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# Allocating Risks in Outsourcing

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# Allocating Risks in Outsourcing

## Introduction

All contracts allocate risks. Contract negotiation largely consists of allocating risks. Zealous counsel attempt to shift as much risk as possible to the adversary, while minimizing their own client's exposure. This is hardly surprising, but in outsourcing, as the parties begin a prolonged, intimate (or at least entangled) business relationship, other considerations come into play. Risk allocation commonly (and properly) respects lessons learned in kindergarten about cleaning up one's own mess.

Outsourcing is different because the closing is just the beginning. When real estate is sold the deal is complete when the deed is recorded and funds are released. The parties rarely contemplate further dealings, and hope that any surviving obligations (indemnities, for instance) will lapse uneventfully. With outsourcing, signing begins a relationship meant to last years. The contract will not succeed unless both sides succeed. The customer expects good service for a fair price. The supplier expects to deliver that service profitably. The contract may succeed, in part, because risks are allocated fairly, to give both parties incentives to perform when issues arise (as they surely will). Conversely, each side's interests merit reasonable protection.

Ultimately, the relationship matters more than the contract; but each should reinforce the other. Lopsided contracts usually come to grief. Customers saddled with excessive risks (and thus costs) are hardly likely to renew contracts, or extend their scope. Suppliers with minuscule margins may be tempted to skimp on service, work to the letter of the contract, and bombard the customer with change requests. These outcomes are recipes for trouble.

This paper examines risks that commonly arise in outsourcing contracts, suggests ways in which those risks can be allocated, and reviews typical contractual protections, including representations and warranties, liability limits and termination rights, among others.

## 1 What Risks?

Risk allocation necessarily begins with an assessment of risks. What exactly could go wrong? In complex outsourcing relationships, a great deal can go wrong. Several kinds of risk spring to mind:

- *Operational Risks* such as poor (or merely mediocre) service, or botched transitions (at commencement or conclusion of the contract) that disrupt operations and involve substantial direct and indirect costs.

- *Financial Risks*, including excessive consumption, project overruns, unexpected (thus unwelcome) change requests or third party charges. Suppliers want to be paid. Each side ponders the other's solvency.

- *Scope* may be the most frequent source of friction after signing. Suppliers fear "scope creep" that erodes margins. Customers fear blizzards of "nickel and dime" change requests.

- *Security Risks* such as disclosure of sensitive information to competitors through transfers of personnel, breaches of security or wrongdoing. Suppliers wish to keep their methods to themselves, rather than allow a customer to disclose their stock-in-trade to a competitor when the relationship ends. Customers may value the supplier's experience in their industry, but have no desire to share their own secrets with competitors served by the same supplier.

- *Legal and Regulatory Risks* affect not only such regulated industries as health care and banking, but increasingly, most businesses (for example, when obliged to comply with new security or privacy laws and regulations). Who is responsible for recognizing these issues as they arise, and paying costs of compliance? What if violations occur?

- *Extraordinary Risks* include the familiar circumstances that constitute *force majeure* – fire, flood, earthquake, and now terrorism. Parties must also consider other extraordinary risks and events, including acquisitions and divestitures, changes in control, environmental contamination and misconduct of various kinds. These include many "worst cases" – remote, but potentially ruinous contingencies.

This list is not exhaustive, but illustrates the range of circumstances for which a good contract should provide, through (i) customary protections, such as representations, warranties, indemnities, termination rights and other remedies; (ii) processes meant to prevent (or at least mitigate) unpleasant contingencies; and (ii) allocation of residual risks between the parties.

## 2 Representations, Warranties And Covenants

Contracts should (but often do not) distinguish representations and warranties (verified "snapshots" of circumstances at signing) from covenants (affirmative obligations to take or refrain from particular action during the term of the contract).

Outsourcers prefer to avoid the term "warranty," which suggests "guarantee" to jurors. "Representations" may invite fraud claims that might expose the outsourcer to unlimited liability and enhance the customer's leverage in settlement negotiations. Customers often have sufficient leverage to insist that various commitments be phrased as representations or warranties. For their part, customers resist warranting the condition of, among other things, their assets and facilities.

### *2.1 Mutual Representations, Warranties And Covenants*

Many outsourcing contracts contain customary representations and warranties concerning corporate power and authority, good standing, authorization by appropriate corporate action, and the absence of defaults, or conflicts with any law, judgment or other obligation. These are rarely controversial, although some may be limited to material issues within management's knowledge. As in other complex transactions, these reciprocal obligations assure accountability in the unlikely event that corporate formalities have not been observed, or the transaction violates some other obligation. Requesting these and other representations and warranties helps to "smoke out" potential issues.

Often, each side provides some proprietary software or intellectual property, so there may be mutual representations and warranties concerning the absence of infringements and claims of infringement (or at least known infringements or claims). Like some other representations and warranties, this is often coupled with an indemnity, and a corresponding covenant to refrain from infringements.

Both parties usually covenant to comply with applicable laws and regulations, and represent that (at least except as disclosed) no proceedings are pending or threatened concerning alleged violations. When employees are transferred, or the supplier operates from customer facilities, particular attention should be paid to health, safety, environmental and employment laws. When assets are transferred, suppliers may request additional, specific protections, as in any other purchase of assets.

Occasionally, one side or the other may request representations to the effect that customer disclosures or supplier proposals are complete, accurate and without material omissions. These are rarely acceptable. Customer data and disclosures are rarely complete. Suppliers do not warrant sales presentations.[1]

### *2.2 Customer Representations, Warranties And Covenants*

The supplier may ask for a variety of representations and warranties. Where assets change hands and employees are transferred, the representations and warranties resemble those seen in acquisitions. Typical requests include:

[1] General scope or sweep clauses, discussed in Section 7, below, are another way to manage and allocate risks associated with undocumented responsibilities or assets. Suppliers often condition pricing upon assumed conditions, such as consumption data, that, if missed, justify additional charges.

- Clear title to transferred assets, free from liens and security interests. This may be inaccurate if the assets are subject to lenders' blanket liens. In practice, since computers depreciate rapidly, these representations and warranties have modest importance, and are rarely controversial.[2]

- Transferred equipment is in good working condition, excluding wear and tear. Customers universally prefer to unload assets as they are, without warranties, on an "as is" basis, asserting that the supplier is free to inspect equipment, or review operational records. The supplier may request instead a representation and warranty that the equipment is, and has been, maintained to manufacturer's specifications under a manufacturer's maintenance contract.

- There are no material, uncured defaults under leases, maintenance contracts, software licenses and other third party contracts assigned or otherwise transferred to the supplier. The supplier may also request assurance that it has received complete sets of all transferred licenses, leases and other agreements, including all amendments.

- Operational, consumption and similar data used to determine charges are accurate. Customers resist this representation, since data may be incomplete or inaccurate, and never agree to blanket assurances that all disclosures were complete, accurate and current. Suppliers may protect themselves indirectly, by conditioning their charges upon explicit assumptions, with adjustment rights if baseline assumptions prove incorrect.

- Hardware, software and other assets transferred or made available to perform services are sufficient for that purpose. This matters when suppliers take over and manage existing operations in place (so-called "facilities management"), but is less important when data centers, help desks and other operations are consolidated in the supplier's facilities.

- There are no violations of law, or pending or threatened proceedings concerning transferred assets, contracts and employees. When large numbers of employees are transferred, employment claims are a particular concern. When the supplier operates customer facilities, or the customer provides office space for the supplier's staff, suppliers may request detailed representations and warranties concerning

[2] When suppliers purchase data centers or other facilities, they generally request the same representations, warranties and indemnities as other purchasers of real estate, notably concerning title, environmental contamination, compliance with zoning and other laws, and the condition of facilities, among others. Since sales of facilities are commonly documented separately, as real estate transactions, apart from the basic services agreement, they are not treated here.

compliance with health, safety and environmental laws, and the absence of any proceedings.

### *2.3 Supplier Representations, Warranties And Covenants*

Customers often request the following:

- Covenants or warranties to the effect that the supplier will deliver good professional service that meets or exceeds good industry standards (or some similar form of words). Customer drafts may be replete with references to quality, reliability, efficiency and other imprecise terms, to which suppliers object (even when they seem to echo sales presentations). Customers usually agree that, whatever the language, general quality standards do not alter or supersede agreed service level commitments.

- Covenants to maintain equipment and software, and keep them up-to-date through regular replacements (or "refresh" as it is known). Suppliers sometimes contend that this should be up to them, so long as they meet agreed service levels (which do not, however, measure all aspects of all services). Customers fear older, failure-prone equipment, and the possibility of inheriting museum pieces when the contract expires. The final language may qualified by reference to any agreed commitments to replace or upgrade systems, and limited to more important and expensive items (since PCs and other inexpensive equipment may simply be replaced).

- Covenants to perform efficiently and minimize charges. Many charges are consumption-based, and may depend, in part, upon efficient tuning and management by the supplier. Customers fear that the supplier will just run the meter and maximize revenues. Suppliers have misgivings about guaranteeing efficiency, which involves judgment and may not become contentious until the relationship is in difficulties, when circumstances invite second-guessing. Moreover, efficiency is not always the supplier's exclusive responsibility. In recent years, the market has moved toward more granular, quantitative pricing, driven by customer usage and demand. Efficiency commitments can be tempered by references to reasonable efficiency, good industry standards and a limitation to matters within the supplier's control.
- Representations, warranties and covenants to the effect that the supplier has authority to use all required software. Suppliers often wish to qualify this commitment, bearing in mind the hazards of obtaining consent, and current litigation risks – including claims concerning open-source systems and certain patents upon call center technology. Some suppliers, as targets of those claims, attempt to limit representations, warranties and indemnities concerning these issues. They point out, with some justification, that customers' own operations already contend with these risks, if those operations include call centers, Linux or other disputed technologies.

- Covenants or warranties concerning detection and eradication of viruses. In a sense, viruses, like vandalism or other crimes, are a kind of *force majeure* event, and introduction of viruses may depend in part upon users. However, customers want, if not ironclad guarantees, at least an assurance that the supplier will use commercial tools and best practices to prevent introduction of viruses, and, when necessary, cleanse infected systems and data. Sometimes, the parties agree to share financial responsibility for virus attacks, either proportionally, or above some "deductible" built into the price.

- Representations and warranties that the supplier has not offered any kickbacks or other improper inducement to win the customer's business.

- Warranties concerning the quality of hardware and software products supplied under the outsourcing contract. These follow the pattern in other sales of similar products. Suppliers limit their commitments concerning third party hardware to transferable warranties from manufacturers, and disclaim implied warranties. Warranties of newly developed software are generally brief, and limited to significant flaws. When scope includes applications maintenance, post-warranty support is essentially the same as support for other proprietary software. Support for third party software commonly consists of configuration, tuning, coordination with the third party licensor, and the installation of updates and fixes supplied by the licensor. One party or the other is commonly required to contract with the licensor for support, in order to assure access to telephone support, updates and other maintenance.

### *2.4 Disclaimers*

Suppliers generally propose to disclaim:

- Implied warranties, including merchantability or fitness for a particular purpose (although these may have limited application to services, as opposed to sales of goods).

- Warranties concerning the accuracy of any advice, reports or data delivered to the customer, or business results from action the customer may take based on the supplier's advice, reports or data. This complements and reinforces restrictions upon recovery of consequential damages.

- Any warranty or assurance that any service, or the operation of any computer, network or other system will be uninterrupted or error-free. Suppliers reason that (as most users know only too well) technology is imperfect, and even the most stringent service levels (such as 99% availability) leave some slight margin for error.

Customers naturally prefer to avoid, or at least pare back any disclaimers. If service levels and warranties are reasonably stringent, they may agree to dispense with implied warranties and accept some other disclaimers.

## 3 Indemnities

Representations and warranties are often paired with corresponding indemnities, or there may be a general indemnity against third party claims related to breaches of representations and warranties. Often, the principal indemnities are reciprocal. Both sides are supposed to obey laws, refrain from infringements, use reasonable care and the rest.

Occasionally, as in other transactions, one party or the other may propose to indemnify, but without giving a corresponding representation or warranty. The recipient may appreciate the commitment to defend and indemnify against claims of infringement, for example, but still wish to know that there are no known claims, and reserve the ability to pursue damages for breach against the other party.

### *3.1 Mutual Indemnities*

Many indemnities are mutual and symmetrical, or nearly so. Each side, for example, usually indemnifies the other against personal injury and property damage claims. These kinds of claims are often insured, and rarely controversial.

Typical mutual or reciprocal indemnities include:

- Claims by transferred employees concerning their employment. The customer is generally responsible for claims arising before transfer. Thereafter, the supplier bears responsibility. The supplier should also be responsible (here, or by virtue of its obligation to obey the law) for acts or omissions in its selection of transferred employees before the contract was signed.

- Claims concerning equipment leases, software licenses, maintenance agreements and other contracts transferred to the supplier. Again, the customer is responsible before transfer, and the supplier, thereafter. Since many of these contracts may be software licenses, this indemnity may overlap the indemnity against infringements.

- Breaches of confidentiality. This too may overlap with infringement claims, since software and other licenses contain strict nondisclosure provisions.

- Infringement of patents, copyrights, trade secrets and other intellectual property rights. Generally, the indemnitor has no responsibility to the extent claims concern unauthorized modifications, misuse, or infringing matter, acts or omissions by the indemnitee. The indemnitor generally insists upon reasonable flexibility to defend the claim, procure a license, provide a substitute or, if there is no practical alternative, discontinue use of infringing materials and any affected service. Customers, on the other hand, want reasonable assurance of continuous service, however the supplier may deal with any claims of infringement.

- Violations of law. Each side generally indemnifies the other against claims concerning its violations of applicable law. When assets and employees are transferred, the supplier uses customer facilities, or particular regulations apply, there may be additional or more specific representations and warranties concerning specific laws and regulations.

### *3.2 Supplier Indemnities*

Customers sometimes request additional indemnities from their suppliers:

- Apart from the basic obligation to comply with laws, and indemnify the customer against violations, suppliers are sometimes asked to defend the customer against failures to comply with legal or regulatory requirements attributable to the supplier's acts or omissions (excluding, of course, actions or omissions directed by the customer).

- Customers sometimes propose that suppliers indemnify them against claims covered by whatever insurance the contract may require. Suppliers may object to this broad indemnity, especially if commercial general liability or umbrella coverage is required. In practice, many indemnities are supported by insurance, and contracts often require suppliers to obtain insurance.

- Where services are provided from facilities shared with other customers, a customer may require indemnification against any claims arising from shared use.

### *3.3 Customer Indemnities*

When suppliers buy assets, and especially facilities, they seek (as noted earlier) representations and warranties concerning title to those assets, the assets' condition, and the facilities' compliance with health, safety and environmental laws. They also request corresponding indemnities, or a blanket indemnity against all claims related to the representations and warranties.

Apart from asset sales, there is generally less need for suppliers to require additional indemnification from their customers. Customers are not passive after signing, but their primary obligations are payments, rather than performance.

### 3.4 Indemnification Procedures

The procedures for indemnification resemble those in other contracts, and commonly include:

- Prompt notice, with full particulars, sometimes with time limits, and in any event without prejudicial delay.

- Cooperation in the investigation and defense of claims.

- Control of the defense by the indemnitor, with counsel reasonably acceptable to the indemnitee. One firm usually defends all parties, unless conflicts require separate counsel. The indemnitee may engage separate counsel, at its own expense, even where the indemnitor provides a defense.

- Settlements require both sides' approval, which should not be unreasonably withheld or delayed. Greater discretion may be reserved where resolution involves equitable relief, affects confidential information or intellectual property, does not release all liability, admits liability or otherwise involves more than payment.

- After payment, an indemnitor is usually subrogated to the indemnitee's claims, but insurance carriers are sometimes asked to waive subrogation rights.

Liability is generally proportional, and in any event limited to the extent of the indemnitor's responsibility. Neither party indemnifies the other against its own negligent or wrongful acts, errors or omissions. Indemnities against infringement, for example, do not apply to the extent that claims concern unauthorized modifications of the indemnitor's software.

### 3.5 Insurance

Customers often require that suppliers' indemnities be backed up by insurance coverage, such as workers compensation (required by law), automobile liability, comprehensive public liability, employee dishonesty, errors and omissions, and computer fraud, among others. Counsel (unless expert in insurance) generally do not advise clients what policies or amounts of coverage are appropriate, leaving that business decision to their clients' risk managers. Whatever the coverage requirements, customers may ask that they: (i) be additional insureds (at least for some policies); (ii) approve carriers (often based on ratings), (iii) receive proof of insurance, and (iv) notice of any cancellation or reduction in coverage. Suppliers would, of course, prefer simply to maintain workers' compensation coverage (which the law requires) and such other coverage as prudent people would maintain. Occasionally, large suppliers provide some coverage through self-insurance. Most policies have substantial deductibles, for which the supplier is responsible.

Whether to insure is, of course, a business decision. Insurance coverage can help to protect the business relationship, since the existence of insurance coverage shifts at least some of the risk to a third party insurance carrier.

## 4 Liability Limits

Outsourcing contracts invariably limit the supplier's liability (and often, both parties' liability) by: (i) precluding recovery of indirect, punitive and consequential damages, and (ii) imposing a ceiling upon recovery of actual damages, subject to (iii) some narrow, and often intensely negotiated, exceptions for infringements, wrongdoing and other remote, but serious risks. Newcomers to this arena may find the practice surprising, for in many other transactions, liability is unlimited. Suppliers say they cannot afford to assume unlimited liability, especially if they are to deliver service at lower cost than a customer's former internal operation. Supplier cost models do not include, for example, any premium to insure the customer against business interruptions attributable to outages – coverage that customers rarely had when operations were their responsibility. Suppliers are unwilling to assume risks that customers already bear, or to bet their companies upon individual contracts.[3]

### *4.1 Consequential Damages*

Outsourcing contracts uniformly restrict, and often prohibit, recovery of lost profits or other consequential damages. Sophisticated customers with sufficient bargaining leverage sometimes secure limited rights to recover consequential damages, up to a negotiated ceiling, in situations where the only damages are virtually certain to be consequential, such as misappropriations of confidential information and intellectual property. Contracts more frequently:

- Permit recovery (as indemnified losses) of consequential damages paid to third parties.

- Classify various costs related to corrective action as direct, rather than indirect or consequential damages.

### *4.2 Limits On Recovery Of Actual Damages*

Ceilings upon actual damages are sometimes fixed sums (as in an insurance policy). More often, ceilings equal total charges during an agreed number of months. If, for example, the parties decide that six months' worth of charges is an appropriate overall limit, the contract will limit actual damages to (i) charges during the six months before the claim arose, <u>or</u> (ii) for claims spread over longer periods, the greatest total paid for

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[3] A sample clause follows the text.

any six months during the longer period, or (iii) for claims arising before six months elapse, estimated charges during the first six months.

No hard and fast rules govern resolution of this issue. Suppliers have their own internal policies, and variations may require executive-level approvals. Customers, naturally, prefer higher limits, with as many exceptions as possible. For the customer (and, in practice, both sides) the questions are similar to those surrounding limits upon insurance coverage. How much is sufficient to cover dire contingencies: breakdowns in service or project failures, related corrective work or "cover," and costs of unwinding the relationship by engaging another supplier or bringing the functions back in-house?

Liability limits are sometimes the last major issue to be decided, and resolutions vary, depending upon the scale of the transaction, the parties' bargaining leverage, the presence or absence of competition, the number and extent of exceptions, and resolution of other major (but unrelated) issues, among other things. Often, the final figure amounts to between six and twelve months' worth of charges, but this is only a rough range, and lower or higher figures may also be agreed in particular cases.

For the very worst contingencies, such as intentional wrongdoing, liability may be unlimited. The existence of limits upon recovery makes other remedies – notably termination – all the more important to the customer. If unable to recover all losses, a customer must be able to cut its losses.

### *4.3 Exceptions – Greater Or Unlimited Liability*

Often, certain classes of claims are at least partly exempt from overall limits on liability. Exceptions, like the basic limit, are intensely negotiated. Negotiated resolutions vary for all the usual reasons. Generally, the higher the basic limit upon actual damages, the stingier a supplier will be about exceptions. The lower that basic limit, the harder the customer will press for more and broader exceptions. Sometimes liability for actual damages is unlimited, or subject to a higher ceiling, but consequential damages are barred. Sometimes consequential damages are recoverable, up to an agreed limit, where the likely damages are consequential; but liability for actual damages is unlimited. Sometimes, liability for both actual and consequential damages is unlimited.

The following exceptions are, if not typical, at least common:

- Infringement, provided the indemnitor enjoys reasonable flexibility to defend indemnified claims by procuring a license, providing a non-infringing substitute or taking other, reasonable measures. For the indemnitor, infringement claims are often "life or death" cases, where no expense will be spared, so this exception may be fairly readily agreed.

- Liability for some other indemnified claims may also be unlimited, or subject to higher ceilings. Suppliers naturally prefer that liability for indemnified claims be limited, just like general damages for breach. Customers ask why this is fair, if the supplier's acts or omissions expose them to liability above the basic limit. Indemnitees can usually recover consequential damages actually paid to a third party, despite the usual prohibition upon recovery of consequential damages for a party's breach of the contract.

- Breaches of confidence, intentional torts, violations of law and other willful misconduct. Few attempt to defend the indefensible, or contend that liability limits should shift costs of wrongdoing to an innocent party. Suppliers sometimes propose that liability be unlimited only for intentional wrongdoing. Accidental or immaterial breaches of confidence or regulatory requirements should not, they contend, carry unlimited liability. Especially in regulated industries, where the risks of unintentional violation are not negligible, the contention has some merit. Customers sometimes insist that consequential damages be available for breaches of confidence, infringement and certain other wrongdoing where the only significant damages may be lost profits or other consequential damages.

## 5 Operational Risks

These pervade the relationship, from initial transition, through final disengagement. Customers entrust vital systems, processes and functions to a third party, just as surgical patients entrust respiration to an anesthesiologist and his equipment. Since legal remedies are rarely complete, punctual or satisfactory, the ability to shift these risks is limited – especially when contracts forswear consequential damages. Contractual protections therefore emphasize prevention and deterrence.

### *5.1 Transition Plans*

Well-advised customers require at least a preliminary transition plan before the contract is signed, as well as assignment of an experienced manager to oversee the process. Payments for transition-related services may be contingent upon achievement of key milestones. Suppliers' delays may be penalized (and hopefully deterred) through fee reductions or liquidated damages.

If transition involves relocation of a data center, there may be a further, detailed migration plan, with testing, milestones, incentives, approval rights and the like (sometimes with in liquidated damages for delays, interruptions in service and other problems).

Some operations (such as customer support or software maintenance) may relocate offshore. If so, customers may require that the domestic supplier (and not a faraway affiliate) be fully responsible, and provide every reasonable assurance of good service, with appropriate arrangements for security, change management, oversight, backups, regular deliveries of work product, business continuity and the rest.

Good outsourcing contracts also include specific commitments to support transition to another supplier, or re-patriation of operations to the customer, when the contract expires or terminates. Required support often includes (i) transfers of data, software and assets; (ii) collaboration in the preparation and execution of transition plans; (iii) familiarization of successor staff with operations and working documents; and (iv) an opportunity for the customer (or a successor provider) to recruit dedicated or on-site staff. These commitments may be enforceable by injunction, and insulated from other disputes by unconditional payment obligations, including prohibitions upon setoffs or withholding, and in cases of termination for nonpayment, requirements to prepay or provide other appropriate assurances of payment.

### *5.2 Service Quality*

Customers paying hundreds of thousands or even millions of dollars for service expect quality, and since disengagement is drastic, expensive and disruptive, termination threats are neither desirable nor (except in extreme cases) credible.

Customers attempt to assure quality through general quality standards and detailed, specific service levels. Suppliers commonly agree to provide good quality service that meets good standards in their industry (or, in other words, to perform at least as well as their competitors). Service levels measure selected services. General standards apply to everything else, without raising or reducing specific service level commitments.[4]

Service levels are objective, repeatable measures of performance (such as system availability or response time). They should be measured and reported regularly (typically, monthly) and be subject to audit. Often, there are two categories: a short list of critical service levels (for which credits may be paid) and a longer list of secondary service levels that are measured and reported, but bear (at most) modest financial consequences. Assigning some financial consequences to these secondary service levels (especially if missed repeatedly, or in combinations) helps to protect the customer against mediocre service and epidemic failures.

Unexcused failures to meet critical service levels obligate the supplier to pay liquidated damages (credits, or in the vernacular, “penalties”). Their purpose is deterrent, rather than compensatory, since the amounts are rarely sufficient to compensate for serious disruptions in service (and, in any event, consequential damages are almost never available). Suppliers prefer that payment of credits be the sole remedy. Customers resist, because the credits are invariably modest. One common compromise is to make

[4] Suppliers routinely disclaim implied warranties.

credits the sole monetary remedy, except in cases of material default (and even then credits paid may count toward the customer's damages).

Suppliers generally impose a ceiling upon credit payments roughly corresponding to their anticipated margin (say, 7-12% of the monthly invoice). Specific arrangements vary from simple "traffic offense" charges (so much for double-parking, more for speeding) to elaborate formulae or matrices that calculate credits as percentages of the monthly invoice. Multiple or repeat offenses may cost more.

Repeated failures may be classified as "unacceptable service" that constitutes "material breach" and justifies default termination. These are not necessarily the only grounds, but an "unsafe harbor." Suppliers, ideally, would prefer to designate a few combinations of missed service levels as exclusive grounds for termination, but rarely carry the day. Suppliers do not accept responsibility for incidents beyond their control, such as:

- *Force majeure* (excluding failures to execute disaster recovery plans or to provide customary redundant equipment, such as emergency power for data centers).

- Acts or omissions of the customer, its agents and contractors. These may include, among others, negligence, violations of law, breaches of contracts, infringements, and (to the extent of the customer's responsibility) deficiencies in equipment provided the customer, and failures to take action necessary to maintain performance (e.g., additional investment in its systems).

In practice, service levels leave most of the risk with the customer. Even substantial credits rarely provide full compensation for serious disruptions. The actual importance of service levels may be less than commonly supposed. Suppliers never commit to meet service levels that they cannot consistently achieve (just as title companies never knowingly insure defective title). Credits are rarely due (and, surprisingly, even more rarely assessed). However, service levels reassure customers that service commitments have "teeth" They focus the supplier's attention on key systems and services, so that commitments are met – which is, after all, the point. Paying credits for failures is bad for margins (and for that matter, individual careers).

## 6 Financial risks

### *6.1 Consumption*

Curiously, the financial interests of customer and supplier are more closely aligned than one might suspect. Suppliers still prefer to charge more; and customers, to pay less. However, healthy relationships require flexibility so that charges, costs and consumption remain in reasonable harmony; and the supplier earns decent margins at rates the customer believes to be fair and competitive. Consumption metrics that drive charges – numbers of MIPS, servers, help desk calls and so on – should correlate with the supplier's cost drivers. Incremental charges for additional service (and corresponding credits for reductions) should fairly reflect marginal costs. Suppliers often require minimum commitments sufficient to support basic service. Extraordinary changes, such as surges attributable to an acquisition, can be priced through an equitable adjustment process that (i) examines net additions, savings, and efficiencies, (ii) makes a reasonable allowance for the supplier's margin, and (iii) adjusts charges (including termination charges) accordingly. Pricing is an important, separate subject; but pricing and adjustment mechanisms are, in part, ways to allocate risks associated with changes in operations, technology and consumption.

### *6.2 Benchmarks*

Since many technology costs – notably, computer hardware and telecommunications bandwidth – have tended to decline, customers increasing demand the right to "benchmark" charges, by engaging an independent third party to compare contract rates with the current market. Ideally, customers would require their suppliers to match the market rates fixed by benchmarking, or else risk termination with little or no termination charge – or at least a reduced termination charge. Suppliers have depended on long-term, stable contracts to recoup transition costs and investments in facilities and equipment; so they are wary of a process designed to squeeze their margins. Given the issue's significance, negotiated terms vary, especially concerning the consequences of unfavorable findings. Benchmarking can be contentious and expensive. It is not science. On the contrary, comparisons (normalized to reflect scale, volume, investments, geography and other variables) involve judgment. Conclusions are usually debatable. Nonetheless, the process can be a catalyst for re-negotiation of charges. From the customer's standpoint, benchmarking appropriates (or at least shares) any benefit from future declines in technology costs.

### *6.3 Financial Condition*

Recession has renewed concern about solvency. Suppliers want to be sure their bills are paid, and if possible, avoid what they regard as the morass of Bankruptcy Court – with its potential effects upon accounts receivable, cash flow, contract terms, and in some cases, the supplier's own share price. Customers want to feel confident that their primary supplier and "technology partner" is sound financially. Insolvency is a separate, important topic, capably addressed by others. Financial risks short of bankruptcy merit at least brief mention. Some commentators have suggested reinforcing performance obligations with financial covenants, like those commonly found in loan agreements that, if missed, permit lenders to declare default, call loans and realize upon their security if the borrower's financial condition should deteriorate. In practice, suppliers are no more receptive to such terms than customers would be if suppliers sought rights to "pull the plug" upon a decline in the customer's credit rating or financial condition. Customers can and do protect themselves in other ways, with the usual panoply of remedies for deficient performance, and convenience termination rights, preferably with modest termination charges. Suppliers commonly insist upon the right to terminate if bills are not paid promptly, and advance payment (or comparable assurances) for any transitional service they may provide after a default in payment.

### *6.4 Taxes*

Taxes are another financial risk. Some states subject IT and other services to sales, use and similar taxes; but many do not. Contracts may be written to account for existing taxes, either by building tax expenses into the charges, or (more often) passing them through to the customer (just as department stores or restaurants pass sales taxes through to their customers). Future taxes, or rate increases, are a wild card. Customers sometimes press suppliers to absorb or at least share this risk. Usually, the customer is at risk for future taxes, but customers sometimes negotiate the right to terminate for a reduced termination charge if future changes erode the anticipated benefits of outsourcing.

### *6.5 Errant Projects*

Occasionally, relationships sour when major development or infrastructure projects are late, unsuccessful, overrun budgets or (worse) all three. Even if day-to-day service purrs, nothing fouls the nest quite like a disastrous project. Customers protect themselves against these risks in several ways.

- First, of course, comes good project management, with effective oversight, reporting and testing to anticipate or forestall serious difficulties.

- Second, formal acceptance criteria and procedures. Tailored to customer expectations, these help to assure that the customer gets what it bargained for. Objective standards (reinforced by materiality thresholds and the doctrine of substantial completion) protect the supplier against fickle, whimsical or subjective decisions.

- Third, payments may be tied to milestones, such as delivery of acceptable subsystems, and retention of a small percentage of each progress payment until final acceptance of the entire project.

When parties expect numerous projects, they sometimes consider sharing financial responsibility for overruns – on the theory, widely validated by painful experience, that when projects fail, both parties are almost always at least partly to blame. Overruns become painful for both sides. They are neither ruinous to the supplier, nor “free” to the customer. Both sides have incentives to avoid (or at least minimize) overruns. Over time, sharing overruns may achieve some rough approximation of justice, while sparing both sides the expense of debilitating post-mortems that can poison relationships and (for the supplier) foreclose future project opportunities.

Very large projects sometimes have separate liability limits. Curiously, separate limits may serve both parties' interests. If there is a large services contract, with a correspondingly large limit upon liability, the supplier may not wish to put the full amount at risk upon a single project worth far less than the limit; and the customer may not wish to run the risk that a disastrous project might exhaust much of the overall limit.

### *6.6 Setoff And Withholding*

Dissatisfied customers sometimes withhold payment. Few measures are better calculated to assure immediate attention, or apply pressure. Suppliers fear abuse, and the possibility that they not be paid, even when obliged to perform (and most contracts obligate the supplier to continue to perform while disputes are pending). These differences are commonly reconciled through:

- Commitments to continue both payment and performance while disputes are pending;
- Limitations upon the amount that can be withheld from any single invoice (commonly expressed as a percentage of base charges); and
- Obligations to place larger disputed amounts in escrow, pending resolution of the dispute. Escrow is cumbersome, but curbs any temptation to withhold for cash management purposes by eliminating any "float" and assigning interest upon escrowed funds (less charges) to the eventual recipient.

## 7 Scope Risks

Scope, which drives charges (and much else), may be the single most important issue. After signing, scope is the most frequent bone of contention. The best protection against misunderstanding is, of course, preparation: well-defined requirements, accurate cost data, full disclosure, and thorough investigation by the supplier, culminating in a precise, well-drafted statement of work with clear limits, qualifications and exclusions. These ideals are rarely achieved. Even the best contracts must allocate risks for the unknown, such as undocumented service commitments, or systems, assets and contracts that were overlooked in either the customer's disclosures or the supplier's due diligence (or both).

The supplier's ideal would be to perform only the functions written down in the contract documents. Anything else would cost more. The customer would prefer loose, open-ended scope: whatever was formerly done or alluded to in sales presentations must be done for the quoted price. Neither extreme is appropriate. In between these extremes lies ample room for compromise. Often, these compromises involve general scope clauses and special provisions for unidentified or undiscovered resources.

### *7.1 "Sweep" Clauses*

General scope (or "sweep") clauses supplement detailed statements of work by obligating the supplier to perform (i) "lesser-included" or inherent functions not specifically described but inherent in other functions described in general terms; and (ii) related functions formerly performed by displaced staff, or with assets, budgets or other resources transferred to the supplier. During negotiations, these provisions impose a burden upon suppliers to specify limits and exclusions. Afterward, the supplier bears considerable risk for unknown and unspecified responsibilities. A typical customer-oriented provision might read as follows:

> Supplier shall provide the services, functions and responsibilities:
>
> (a) described by the Statement of Work ("SOW"), as it may be amended and supplemented from time to time;
>
> (b) performed during the twelve (12) months preceding the Effective Date by the personnel who were displaced or whose functions were displaced by this Agreement [Optional**:** and are identified in writing by one party to the other within twelve (12) months after the Effective Date];
>
> (c) performed by or for Customer under the base case budget dated [date]; and
>
> (d) not specifically described or excluded, but inherent in or necessary for the proper performance of the services, functions or responsibilities described above.

This shifts the risk of unknown scope to the supplier, but services are their business (in which they are presumably expert). Reasonable disclosure and investigation should give the supplier an opportunity to specify qualifications, limitations and exclusions. Thus, the actual scope for surprise should be reduced. The optional clause in the sample illustrates one method suppliers sometimes propose to limit their exposure: requiring the customer to identify any gaps or oversights within a reasonable period after the contract begins.

### *7.2 Undisclosed Assets*

Some scope issues concern assets, contracts or other resources omitted from contract documents and cost models, or overlooked by one or both sides. Records are often incomplete, and inventories inaccurate. Who, then, should bear the risk for these oversights and omissions? Suppliers, naturally, wish to charge for each additional device, and pass through unexpected third party costs (e.g., undisclosed equipment leases and software licenses). This is a variation on the familiar risk of latent defects in goods or real estate. Negotiated allocations of these risks vary, depending upon disclosures, leverage and other circumstances. One common resolution is an "unidentified resources" clause, sweeping into scope matters that were disclosed, or should have been discovered, but obligating the customer to pay for additional resources, effort and services that were not disclosed, and could not have been anticipated. For example:

> The Parties recognize that the lists of equipment, leases, software licenses, and third party service contracts in the accompanying Schedules may be incomplete. Any equipment, lease, license or contract not identified in the Schedules that is used to provide Services ("Unidentified Resources") shall be added to the relevant Schedule when first identified. Supplier shall obtain any required consents. Financial responsibilities for Unidentified Resources (including consents) shall be allocated in the same manner as for other, similar resources, if the Unidentified Resources were: (i) disclosed to Supplier before the Effective Date, or (ii) included within budgets disclosed to or cost or pricing models disclosed to or prepared by Supplier, or (iii) [could] [should] have been discovered by Supplier with reasonable diligence during its investigations and inspections of Customer's operations, facilities and affairs before execution of this Agreement. Customer shall bear financial responsibility for other Unidentified Resources, including incremental charges related to their use to provide or receive Services.

## 8 Security Risks

In a comprehensive outsourcing relationship, each side gives and holds hostages. Each side depends upon its counterpart's integrity and security systems. The customer's most sensitive systems and data may reside on the supplier's equipment. Technicians have access to executive offices and desktops (literally and electronically). The customer's management observes and learn the supplier's methods, and enjoys access to the supplier's tools. Each side may learn a good deal about the other's strategy, strengths, weaknesses and inner workings. Risks of improper disclosure cannot really be shared, since each party bears responsibility for its own negligence and wrongdoing. They are often evenly balanced, and manageable, through a combination of preventive and remedial measures.

- Nondisclosure obligations are reciprocal, and rarely controversial. The typical outsourcing contract includes a bilateral confidentiality agreement with the usual bells and whistles.

- Contract documents often require compliance with stringent security policies (especially where the customer's business is regulated, or subject to unusual privacy rules).

- Licenses to use proprietary software and other intellectual property are commonly limited to use for the particular customer, during the contract term.

- Suppliers may not be permitted to use custom developments for other customers in the same industry.

- Customers often require that the supplier's account management and key technical staff be restricted from performing similar services for the customer's competitors for at least a year or more after they cease to support the customer.

- When contracts conclude, suppliers will readily supply customer-specific information (for example, concerning the customer's particular configurations) and their commercial software products (on the usual terms). They may make their tools and utilities available to the customer, but not to any of their competitors, if the customer should switch suppliers. In information technology, these restrictions are not burdensome, since all suppliers have their own (often similar) processes, tools and utilities. When business processes are outsourced, and the supplier introduces proprietary methods, the challenge may be far greater.

Serious breaches of confidence or security, and violations of intellectual property rights invite the most serious issues and consequences, including termination for material breach and unlimited liability for breaches of confidence and other wrongdoing.

**9 Legal And Regulatory Risks**

Legal and regulatory issues commonly fall in two categories.

- Customers in regulated industries – banks or hospitals, for example – must comply with distinctive, and often stringent regulatory requirements (for example, concerning privacy of customer and patient records). Changes in requirements may mean costly changes in outsourced systems and operations.

- Laws of general application affect customers and suppliers alike. All employers, for example, must comply with employment laws and regulations. All employers at least occasionally face claims from aggrieved (or at least disgruntled) employees and former employees. Some laws of general application assume greater importance in particular industries. Environmental laws, for example, may matter far more to an oil or chemical company than to a retailer.

Compliance is not optional. Everyone must obey the law. Most companies accept responsibility for their own compliance, and indemnify others for violations within their sphere of responsibility. Details may be vigorously negotiated, but the principle is rarely controversial.

Complex questions arise when laws and regulations change, especially in regulated industries. Which party should track changes, and (at least implicitly) assume risks of noncompliance? When compliance costs money – for new systems or more stringent security – who pays? If a contract is silent, changes in law may be a *force majeure* event. If changes in law raise costs of performance, a supplier may claim compensation, under constructive change or other legal theories. Indeed, when changes dictate changes in systems, the supplier may see a sales opportunity.

Customers in regulated industries cannot afford to rely upon anyone else to monitor regulatory developments and keep them in compliance. Suppliers commonly propose that their regulated customers (i) advise them of regulatory changes affecting the service, and (ii) give direction, in the form of business requirements, based on the customer's interpretation of regulatory requirements. Suppliers actually possess considerable sophistication in regulatory matters. Customers often prefer to work with suppliers experienced in their particular industry. Suppliers who support drug companies, for example, know a good deal about FDA-validated systems. However, suppliers prefer to sell their consulting expertise separately (at healthy rates), rather than as part of basic service; and suppliers take pains not to give legal advice concerning compliance.

Costs of regulatory compliance often present negotiation challenges. Each side would naturally prefer to shift risks and costs of compliance to the other; but most recognize that regulatory changes are, like *force majeure* events, beyond either party's foresight or control. Compliance with existing regulations may and should be built in to supplier's cost models and pricing. Future changes are "wild cards." Suppliers therefore contend that charges should rise to offset added costs of compliance, with appropriate allowances for overhead and profit. Customers respond that compliance is a cost of serving their particular industry, and fear that they may bear disproportionate burdens if they are "pioneers."

Negotiated resolutions of these issues vary, depending upon the industry, the regulations' impact and other circumstances, but it is often useful to separate general costs of compliance – what the supplier must do to serve any and all customers affected by new regulations – from customer-specific measures and plans. Some recent laws and regulations, for example, apply to the health care business generally, but individual hospitals, HMOs and health insurance companies have their own compliance programs and initiatives. Customers should and do expect to pay for their individual compliance programs. However, they believe that a supplier's additional costs of supporting customers across an entire industry may be absorbed into overhead, capped, or spread proportionally among affected customers, so that no single customer bears a disproportionate burden.

## 10 Extraordinary Risks And Remedies

Conventional remedies address many of the worst cases. Liability for wrongdoing, for example, is often unlimited. Indemnities usually cover such potentially serious risks as infringement. A few other situations, however, merit brief discussion.

### *10.1 Termination*

Material breach may mean termination, although termination of a long term services contracts are so disruptive, complex and costly that an ugly, expensive divorce is the very last resort.

Termination rights are often asymmetrical. Customers may terminate for material breach, and various specific breaches, such as failure to perform disaster recovery services, or repeated failures to meet service levels. Customers may also terminate for convenience, without cause, upon payment of an agreed termination charge. Suppliers' termination rights are often limited to nonpayment, and other egregious circumstances, such as intentional infringement or misappropriation of intellectual property. Customers contend that if the suppliers' termination rights were coextensive with the customers', suppliers could exercise overwhelming (and inappropriate) leverage by threatening to cut off service, and bully the customer into submission.[5]

Dissatisfied customers who shy away from litigation, are unsure whether the supplier's faults constitute "material breach," or face counter-claims by the supplier, may terminate for convenience. When grounds for default termination are debatable – as often they are – the supplier will contend that, whatever the customer's complaints, termination is actually for convenience, and claim a termination charge. These competing claims and uncertainties may position the parties for a negotiated termination or partial termination. Whatever the circumstances, the contract should (as noted earlier) spell out detailed transition arrangements whenever and however the contract concludes, amicably or otherwise.

### *10.2 Calamities – Force Majeure And Disaster Recovery*

In outsourcing, as in other service contracts, *force majeure* commonly excuses performance, unless such customary precautions as emergency power or anti-virus software were neglected, or the supplier breached an obligation to execute a disaster recovery plan. *Force majeure* clauses commonly allow customers to obtain substitute service (sometimes, at the supplier's expense); and, ultimately, terminate the contract if service cannot be restored within a reasonable time. If nothing else, the right to terminate may provide leverage to assure that customer needs receive urgent attention. Where services include disaster recovery, *force majeure* clauses may matter primarily for services outside the scope of the disaster recovery plan.

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[5] In today's uncertain market, some market participants now recommend allowing the supplier limited rights to terminate for convenience, if the relationship is uneconomic. At this writing, such provisions are very unusual.

Disaster recovery services – a kind of operational insurance – are the most important practical protection against fires, floods, earthquakes, hurricanes and other calamities. Disaster recovery services are not cheap and (as others explain in greater detail) may not be fully effective unless kept current and integrated in a broader plan for continuity of operations. They do shift responsibility and risk to the supplier. Failure to execute the plan is material breach, and is not excused by any *force majeure* clause.

### *10.3 Changes in Control*

Outsourcing may (and perhaps should) be something more than a purely economic decision. One buys not only a service, service levels and rate card, but a corporate culture, philosophy and management team. Intangibles matter, as in all professional services. Customers worry that their chosen supplier might change its spots, if acquired by some other owners, with less congenial or compatible ways of doing business. For these kinds of reasons, customers desire an inexpensive way out when their supplier is sold. Suppliers reply that any such termination would be for convenience. The customer is free to give notice, write a check and walk away (after the usual transitional formalities). Privately, suppliers fear that "easy outs" may depress the value of their business, which largely consists of a portfolio of contracts. Who would buy (or, more to the point, pay much for) a services business if the customers can just walk away? This is an especially significant issue for smaller, or less well established suppliers, such as many providers of business process services.

Customers generally attempt to mitigate these risks in two ways:

- First, by reducing termination charges (which may mean up-front transition payments and retention of assets the supplier might buy, since asset and transition costs would otherwise be "baked into" termination charges), and

- Second, by proposing to discount termination charges when rights are exercised promptly following a change in control of the supplier.

For their part, suppliers attempt to preserve as much flexibility as possible through liberal rights to assign the contract to affiliates, successors or a buyer of the business (especially if the buyer has adequate net worth, retains the account and management teams, and is committed to continue the business). Reasonable approval rights give the customer some comfort, but as a practical matter, may oblige the customer to consent, if the successor is reputable, has adequate financial strength, and commits to continue the business and honor the contract.

**Sample Limitation of Liability**

Here is a sample limitation of liability clause. It is moderately customer-oriented, but as the text suggests, the limitations, exceptions and other provisions are often intensely negotiated, and the sample below should not be considered as a form, model or "boilerplate."

(a) Except as set forth below, neither party shall be liable for indirect, consequential, exemplary or punitive damages, regardless of the form of action, whether in contract, tort or otherwise, and even if it has been advised of the possibility of such damages. For purposes of this Agreement, the following costs shall be considered direct or actual damages, and neither party may assert that they are indirect or consequential damages: (i) re-creation or reloading of lost or corrupted data, (ii) implementation of work-arounds following an interruption or failure in Service, (iii) replacement of damaged Equipment, Software or other materials; (iv) corrective work of all kinds (whether performed by Customer or a third party); (v) costs of alternative or substitute Service, following an interruption or failure in Service, (vi) fines, penalties or interest payable to any public authority, and (vii) wages, salaries, overtime, other compensation costs, travel and other reasonable expenses, telecommunications charges and other, similar costs incurred to carry out any of the foregoing.

(b) Except as set forth below, each Party's cumulative aggregate liability to the other, whether in contract or tort (including negligence and strict liability), for all damages arising in connection with this Agreement shall be limited to: (i) an amount equal to the total charges (excluding expense reimbursements) payable to Supplier for [number] complete calendar months immediately preceding the month in which the last event giving rise to the liability occurred <u>or</u> (ii) if the event giving rise to the liability occurs during the first [number] months after the Effective Date, the total charges that would be payable to Supplier pursuant to this Agreement during for such first [number] months, based upon the (Operating Plan / Baseline) <u>or</u> (iii) if the events giving rise to liability occurred over a period of more than [number] months, then the greatest total charges payable to Supplier during any [number] consecutive months preceding any such event that occurred on or before the claim is first asserted. Amounts paid or credited as Service Credits shall not count toward the foregoing limits.

(c) The limitations set forth in subparagraphs (a) and (b), above, shall not apply to (i) losses otherwise recoverable by an indemnitee pursuant to [cross-reference relevant indemnities, e.g., infringement], (ii) Customer's breach of its payment obligations under this Agreement, and (iii) damages caused by the other Party's gross negligence, violations of law or willful misconduct.

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