

E-COMMERCE

Outsourcing Work Facing New Frontiers

Greater Reliance on Technology Increases Complexity of Decisions on Whether to 'Farm Out' Tasks

BY JOSEPH I. ROSENBAUM

IF YOU ARE a history buff, little about the concept of "outsourcing" is actually new. Some of us recall the timesharing companies and service bureaus of the late 1960s and 1970s. Payroll, security and other functions were

commonly operated and managed by an outside company tied to service and price criteria to suit the times and function. In the relative infancy of widespread commercial use of technology, the large mainframe com-

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puter providers or purchasers, with trained personnel and excess capacity, wisely reasoned they could provide the data processing needs of a wide variety of customers and make money at it.

Then came the early 1980s. As more and more processes and operations became automated, single outside vendors were having difficulty meeting increasing demands for flexibility and increasingly complex systems and operational requirements. Many of these companies either died out, folded up these timesharing/service bureau operations or simply reinvented themselves and went on to other businesses.

Other factors played a part in the demise of those business models as well. The technology itself had changed, and the integration and pervasive infiltration of technology into the fabric of business, government and academia became fundamentally different today than it was in the 'early days.' There were no PCs or worksta-

tions, nor any graphic interfaces, client server architecture, networks or competitive global telecommunications in 1970. Large mainframe computers, not software or networking companies, dominated the landscape. It may also be true that the robust economic growth through the mid-1980s allowed companies the luxury of experimentation in leading edge technology well beyond their real needs.

As computing became increasingly cost-effective and internal skills developed to enable bringing technology in-house, operations and functions previously left outside the control of company management were increasingly perceived as strategic disadvantages. The percentage of the operating expense budgets of many companies earmarked for technology and technology related goods and services (e.g., telecommunications, software development, inventory and distribution control and management) increasingly reached into double digits, becoming noticeable to the CFOs, CEOs and the boards of directors, not just to the technology gurus and operations staff.

Technology was becoming critical to the formulation and execution of business plans and the distribution and delivery of goods and services to customers. Marketing and sales, even operations, was sitting up and taking notice at how useful and user-friendly technology was becoming. Technology was able to provide a competitive and potentially sustainable edge, especially if the technology was protectable under intellectual property laws. The computer monitor was no longer the exclusive domain of the senior executive checking stock quotations. Now personal computers, tied to extensive corporate networks, increasingly tied to the Internet, were being provided to every staff member upon their arrival, along with the desk, telephone and business cards.

And so it became time to INSOURCE. Companies began building huge organizations and operations, beefing up infrastructure investments in technology and telecommunications. After all, why spend so much money on technology that was outside your control? Management felt proprietary

ownership of systems, and operations gave them increased flexibility and control over their own destiny, especially as the cost of acquisition decreased dramatically with every new computing industry announcement. In fairness, when you own or control the system, you do have more flexibility, operational control and a stake in the direction and outcome; you also pay more and need the ability to adapt and manage the technology, not just the company's core businesses.

If you looked carefully, after 1987 through the mid 1990s with outsourcing deals aplenty and then the slowdown in the late 1990s corresponding to a healthy economy and renewed desire to control competitive technology, the pendulum swung a bit once again. The new millennium has brought us back to the days when company management is increasingly faced with the decisions of whether to 'scrap or sell' rather than 'buy or build.'

Chief Information Officers, Chief Technology Officers and technology professionals are more frequently charged with the responsibility of determining whether their own organizations or an outside third party should be providing the business solution to their companies' needs--why own when you can rent? Even government has come to the conclusion that being in the business of operating non-critical operations that private corporations can do more effectively and more cheaply is both wasteful and, quite frankly diverting attention away from the more important functions of government and its agencies.

Complex Considerations

Because outsourcing can mean many things, it is important to understand it in the context of our technological and economic environment to truly appreciate its legal significance in today's world. Everyone outsources. For years companies outsourced employee cafeterias or the cleaning and maintenance services in buildings. Law firms routinely outsource photocopying, filing and courier services. To some extent

the pendulum analogy has merit when viewed as part of a normal economic or business cycle. There is always a dynamic balance between internal and external forces. A balance which changes with technology, consumer preference, market and economic factors and financial conditions, internal and external. An all-or-nothing approach to anything rarely makes good sense in any business, and the pendulum does swing on the basis of the interplay of these and other factors.

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However, as computing and technology have invaded more and more of the commercial workplace, the evaluation of which functions, operations and activities and which technology makes sense to keep inside or to 'farm out' has become more complex, with greater potential impact on the organization. The ratio of 'commoditized' to 'customized' technology has increased, making outsourcing ripe. If desktop computing has given technological power back to the people, outsourcing seems to be giving economic and financial control of information technology back to the business management of many companies. Indeed, outsourcing decisions are being more rigorously scrutinized and evaluated by teams comprised of business and technology management, strategic planners, consultants, lawyers, human resource professionals and tax advisers, to name only a few of the specialists involved.

Both providers and customers in an outsourcing transaction consistently articulate several key themes. First, there is a realization that someone else can do it more cheaply, more quickly or better -- the simple desire to save money and reduce operating expenses. Second, companies are tired of struggling with legacy systems, rapidly outdated or obsolescent technology and the overhead needed to either maintain or constantly upgrade them. Third is the unfair, but almost knee-jerk frustration and growing

reluctance to spend time and resources on non-core business activity. Companies with huge technology infrastructures and their associated costs are finding that managing change and using rapidly changing technology as an enabler for business opportunity have become more difficult and expensive to manage. Technology organizations that previously touted the competitive need to be at the leading edge, have made CEOs and CFOs question whether they really mean the bleeding edge.

In truth, outsourcing is not a passing fad, but is one weapon in management's arsenal of choices in managing business. Like any other management responsibility, it is an alternative which is up for consideration and re-consideration as business requirements change. Reliance on technology and its pervasiveness in every aspect of commerce and business operations requires quite a different partner -- a different outsourcing goods and services provider -- than the typical "service bureau" of years ago. Furthermore, while the price/performance ratios of technology itself has declined, companies often find they are the not-so-proud owners of a costly and massive legacy technology infrastructure, revitalizing the need for fully loaded, cost-justification. Reengineering and process improvement make outsourcing an increasingly attractive alternative, if not an almost automatic solution to some infrastructure problems, real or perceived.

Range of Legal Issues

The legal and contractual issues raised by outsourcing range from expense control to confidentiality, from market flexibility to the protection of competitive advantage in the marketplace, from performance benchmarks and assignments of third-party contracts to employee pension vesting rights. Distinctions between strategic technology versus fungible technology are raised. Decisions are required in areas where previously there weren't even any questions. Consultants are called in to evaluate what, how much, for how long, to whom and at what price, outsourcing should be considered.

In structuring the outsourcing transaction and in preparing and negotiating outsourcing agreements there are obvious similarities to a broader array of legal and contractual issues and those specific to e-commerce and digital technology. However,

there are also some issues in outsourcing -- critical issues -- that are unique or need to be treated in a unique way when outsourcing partners are selected and agreements negotiated. A quick summary of some of the key issues may prove helpful:

- *All or Some?* First of all, determine whether the goal is to simply outsource everything or to actually assess needs, evaluate priorities, costs and strategic requirements and come to a conclusion as to which functions, processes or operations should be outsourced and which should be retained. As noted previously, outsourcing is a tool and a means for most businesses to more effectively achieve their business goals, not an end in itself. Nor are these decisions static, although they may be long term. The thinking and ultimately the contract that reflects that thinking should be uppermost in the minds of management when beginning to structure the outsourcing relationship.

- *Control, Flexibility and Cost.* These are key factors in the evaluation of outsourcing as a business and operational alternative. IT management has long been familiar with the interplay among these factors and the balance which is played out over and over again in internal budget sessions, project reviews and investment decisions. Consider the difficulty and implications of changing systems architecture, migrating major applications or consolidating data centers; add to this difficulty, the involvement of a third party, the outsourcing company. A third party that ultimately has differing business objectives, priorities, other customers and a different business and financial model for profitability then your business. This is far from a trivial exercise.

- *Human Resources.* Most outsourcing arrangements involve employees in one way or another -- from the need for confidentiality which surrounds the initial deliberations to the communication advising employees of management's decision; from the consideration and migration of seniority, pensions and benefits, to decisions involving termination, changes in salary and even relocation. Traditional technology deals involve technology; outsourcing deals have a greater and more dramatic effect on people and the organization. These issues need to be handled and resolved in the agreement, and the outsourcing contract must deal with these issues clearly and in great detail.

- *Performance Standards.* From customer service to market flexibility, defining

and prioritizing standards, metrics and performance benchmarks can provoke long internal debates and even longer negotiations with the outsourcing provider. As most organizations learn, the discipline required to define one's own processes and set appropriate service level criteria can be agonizing. Even companies with standards have not reviewed their relevance or appropriateness for some time, and they may no longer relate to today's needs or business processes. Obviously, outsourcing contracts contain painstakingly detailed remedy and liability sections which attempt to fix accountability for achieving or meeting performance criteria.

Since both parties will want to define the standards that will be applied, and correspondingly the consequences of failure to meet these standards, the process of preparing an outsourcing agreement leads to a rigorous and often agonizing internal review before one is prepared to sit down and bargain with a third party, much less reach agreement on appropriate remedies and responsibilities. More often than not, consultants are retained to assist, in many cases not only for their expertise, but also to relieve the workload and strain on an already burdened organization and to inject a measure of objectivity and fresh perspective to an organization resistant to change and fearful of the consequences of the exercise.

- *Compliance and Security.* Sometimes overlooked in outsourcing deals, corporate compliance requires careful examination. Corporate (and director/officer) liability can be at stake here. Regulators and courts provide no immunity for companies because of a decision to entrust their operations to a third party service provider. Ensuring that the service provider understands and can and will meet compliance and reporting requirements in a timely manner is a key issue in many agreements. In addition, concerns over personnel, both physical and logical access to facilities and resources, database administration and access to sensitive customer and financial information (e.g., confidentiality) must be addressed. Indeed, outsourcing often includes the security function, certainly from a data and information processing viewpoint, and yet all too often the outsourcing agreement fails to adequately address the customer's requirements.

- *Relationship Management.* More than virtually any other contractual relationship, the customer and outsourcing company must

develop and maintain a solid working relationship, a partnership, in both operation and spirit, albeit not in a legal sense. From communications regarding problems to shifting priorities, from change control to adherence to performance standards, there is no substitute for a strong and effective team approach between service provider and customer in an outsourcing relationship. Proper management and monitoring of service deliverables effectively determine the degree to which the customer's anticipated benefits of the sourced business operations, processes or functions will actually materialize. Additionally, business is not static, and the contract must provide for change and in fact, provide a mechanism which encourages the parties to recognize and deal with change. It is inevitable, and avoiding this issue will almost always lead to dispute.

- *International.* Global outsourcing is a more complex subset of domestic outsourcing. While international outsourcing transactions certainly complicate many of the more obvious issues (e.g., labor and employment issues need to be reviewed in the context of a variety of laws and jurisdictions), there are some issues which arise as a result of multinational outsourcing: currency considerations, transborder data flow, data security and privacy, governing law, dispute resolution and even the interpretation and enforcement of contracts. Each of these requires different treatment in an international outsourcing arrangement.

- *Insourcing.* A closing and sometimes forgotten item when preparing outsourcing contracts. The decision to outsource is generally reviewed and scrutinized carefully by many. Once the decision is made, however, it should be understood it may not be permanent, in whole or in part. Make sure you have the legal and contractual right, defined in the contract, to re-evaluate and either take back an outsourced operation or move it from one service provider to another in a measured and amicable transition process. Businesses, operations, requirements and costs change; don't lose sight of the fact that 'insourcing' may be in vogue tomorrow. More importantly, don't lose the flexibility to do it.

Conclusion

From preparing Requests for Proposals to negotiating contracts and preparing de-

tailed exhibits and specifics of the transaction, to implementation and management of the relationship, outsourcing decisions are not made lightly or routinely. Into this dynamic quagmire comes the legal professional.

Risks and issues which are new to many organizations are also new or unknown to many lawyers: a host of human resource issues, performance standards, assignment, employment and warranty questions, growth, change control, customer service and termination issues. How to handle a migration plan? How to price one? What if it doesn't work, in whole... in part? What about the people on the payroll? What if I can't get the service or performance I need? What if my needs change and I need to change my systems, my operations or my processes or even my business? The implications are large, the risks enormous and the complexity overwhelming -- don't skimp on retaining people with the right expertise, including lawyers.