possession.

Repayment of the tooling value is still done on a piece-count basis, and, under such an arrangement, the parties are more likely to record the actual number of products made. This offers a twofold benefit to the customer. First, the customer is more likely to get a lower "close–to-market" tooling quotation, because the manufacturer is not required to hedge its risks by building in a contingency factor. Secondly, the direct costing impact makes the customer more likely to be vigilant in counting the number of products shipped in order to ensure discharge of the mortgage and to avoid being overcharged by the manufacturer.

In the second scenario, product manufacturing has stopped before the amortization piece-count was achieved, and the manufacturer has title to the tooling equipment that has not been fully paid for. Despite not having met the full amortization piece-count quantity, the customer will likely have some interest in preventing the manufacturer from using the tooling for the manufacturer's own sales and keeping the tooling from falling into the hands of a third party, especially a party that may feed a market competitor.

[T]ooling agreements should include comprehensive provisions that take into account the full range of possible issues and that hold the realistic prospect of enforceability.

It is important that the customer be able to exercise its rights to collect or immobilize the tooling for safe keeping or to have the tooling destroyed by the manufacturer. A bailment and mortgage arrangement as outlined above is well suited to provide the customer with this power. Depending on the circumstances, the customer may want to license, sell or grant to the manufacturer the right to the use the toolings and some or all of the intellectual property or simply pay off the outstanding amount to discharge the mortgage. Under such an arrangement, the customer will have tools that should enable it to control how the tooling is managed for the remainder of the tooling life-cycle.

Importance of Comprehensive, Enforceable Tooling Arrangements

For the reasons highlighted above, tooling agreements should include comprehensive provisions that take into account the full range of possible issues and that hold the realistic prospect of enforceability. For this, with Chinese manufacturers, contracts governed by Hong Kong can be effective. Hong Kong judgments, as well as Hong Kong arbitration awards orders, can be enforced in Mainland China. Court awards from the United States and many other jurisdictions are not afforded such enforcement.

Tooling agreements need to incorporate specific terms for all relevant tooling, based on their circumstances.

It is inevitable that, in any given customer-manufacturer relationship, different factors govern different pieces of tooling in use at any given time. Tooling agreements need to incorporate specific terms for all relevant tooling, based on their circumstances. Customers that source products through Chinese manufacturers using their own capital for manufacturer-fabricated and -managed tooling face much the same range of problems as those who use manufacturer capital. It is good practice to create and diligently work through an issues checklist that takes into account each of the problems highlighted above in each customer-manufacturer relationship and ensure that tooling agreements include provisions to address them.

Careful consideration and treatment of the tooling issues in any customer-manufacturer arrangement can avoid problems and set the stage for predictable manufacturing and protection of customer assets and business opportunities, both during the product life-cycle and afterward.

Conclusion

Tooling constitutes one of the most basic components of manufacturing, and, consequently, is a critical issue to get right in any arrangement for manufacturing in China. Careful consideration and treatment of the tooling issues in any customer-manufacturer arrangement can avoid problems and set the stage for predictable manufacturing and protection of customer assets and business opportunities, both during the product life-cycle, and afterward. ◆

Alignment of Sourcing and Tax Principles in Contract Manufacturing

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Contract manufacturing offers a variety of benefits to non-US subsidiaries of US-based multinational companies that want to outsource the manufacture of their products to be sold in the United States.

Contract manufacturing offers a variety of benefits to non-US subsidiaries of US-based multinational companies that want to outsource the manufacture of their products to be sold in the United States. It includes the provision of manufacturing and supply services, such as sourcing, manufacturing, packaging and labeling of products, by an offshore manufacturer for the benefit of a multinational company's non-US affiliate. The non-US affiliate then transfers title to the products to the multinational parent company, or one of its US affiliates, prior to the time the products enter the US. Profits from the sale of the products are recognized by the offshore affiliate. Such profits generally are not subject to US tax until the non-US affiliate dividends the funds up to the US parent (or another US affiliate).

Fundamental sourcing principles apply to contract manufacturing services in virtually the same manner in which they apply to other outsourcing arrangements. Contract manufacturing agreements should include:

- Provisions ensuring the timeliness and quality of product research and development;
- Strong quality assurance and internal controls covering, among other things, raw material sourcing, the manufacturing processes and the products themselves;
- Performance standards, including service levels and development milestones, coupled with remedies for failure to meet the same; and
- Appropriate intellectual property protections related to both the products and tooling.

Further, the agreement should have (i) cost control provisions, (ii) efficient and effective inventory, forecasting and ordering processes, (iii) timely delivery requirements, (iv) appropriate termination rights and (v) post-termination transition obligations to ensure the uninterrupted availability of products. Product quality should be enforced through, among other things, reporting obligations, inspection and audit rights, remedies for defective products and failure of the contract manufacturer to meet its obligations and an active program of exercising and enforcing these rights.

Similarly, from a tax perspective, the offshore affiliate must make a "substantial contribution" to the sourcing, manufacturing, packaging and labeling of the products. Many of

the key factors examined to support the substantial contribution test align well with sourcing principles:

- **Quality standards/controls.** It is essential that the offshore affiliate retain and exercise rights of inspection and control over the manufacturing process and the products themselves. This includes (i) requiring that the contract manufacturer employ adequate equipment, production methods and manufacturing quality control procedures to ensure that the products meet the specifications and that the products are manufactured in compliance with good manufacturing practices, (ii) rights of the offshore affiliate to inspect and test the manufacturer's performance and facilities in order to ensure compliance by the manufacturer with its obligations under the agreement, (iii) tight product specifications and controls over changes thereto and (iv) the right of the offshore affiliate to make recommendations to improve the manufacturing processes and to exercise remedies should the contract manufacturer decline to adopt such recommendations.

Quality standards/controls. It is essential that the offshore affiliate retain and exercise rights of inspection and control over the manufacturing process and the products themselves.

  The tax principles related to quality standards and controls align nicely with key sourcing principles concerning quality assurance, internal controls and performance standards discussed above.

- **Cost savings.** Another important factor to support the "substantial contribution" test is the right of the offshore affiliate to maintain cost controls. This is usually accomplished through requiring the manufacturer to provide detailed data related to the costs of raw materials and packaging materials and other manufacturing costs on a regular basis, accompanied by rights of the offshore affiliate to audit the books and records of the manufacturer.

  The above tax principle aligns well with the key sourcing principles around cost control and cost savings. A "cost plus" structure is common in contract manufacturing, which means there will be some fluctuations in prices due to the changes in the costs of raw materials, together with a fixed charge or fixed pricing methodology for the manufacturer's services. From a sourcing perspective, the offshore affiliate will want to maintain controls over costs to support the goal of cost reduction.

- **Raw materials sourcing/vendor selection.** Under most contract manufacturing arrangements, the offshore affiliate will have the right to provide raw materials to the manufacturer or to direct the manufacturer in purchasing raw materials. The offshore affiliate can further establish its substantial contribution to the manufacturing and supply services by bearing the costs and risk of loss associated with the raw materials.

  The ability of the offshore affiliate to maintain controls over raw materials sourcing will enhance the ability to maintain quality over the products, consistent with sourcing principles.

  Nevertheless, there are instances where there is a divergence between tax and sourcing principles: for example, with the issues of risk of loss, indemnities and transfer of title. An offshore affiliate's substantial contribution to the manufacturing process is enhanced through bearing risks and assuming indemnity obligations related to raw materials, manufacturing processes and the products themselves (with the likely exception of risks related to the negligence or breach of contract by the contract manufacturer). Similarly, the tax structure requires that title to the products transfer outside of the US, with title often transferring either at the manufacturer's facilities or just outside the territory of the country in which the manufacturer's facilities are located and the multinational bearing the risk of loss related to the products while in transit. No similar benefit exists under sourcing principles, and the typical sourcing position is to require that the manufacturer bear such risks.

Outsourcing principles and tax requirements need to be coordinated in order to meet contract manufacturing objectives. In many instances, sourcing principles support a company's tax objectives. However, in instances where sourcing principles and tax requirements diverge, the arrangements must be structured carefully from both a sourcing and tax perspective to achieve the desired results. ◆

When Is a Software License Transferable Even If It Says It's Nontransferable?

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Second-hand Software Licenses and the European Court's Judgment in *UsedSoft v. Oracle*

Software companies cannot prevent the sale of "second-hand" software licenses where those licenses are for a one-off fee and an unlimited period. Clauses in these licenses stating that they are nontransferable will not be enforceable. This is the effect of a recent judgment by the Court of Justice of the European Union in the case of *UsedSoft GmbH v. Oracle International Corp.* (3 July 2012).

The case is based on EU competition law "exhaustion of rights" principles, according to which, once a product incorporating intellectual property rights has been sold inside the EU by the rights owner (or with his consent), the rights owner cannot object to the product then being sold to someone else. The European Court has now looked at how that principle applies to software licenses.

UsedSoft is a Munich-based company (www.usedsoft.com) that on-sells used software licenses for Oracle and other products. Oracle's licenses were expressly stated to be nontransferable, and Oracle sued UsedSoft in Germany. The German court referred a number of questions up to the European Court back in April 2009 to determine whether or not UsedSoft's business model was legitimate.

Relevant Clause of Oracle License

"With the payment for services you receive, exclusively for your internal business purposes, for an unlimited period a non-exclusive non-transferable user right free of charge for everything that Oracle develops and makes available to you on the basis of this agreement."

Key Legal Provisions

Recital (28) of InfoSoc Directive[1]
"The first sale in the Community of the original of a work or copies thereof by the rightholder or with his consent exhausts the right to control resale of that object in the Community."

Article 4(2) of Software Directive[2]
"The first sale in the Community of a copy of a program by the rightholder or with his consent shall exhaust the distribution right within the Community of that copy ...".

Article 5(1) of Software Directive
"In the absence of specific contractual provisions ... [acts such as running, copying, translating etc., the program] shall not require authorisation by the rightholder where they are necessary for the use of the computer program by the lawful acquirer in accordance with its intended purpose, including for error correction."

Software companies cannot prevent the sale of "second-hand" software licenses where those licenses are for a one-off fee and an unlimited period.

The Decision

When Oracle's original customer downloaded software from the Oracle web site, was this a "first sale", which would mean that Oracle could not object to the on-sale? "First sale," in this context, the Court said, means a transfer of the right of ownership in the particular copy of the software.

The Court went on to say that, if the copyright holder (i.e., Oracle), who has authorised the downloading of the software (even if free of charge) has also conferred a right to use that copy for an unlimited period in return for "payment of a fee intended to enable him to obtain a remuneration corresponding to the economic value" of that copy of the software, the right of distribution of a copy of a computer program is exhausted. It does not make any difference whether the first customer acquired the software on a tangible medium, such as a CD, or downloaded a soft copy.

In other words, the software company cannot sue the buyer of a second-hand license where the license was:

- For a fee that represents the value of the software, which seems to mean a one-off fee (i.e., not a recurring license fee that is still payable after the sale of the second-hand license) and
- For an unlimited period.

The person who buys the second-hand license in this situation is a "lawful acquirer" (as is anyone to whom he on-sells the license), which means that the software house cannot use its copyright to object to the buyer using the software or on-selling the license.

Not All Bad News for Software Companies

However, there are limits to this freeing up of the second-hand market in software licenses.

- As noted above, it does not apply where the software is licensed for a recurring fee or for a limited time (nor where software is rented). So those business models are not affected.
- Where the license is for a single block of users, you cannot split it up into chunks and sell off only part of the license for the excess number of users. So "enterprise" licenses, as opposed to individual licenses, are not affected unless the original licensee wants to sell off the right to use the whole block.
- You cannot sell a services agreement (such as a software maintenance agreement) in this way, since the exhaustion principle does not apply to services. So the acquirer of the license cannot oblige the software company to provide services.

Where the license is for a single block of users, you cannot split it up into chunks and sell off only part of the license for the excess number of users.

- The original licensee must not carry on using the software after the sale; otherwise it will be infringing copyright. It must make its own copy of the software "unusable." Technical protection measures may provide some help, but, in practice, it will be hard for Oracle and other software houses to be absolutely sure whether the original customer is still using the software in parallel with the acquirer of the second-hand copy.

These limits on the judgment may influence the business models adopted in the software industry wherever the existence of a second-hand market is seen as posing a significant threat. ◆

Endnotes

1 Directive 2001/29/EC of the European Parliament and of the Council of 22 May 2001 on the harmonisation of certain aspects of copyright and related rights in the information society.

2 Directive 2009/24, which codifies Council Directive 91/250/EEC of 14 May 1991 on the legal protection of computer programs.

Material Breach in Outsourcing Contracts

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A well-negotiated outsourcing agreement typically grants a customer the ability to terminate the arrangement without payment of any penalties in the event of a "material breach." However, unless the agreement names specific events that constitute a material breach, that determination will be left to a court. While there are no "bright line" rules to assist a court in making its decision, some case law exists that offers customers guidance in navigating these murky waters. In particular, the primary focus of a recent case, *State of Indiana v. IBM*,[1] was whether or not the State of Indiana was properly entitled to terminate its agreement with IBM for material breach.

This article will explore some of t he key points that can be gleaned from cases where material breach was a focus of the litigation and will culminate in some concepts and best practices that customers can implement to provide more predictability when evaluating whether a supplier materially breached an agreement.

What Constitutes a Material Breach?

When is a supplier in "material breach" for its failure to perform in an agreement? Law treatises offer some guidance to assist with that determination. For example, a material breach has been explained as a breach that "is so fundamental to a contract that the failure to perform … defeats the essential purpose of the contract," "go[es] to the 'root' or 'essence' of the agreement," or "touches the fundamental purpose of the contract and defeats the object of the parties in entering into the contract."[2] One authority, *The Restatement (Second) of Contracts*, recommends a multi-factor test that courts can invoke to determine whether a breach is material. Specifically, the court should consider the following factors:

- The extent to which the injured party will be deprived of the benefit that he or she reasonably expected
- The extent to which the injured party can be adequately compensated for the part of that benefit of which he or she will be deprived
- The extent to which the party failing to perform or to offer to perform will suffer forfeiture
- The likelihood that the party failing to perform or to offer to perform will cure his or her failure, taking account of all the circumstances, including any reasonable assurances
- The extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.[3]

Another view on materiality offers this insight: "Ordinarily the issue of materiality is a mixed question of law and fact, involving the application of a legal standard to a particular set of facts. However, if reasonable minds cannot differ on the issue of materiality, the issue may be resolved as a matter of law."[4]

In Illinois, a material breach is one that is "so substantial and fundamental as to defeat the objects of the parties in making the agreement, or whether the failure to perform renders performance of the rest of the contract different in substance from the original agreement."

How have state courts interpreted the issue of material breach? In Illinois, a material breach is one that is "so substantial and fundamental as to defeat the objects of the parties in making the agreement, or whether the failure to perform renders performance of the rest of the contract different in substance from the original agreement."[5] Case law in Illinois further opines that a "breach must be so material and important to justify the injured party in regarding the whole transaction at an end."[6]

In applying these concepts, Illinois courts have stated that "[t]he determination of materiality must turn on the facts of each case" and that, "to properly consider whether [a] defendant's breach was material, it is necessary to begin by placing that breach in context."[7] An Illinois court will most likely apply the multi-factor test cited above from *The Restatement (Second) of Contracts* to determine the materiality of the breach. However, one Illinois court has also examined external and/or industry factors to determine whether the "custom or usage shows the breach to be material."[8]

Courts in California have adopted the majority of the multi-factor test set forth in *The Restatement (Second) of Contracts* but have slightly modified the elements and added some additional factors to consider. In lieu of examining the extent to which an injured party will be deprived, the California test examines "[t]he extent to which the injured party will obtain the substantial benefit which he could have reasonably anticipated." The test in California will also consider "the greater or less hardship on the party failing to perform in terminating the contract" and "the willful, negligent, or innocent behavior of the party failing to perform."[9]

In New York, courts have defined a material breach as a breach "that goes to the root of the contract."[10] Moreover, a court in New York will evaluate whether a breach is material using this guidance: "A breach is material if a party fails to perform a substantial part of the contract or one or more of its essential terms or conditions, the breach substantially defeats the contract's purpose, or the breach is such that upon a reasonable interpretation of the contract, the parties considered the breach as vital to the existence of the contract ... [or] if the promisee receives something substantially less or different from that for which he or she bargained."[11]

State of Indiana v. IBM

So how will a court apply the multi-factor test to determine whether a party indeed materially breached its obligations under an outscoring agreement? There is scant case law on the topic, but an Indiana court recently provided some insights with its decision in *State of Indiana v. IBM*. In 2006, the State of Indiana and IBM entered into a 10-year, $1.3 billion outsourcing agreement under which IBM would transform and modernize the state's welfare system. The project, which was intended to overhaul a welfare system that produced the worst welfare-to-work record in the country, was designed to let Indiana citizens apply for welfare benefits online or via a call center, while eligibility determinations would be made on a "centralized, statewide basis rather than in the local country welfare offices." However, the transformed system produced high error rates and slowed the pace of eligibility determinations. In 2009, the State of Indiana terminated its contract with IBM by invoking the termination for cause provision of its master services agreement, citing that IBM was in material breach for "quality and timeliness."[12]

IBM and the State of Indiana eventually found themselves in court; the state sued IBM for $1.3 billion, claiming breach of contract. IBM countersued the state for the value of equipment it was obligated to leave with the state under the terms

of the agreement. The court stated that both parties were to blame, and that, consequently, "[n]either party deserves to win this case." In its ruling, the court invoked parts of the multi-factor test from *Williston on Contracts* and concluded that the state failed to meet its burden to show that IBM committed a material breach, despite a record showing that "IBM did not perform well in some respects." [13]

In its ruling, the court invoked parts of the multi-factor test from and concluded that the state failed to meet its burden to show that IBM committed a material breach despite a record showing that "IBM did not perform well in some respects."

Two factors from the multi-factor test played a prominent role in the court's decision of whether IBM materially breached the agreement, namely, "the extent to which the injured party will be deprived of the benefit which he reasonably expected" and "the likelihood that the party failing to perform or to offer to perform will cure his failure." Despite a painful transformation, the court determined that the state was able to achieve a "new welfare system that works better" as a result of the modernization efforts with IBM. The court found this fact "to have great weight regarding whether there is a material breach or not." In its opinion, the court states that "[a]ll in all, the State was not deprived of benefits it reasonably expected from the contract, although some benefits were not received as smoothly as the parties would have expected."[14]

As to the second factor, the court acknowledged that determining IBM's performance was "premature and problematic" given the length of time the parties were bound under the agreement before the state terminated. (The final term of the agreement was 19 months—only 12 of which contained applicable performance measures.) Despite the state's claim that IBM breached the agreement for "timeliness" and the court's acknowledgement that key performance metrics for timeliness were "consistently missing the mark," the court found that IBM's performance was "steadily improving during 2009, especially in the months leading up to the October 2009 termination." Based on this, the court extrapolated IBM's performance and determined that IBM's failures had the "likelihood of being cured" and were "apparently in the process of being cured." Consequently, the court did not find that IBM materially breached the agreement under this factor and did not devote much effort to evaluating the other three factors.[15]

Nonetheless, the court considered another issue when determining whether there was a material breach—the extent to which the breach went "to the heart of the contract," stating that, "where a party substantially performs, there is no material breach." This finding is perhaps the most troublesome for customers of outsourced services, because the court did not grant much deference to IBM's service level performance, and, instead, determined that "these examples ... have to be balanced against the whole of the contract and IBM's whole performance showing benefits to the State and adhering to [master service agreement] policy objectives."[16]

Two factors from the multi-factor test played a prominent role in the court's decision of whether IBM materially breached the agreement, namely, "the extent to which the injured party will be deprived of the benefit which he reasonably expected," and "the likelihood that the party failing to perform or to offer to perform will cure his failure."

As a result of the court's findings, IBM was able to avoid the material breach claim by only meeting between 50 and 80 percent of its service levels. In fact, the court minimized problems that many IT managers would find unforgiveable, such as a 48-hour call center outage under IBM's watch. The court refused to give much credence to the State of Indiana's breach claims for performance items that were not measured by service levels, but it did give strong deference to a clause in the agreement that disclaimed any warranty of "uninterrupted or error-free operation." When analyzing these performance items, the court refused to impute any additional interpretation in light of that disclaimer. The court also refused to grant much credence to the state's claim of dissatisfaction with IBM's performance as a basis for material breach and indicated

that customer satisfaction was one of eight enumerated ways to judge IBM's performance.[17]

Uncertainty for Customers of Outsourcing and Recommendations

The ruling in *State of Indiana v. IBM* does not support the finding of material breach on which the state based its termination claim. While that court applied the multi-factor test to determine whether IBM materially breached its obligations, it chose to focus on two factors and view the agreement from a more holistic point of view.

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As was discussed above, case law in other states suggests that all factors of the multi-factor test should be considered, and the facts of the case should be evaluated to determine if the essence of the agreement has been violated. The court in *State of Indiana v. IBM* took the position that performance metrics that failed to meet certain levels did not violate the main objective of that agreement—namely, to have a better welfare eligibility system. However, performance metrics are typically heavily negotiated items in an outsourcing contract; the State of Indiana was purchasing not only a welfare system that worked better than the worst system in the country, but one that met certain performance metrics for the price it agreed to pay.

In light of this uncertainty, there are several measures a customer of outsourcing services can implement to minimize the chance of a similar judgment and provide more assurances that a court will support a termination for material breach:

- Memorialize specific events that the parties agree would constitute material breach, such as failure to meet a specified number of service levels or intellectual property theft, and that would allow termination without the payment of termination charges. A court will enforce these negotiated items, but, even if a breach does not meet the requirements of these "bright line" events, they can still be useful in assessing whether the breach in question is material and offering the court some guidance.
- Include a notice requirement in the agreement prior to terminating for a "bright line" material breach event and provide an opportunity to cure the defect. Notice to the supplier will reveal any arguments it may have that the conduct at issue does not meet the "bright line" test.
- In addition to memorializing specific "bright line" material breach events, ensure that the agreement has a general material breach provision. Ensure that important operational items are the subject of performance measurements. For example, the call center in the agreement between the State of Indiana and IBM did not have a service level to measure the timeliness of answering phone calls, a fairly standard call center metric.
- Define specific standards of performance and try to avoid ambiguous terms, such as "industry standards" or performance that is "appropriate," "sufficient" or a "best practice."
- Ensure that service levels have meaningful service level credit amounts to stress the importance of achieving those measurements. In *State of Indiana v. IBM*, the court commented that the service level credits were "miniscule" and consequently failed to give much weight to the importance of missed service levels.
- Try to minimize the number of service levels to avoid diluting the "At Risk Amount;" if this cannot be achieved without compromising operational performance, group service levels in a few performance categories.
- Do not position service level credits as liquidated damages. In *State of Indiana v. IBM*, the service level credits at issue were actually labeled "liquated damages" in the agreement, and the court viewed IBM's payment of these "liquated damages" as an alternative means of performance. Most customers prefer to have the service levels met rather than to receive financial compensation for missed performance.

- Break up big projects into smaller deliverables with measurable results.
- Set service levels that allow for termination if performance falls below a predefined metric. ◆

Endnotes

1 *State of Indiana, et al., v. International Business Machines Corporation* (Marion Superior Court, Cause No. 49D10-1005-PL-021451).

2 23 Williston on Contracts § 63:3 (4th ed.).

3 Restatement (Second) of Contracts § 241 (1981).

4 23 Williston on Contracts § 63:3 (4th ed.).

5 *Village of Fox Lake v. Aetna Casualty & Surety Co.*, 178 Ill. App.3d 887, 900–01, 128 Ill.Dec. 113, 534 N.E.2d 133 (1989).

6 *Id.*, at 901.

7 *Machesney v. World Novelties, Inc.*, 363 Ill.App.3d 558, 844 N.E.2d 462, 300 Ill.Dec. 464.

8 *McBride v. Pennant Supply Corporation*, 253 Ill.App.3d 363, 623 N.E.2d 1047, 191 Ill. Dec. 461.

9 *Sackett v. Spindler* (1967) 248 Cal.App.2d 220, 229.

10 *Department of Economic Development v. Arthur Andersen & Co.*, 924 F.Supp 449, 483.

11 *Viacom Outdoor, Inc., v. Wixon Jewelers, Inc.*, 25 Misc.3d 1230(A), 2009 WL 4016654 (N.Y.Sup.), citing 23 Williston on Contracts § 63:3 (4th ed.).

12 *State of Indiana, et al., v. International Business Machines Corporation*, at. 9, 3-4, 36.

13 *Id.*, at 1, 38 [citing 23 Williston on Contracts § 63:3 (4th ed.)], 2.

14 *Id.*, at 40, 41, 46.

15 *Id.*, at 46, 47.

16 *Id.*, at 38, 47.

17 *Id.*, at 49, 51.

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