



# Contractual Framework: The Business Process Outsourcing Agreement

by

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## **I. STRUCTURE OF THE AGREEMENT**

As is the case with respect to any material agreement, the structure of the business process outsourcing agreement is a key issue because it embodies the rights, remedies, duties and obligations of the parties and provides a blueprint for the parties' relationship. These considerations are magnified in an outsourcing arrangement because (i) the functions to be performed are typically mission-critical or strategically important, and (ii) the relationship between the service provider and the customer is typically of a longer duration and greater intimacy than the relationship created in other commercial contexts. Accordingly, both parties bear greater short- and long-term risks in such a relationship that they need to address to the greatest extent possible in the outsourcing agreement.

- A. Content. The agreement (i) should set forth the specifics of the outsourcing relationship, (ii) should describe the process by which the parties will agree upon other specifics as the need arises, and (iii) most typically, should use both approaches depending on the particular issue.
- B. Form. The agreement may be a single, holistic instrument (which may be administratively simpler) or a "master" agreement that includes a process by which specific order forms, statements of work, or other ancillary "sub-agreements" may be included as needed (which should provide greater flexibility).
- C. Structure of the Relationship. To effect one form of gain-sharing, the parties may form a joint venture in which the customer and the service provider together create an entity responsible for providing the outsourced services not only for the customer but also for third parties. The use of a joint venture structure typically increases the complexity and duration of the negotiations.

## **II. SCOPE OF SERVICES**

The scope of the services to be outsourced is a key issue because of the greater potential for conflict or ambiguity stemming from imprecise or ambiguous terms.

- A. Clarity. The specification of the scope of services should be as clear as possible at the time of execution of the agreement because the scope of the services affects many other critical aspects of the agreement, such as pricing, service levels, warranties and exclusivity.
- B. Content. The specification of the scope of services should include the following:
  - (i) all functions that the parties intend to expressly include within the scope of services;
  - (ii) all functions that the parties intend to expressly exclude from the scope of services;
  - (iii) all functions that are the responsibility of the customer or third parties;
  - (iv) all dependent services (*i.e.*, those functions that the service provider must perform that are contingent upon the performance of the customer's or a third party's responsibilities); and
  - (v) all assumptions regarding the scope of services.
- C. Exclusivity. The agreement should expressly delineate where, along the continuum of degree of exclusivity, the relationship between the service provider and the customer is (*i.e.*, whether the agreement will be the exclusive, sole, right of first offer or refusal, preferred provider or nonexclusive)).

1. Under an exclusive arrangement, the customer may neither hire another service provider to perform the same services the service provider is providing under the agreement, nor perform those same services itself. This type of arrangement may be characterized as a requirements contract.
2. Under a sole arrangement, the customer may not hire another service provider to perform the services but the customer may perform the services itself.
3. To the extent that the service provider is not an exclusive or sole provider of a service, the agreement may grant the service provider a right of first refusal (*i.e.*, the customer makes all submitted bids available to the service provider and the service provider has the option of meeting the best bid) or a right to submit the first bid for such service.
4. The parties may also agree to granting the service provider “preferred provider status” if the agreement does not contemplate an exclusive or first bid arrangement. “Preferred provider status” confers on the service provider a right to bid on future projects without re-submitting its qualifications to the customer and generally means that, all other things being substantially equal, the service provider should be offered the project.
5. Nonexclusivity allows the customer to do the work itself or to use another service provider.
6. Exclusivity does not need to be determined for the outsourcing project in its entirety. The parties may agree to a hybrid arrangement whereby exclusivity varies according to one or more of the following:
  - (i) a given geographical area (*e.g.*, for the customer’s functions in the United States);
  - (ii) certain specified functions (*e.g.*, for the customer’s payroll and accounting functions but not for the development or maintenance of related applications); or
  - (iii) certain of the customer’s business units, affiliates, suppliers and customers (*e.g.*, for all future business units, affiliates, suppliers and customers of the customer that do not already have a third party service provider providing the same services).
7. It is important to note that, irrespective of the legal status of the outsourcing arrangement, many outsourcing arrangements/relationships will be *de facto* requirements contracts, at least in the short-term.

D. Change. Since most business process outsourcing arrangements contemplate a relatively long-term relationship, it is important that the agreement address the procedures to be followed when circumstances change. The agreement must be sensitive to the interrelationship among price, the scope of service and service levels. To this end, the agreement should include:

- (i) change control procedures;
- (ii) a definition of change (*e.g.*, a requirement for a specified number of transactions or resources that are above or below defined “bandwidths” of numbers of transactions or resources required to perform the services); and

- (iii) either established incremental increases and decreases for the base charges or a process of negotiating changes in pricing terms as the need arises.

Consideration should be given to the mechanism required to handle changes to process that are mandatory (*e.g.*, changes required by a change in laws).

- E. Information Technology Function. One of the key issues often associated with business process outsourcing arrangement is the relationship between the outsourced function and the information technology function. The parties should decide what and whose information technology resources will be used.

### III. QUALITY OF SERVICES

Performance standards and service levels are key issues in the business process outsourcing agreement. They act not only as metrics of performance by which to measure the service provider's performance but also as a means of providing both parties with meaningful information on which to base fees, costs, remedies, and performance incentives and disincentives.

- A. Standards. The performance standards and service levels specified depend upon the type of service being measured and the relevant phase of the agreement (*e.g.*, during the initial transition period service levels may be lower than during steady state).
  - 1. Subjective performance standards include (but are not limited to):
    - a. use of reasonable efforts in providing the services;
    - b. use of best efforts in providing the services; and
    - c. performance of the services in a professional and workmanlike manner or in accordance with industry standards.
  - 2. Objective standards include (but are not limited to):
    - a. conformance to specifications;
    - b. conformance to baseline operational performance metrics;
    - c. conformance to service levels previously attained by the customer or a third party provider for the same services; and
    - d. conformance to benchmarked operational standards and service levels.
- B. Remedies. The agreement should specify what remedies will be available to the customer in the event the service provider fails to meet a service level. The agreement should also specify whether one or more of the remedies is exclusive (*i.e.*, to the exclusion of other remedies). Remedies include:
  - (i) service level credits;
  - (ii) liquidated damages;
  - (iii) correction of the failure;
  - (iv) refund or credit; and
  - (v) characterization of the failure as a material breach giving rise to a claim for damages or the right to terminate the agreement.

#### IV. FEES AND PAYMENTS

Because cost savings are usually a significant driver in outsourcing arrangements (particularly in offshore outsourcing), issues concerning the amount of, and terms governing, the fees and payments are typically considered early in the relationship between the parties.

- A. Pricing Options. The appropriate pricing mechanism will vary from relationship to relationship. Options include:
- (i) fixed price;
  - (ii) resource-based (*e.g.*, number of FTEs);
  - (iii) volume-based (*e.g.*, price per transaction);
  - (iv) time and materials;
  - (v) cost-plus arrangements;
  - (vi) gain-sharing/risk-sharing; or
  - (vi) hybrids of the above.
- B. Price Controls. The parties may consider price control terms, such as:
- (i) CPI/PPI/ECI adjustment factors;
  - (ii) price ceilings or floors/percentage cap on increases or decreases;
  - (iii) “most favored nation” clauses;
  - (iv) shared cost reductions; and
  - (v) benchmarked pricing.
- C. Records and Audits. The parties should specify responsibilities with respect to record retention (*e.g.*, the service provider shall retain records relating to the provision of services under the outsourcing agreement for the term of outsourcing agreement and for three years thereafter). The outsourcing agreement may also include terms regarding audits, such as the types of audit, the numbers of audits that may be conducted within a given period for time, restrictions on who may conduct the audits and remedies in the event an audit reveals erroneous billing.
- D. Payment Terms. The outsourcing agreement should include terms regarding the submission and payment of invoices, late payments, disputed payments and currency.
- E. Taxes. The outsourcing agreement should include terms regarding the responsibility for taxes arising from the outsourcing arrangement. Note that certain jurisdictions impose taxes on services. This fact should be considered in determining whether using a service provider makes economic sense and, if so, determining the location where the services are to be provided.

#### V. HUMAN RESOURCES

Human resources are a key issue in many business process outsourcing arrangements. Typically, the concerns are different in outsourcing arrangements where the customer’s employees are being transferred to the service provider. In those transactions, this aspect can be the source of the greatest concern and disruption in the customer’s work place. (Note, this is atypical in offshore outsourcings).

- A. Disclosure. The parties should discuss how and when the contemplated outsourcing arrangement will be disclosed to the customer’s employees (and independent contractors). Since the fact that the customer is considering an outsourcing arrangement typically leaks out, it is usually better to put in place an employee (and independent contractor) communications plan that keeps people

apprised of the status of such arrangement so that rumors, misinformation and the potential for sabotage are reduced. This communications plan must be consistent with, and take into account, the communications plans for various other interested constituencies (*e.g.*, customers, Wall Street, governments) and the requirements of applicable law.

- B. Transferring Employees. If the service provider is going to hire the customer's employees as its own (as opposed to using the customer's employees as seconded employees or independent contractors), then the agreement should set forth the parties' understanding with respect to the following:
- (i) how many offers of employment will the service provider make to the customer's employees (if any);
  - (ii) will there be any sign-on or retention bonuses to facilitate access to key personnel and institutional knowledge;
  - (iii) will the service provider require the customer's employees to complete employment applications and to go through the service provider's typical hiring process;
  - (iv) what are the terms under which the service provider will hire the customer's employees (*e.g.*, will the service provider provide the same level of compensation, including benefits plans, as did the customer);
  - (v) what percentage of employees must join the service provider and what happens if this percentage is not met;
  - (vi) what effect will any labor contract have;
  - (vii) what effect will any employee termination, transfer or relocation laws (*e.g.*, WARN Act, TUPE) have;
  - (viii) what level of compatibility is there between each of the parties' employment policies (*e.g.*, drug-testing policies);
  - (ix) will any employees be designated as "key" and what is the impact of such designation;
  - (x) what happens to employees upon expiration or termination of the agreement;
  - (xi) what restrictions will there be on hiring the other party's employees; and
  - (xii) what background checks must be run on the service provider's employees and, for offshore outsourcing, what type and quality of background checks are even available.
- C. Transferred Employees. The agreement should address several issues regarding the provision of benefits to the employees transferred from the customer to the service provider, including:
- (i) accrued vacation time and vacation policies;
  - (ii) retirement plans and policies;
  - (iii) insurance plans, waiver of pre-existing condition exclusions and deductibles;
  - (iv) severance availability and policies;
  - (v) retention of seniority; and
  - (vi) employment policies.

- D. Seconded Employees. Seconded employees are those employees of a party that such party “lends” to the other party for some period of time. The parties will need to determine who will bear the actual economic responsibility for the seconded employees’ compensation and benefits, and who will have the authority with respect to the replacement or termination of seconded employees. Care must be taken so as to avoid (i) joint employer liability with respect to seconded employees and (ii) permanent establishment tax exposure. The parties should clearly articulate responsibilities and indemnities.
- E. Independent Contractor Agreement. The agreement should specify which party will be responsible for obtaining consents for the transfer of any relevant independent contractor agreements.
- F. Terminated Employees. There are a host of issues to be considered if employees are to be terminated. Depending upon the number of employees and jurisdictions involved various notices must be given and laws complied with (*e.g.*, WARN Act).

## VI. INTELLECTUAL PROPERTY

Use and ownership of intellectual property are key issues in the business process outsourcing agreement because the outsourcing relationship, depending on the nature of the services, often produces new or improved products, services, technologies or other intellectual property. Also, the customer and service provider share many of the same resources in an outsourcing relationship, some of which may be proprietary. The outsourcing agreement should state whether the customer or the service provider will retain ownership of any intellectual property that may be used or developed by the other party during the course of their arrangement. The agreement should also address the issue of which party will own the results of any new developments or improvements. The parties should also consider issues involving confidentiality and privacy.

## VII. RISK ALLOCATION

An important function of the business process outsourcing agreement is the allocation between the parties of the various risks associated with the contemplated transaction. The risk allocation and exculpatory schema pose some of the thorniest issues between the customer and service provider, reflecting each party’s legitimate business interests.

- A. Limitation of Liability. Outsourcing agreements often contain a cap on direct damages for which a party may be liable. This cap can be an absolute dollar amount or a percentage of the fees paid or to be paid under the agreement.
- B. Exclusion of Consequential Damages. Most outsourcing agreements will contain an exclusion of any special, indirect, exemplary, incidental or consequential damages (including loss of profits). Sometimes the parties consider certain specific exemptions from such exclusion, such a gross negligence, willful misconduct certain breaches (*e.g.*, confidentiality obligations), and indemnification obligations.
- C. Indemnification. The indemnification clause identifies the claims and causes of actions from which each party will protect the other (*e.g.*, the service provider may indemnify the customer from any damages arising from claims made by the service provider’s employees).
- D. Disclaimers. The agreement will also likely disclaim other warranties and set forth certain situations for which a party will not be held responsible (*e.g.*, malfunctions of third-party software).

- E. Insurance. The parties should consider the existence of, and need for, insurance for various types of losses as part of the overall risk allocation construct.

## VIII. DISPUTE RESOLUTION

The time and expense involved in effecting the orderly transition of services from the customer to the service provider (and back again) typically dictate that the outsourcing relationship must last for several years to make economic sense. Therefore, the business process outsourcing agreement should set forth procedures for the resolution of disputes between the parties that fall short of termination or litigation. The agreement should also state whether the customer will pay for the services during disputes. One option is to have the customer put any disputed payments in an interest-bearing escrow account until the dispute is resolved, with interest on the escrowed amount disbursed in accordance with the resolution.

## IX. TERMINATION

Just as the outsourcing relationship may be analogized to a marriage, the outsourcing contract may be analogized to a pre-nuptial agreement: (i) the effects of termination often depend on the cause of termination (*e.g.*, if one of the parties is in breach of the agreement, the agreement may place more post-termination burdens on that party or provide fewer benefits to that party); (ii) the agreement gives the parties a chance to decide how to wind down the relationship at a time when they are not involved in a dispute and are probably more inclined to be reasonable; and (iii) if the parties dissolve their relationship without the protection of an agreement, it is not uncommon for one party to suffer significant economic consequences.

- A. Triggers. The agreement should specify the circumstances under which one or both of the parties may terminate the agreement. For example:
- (i) the agreement should specify a date on which it will expire and any renewal rights or mechanisms;
  - (ii) one or both of the parties may want the option to terminate the agreement if the other party undergoes a change of control (or at least if the change of control is a competitor of the party non undergoing the change);
  - (iii) one or both of the parties will probably want the agreement to provide for termination if the other party commits a material breach; and
  - (iv) the agreement may include a provisions allowing either party to terminate the agreement for convenience (*i.e.*, for any reason, or no reason at all).
- B. Effects of Termination or Expiration. The rights and duties of each of the parties upon termination or expiration of the agreement should depend upon the circumstances of the termination. For example, the agreement may provide that certain pre-termination obligations of one party do not continue after termination of the agreement if termination is due to a material breach by the other party. The parties should include a matrix in the agreement that shows what terms will apply in the event of expiration or for each type of termination, including the following:
- (i) ownership of any proprietary information, technology or other intellectual property created under the agreement;

- (ii) application of a termination fee or repricing charge, and its amount (which may differ depending on the length of performance under the agreement at the time of termination);
  - (iii) responsibility for demobilization and remobilization costs;
  - (iv) obligations under non-solicitation, non-poaching and non-competition covenants in the agreement;
  - (v) ownership in any assets used, transferred or acquired during the term of the agreement; and
  - (vi) transition of any seconded or other employees back to the customer.
- C. Housekeeping. The agreement should set forth the processes the parties will follow upon termination so that the transition is orderly. Some issues to consider are:
- (i) whether the parties will need to return materials to the other party;
  - (ii) whether there will be any ongoing license fees or other payment obligations;
  - (iii) whether the customer will have the right to purchase equipment or other assets or to be assigned any equipment leases; and
  - (iv) whether the service provider or the customer will be responsible for effecting the transition of the transferred employees to the customer or a third party.
- D. Transition Services. The termination transition services are those additional services the service provider may undertake to provide upon expiration or termination of the business process outsourcing agreement. A partial termination (*i.e.*, a discontinuation of only some of the services provided under the agreement due to divestiture or other reason) may also trigger termination transition services. Some issues to consider are:
- (i) the duration that the service provider will provide termination transition services to the customer;
  - (ii) the need for confidentiality agreements should the customer want to effect a transition from the services to a third party service provider (including an agreement that the third-party's outsourcing division will not communicate the service provider's confidential information or proprietary methodology to personnel in other divisions of the third party);
  - (iii) the amount, duration and type of termination transition services that may be provided may vary depending upon the reason for termination (*e.g.*, termination services provided upon termination for the customer's convenience should differ from those provided upon termination due to the customer's breach);
  - (iv) payment; and
  - (v) relief, if any, from service level and other performance obligations.

## X. OTHER ISSUES

There are a myriad of other issues that should be considered by the parties to the outsourcing agreement, some or all of which may be significant in a particular transaction. These include: audit rights (of particular import for Sarbanes - Oxley compliance), tax, data privacy and protection, and disaster recovery/business continuity planning.

## SUMMARY

- ◆ **Structure of the Agreement.** The outsourcing agreement may be structured as a “master” allowing for future and multiple sub-agreements or a single, holistic instrument. Because of the long duration of most outsourcing relationships, the outsourcing agreement should include procedures by which the parties can address expected and unexpected changes and disputes with minimal disruption to the relationship.
- ◆ **Scope of Services.** The outsourcing agreement should identify not only the functions included in the scope of services, but also what functions are excluded from the scope of services and what functions are the responsibility of the customer.
- ◆ **Quality of Services.** Measurements by which the service provider’s performance may be monitored can be subjective (*e.g.*, reasonable efforts in providing services) and objective (*e.g.*, conformance to specifications).
- ◆ **Fees and Payments.** The outsourcing agreement should specify the pricing mechanism (*e.g.*, fixed price, time and materials), any price controls (*e.g.*, CPI/PPI/ECI adjustment factors, price ceilings or floors), requirements regarding records retention, audit rights and responsibility for taxes.
- ◆ **Human Resources.** The outsourcing agreement should include the parties’ understanding regarding the retention, transfer or secondment of the customer’s employees, as applicable.
- ◆ **Intellectual Property.** The outsourcing agreement should state the parties’ intentions with respect to ownership of, and responsibility for, intellectual property, including intellectual property belonging to one party but used by the other and intellectual property developed in the course of the outsourcing relationship. Confidentiality covenants are necessary to better protect confidential information.
- ◆ **Risk Allocation.** Typically included in the outsourcing agreement are provisions limiting each party’s liability for direct damages and excluding each party’s liability for indirect damages (*e.g.*, lost profits). The parties may also allocate risk through indemnities, disclaimers of liability, and insurance.
- ◆ **Dispute Resolution.** Procedures for the resolution of disputes that fall short of termination or litigation should be included in the outsourcing agreement. The outsourcing agreement should contain terms regarding the provision of services and payment of fees during resolution of the dispute.
- ◆ **Termination.** The termination provisions should specify the circumstances under which one or both of the parties may terminate the agreement and the effect of termination or expiration on the rights and duties of the parties (*e.g.*, a party may not continue to be obligated under a non-competition covenant in the outsourcing agreement if the other party has materially breached that agreement). The outsourcing agreement should also include terms regarding the provision of termination transition services.
- ◆ **Other Provisions.** The parties should consider and include provisions regarding audit, disaster recovery/business continuity, data privacy and protection and tax.

## KEYS TO NEGOTIATING BUSINESS PROCESS OUTSOURCING AGREEMENTS

- ◆ **The Relationship:** Keep in mind that business process outsourcing is a strategic relationship.
  - Use of contract negotiation process as an opportunity to identify and treat issues and to build a foundation for the relationship
  - Use of a clear statement of overarching principles and objectives
  - Consideration of the parties' compatibility
  - Maintenance of a long-term focus
  - Use of a win-win approach to negotiations
  - Avoidance of extreme positions
  
- ◆ **Business Orientation:** Identify the business objectives, risks and criteria for success; for example:
  - Cost reduction or cost certainty
  - Service level improvement
  - Specialized expertise and technology
  - Re-engineering and transformation of business processes or technology
  - Economies of scale, knowledge and specialization
  - Declining vs. static vs. growing demand
  - Turnover of work force
  - Regulatory and other legal requirements
  - Spin-off of service-providing entity
  - Use of shared facilities and other resources
  
- ◆ **Strategic Considerations:** Consider the life cycle and character of the outsourcing relationship.
  - Start-up, strategic milestones, duration and winding down
  - Transitions, anticipated changes, process for unanticipated changes and renewals
  - Degree of exclusivity (*e.g.*, a requirements contract)
  
- ◆ **Agreement's Structure:** Select a suitable structure for the agreement; for example:
  - Master umbrella agreement with a process for adding work orders or ancillary agreements
  - Definitive specifications vs. process-oriented
  - Outsourcing joint venture
  
- ◆ **Agreement's Function:** Think of the agreement as a blueprint for answering questions that will arise.
  - Anticipation of who, what, when, where, how and (sometimes) why questions
  - Whose responsibility
  - What rights and remedies
  - Governance and dispute resolution procedures
  
- ◆ **Three Key Dimensions:** Focus first on three key, interrelated dimensions.
  - Scope of the outsourced services
  - Performance criteria for those services
  - Pricing and cost allocation
  
- ◆ **Scope:** Define the scope of the services to be outsourced.

- Detailed specifications vs. evolutionary refinement
  - Existing baselines vs. industry standards vs. to-be-set metrics
  - Relationship with information technology function
  - Change management
- ◆ **Performance Criteria:** Establish how to measure, manage and monitor service performance.
- Linkage to pricing
  - Strict accountability vs. flexible “partnering”
  - Who sets priorities and how
- ◆ **Pricing and Cost Allocation:** Decide on pricing and allocation of costs.
- General pricing model
  - Timing and currency of payments
  - Incentives and disincentives
  - Pricing adjustments
  - Effect of early termination
  - Taxes
  - Retained, pass-through and included costs
  - Records and audits
- ◆ **Personnel, Assets and Work Product:** Handle key legal parameters.
- Human resources
  - Compensation, seniority and benefits
  - Transferred assets
  - Rights under licenses
  - Ownership or other rights in work product
- ◆ **Risk Allocation:** Apportion risks and contingencies.
- Risk management techniques, such as:
    - limitations on liability
    - limitations on time period to bring an action
    - indemnification and insurance
    - representations, warranties and disclaimers
  - Specific concerns, such as:
    - confidential information
    - solicitation
    - force majeure (and disaster recovery)
- ◆ **International Aspects:** Consider cross-border concerns.
- Different laws
  - Different technical standards and requirements
  - Taxation including permanent establishment/foreign qualified business issues
  - Transborder information flow
  - Employment and benefits