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Outsourcing Services in the Face of an Economic Downturn

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Outsourcing Services in the Face of an Economic Downturn

In previous recessions, outsourcing activity has actually increased. Is history likely to repeat itself? And, if it does, what particular features of the current outsourcing and offshoring industries are outsourcers likely to use most?

In this time of extreme economic duress, all companies are looking for ways to decrease expenses significantly and quickly, and to streamline operations as the economy heads into what could be a lengthy recession. Not surprisingly, companies are turning to outsourcing as a means to achieve these ends.

Whereas, over the past five years, industry conferences and publications increasingly focused on outsourcing as a means for transforming one's business or for improving those functions being outsourced, the recent economic collapse has put such outsourcing rationales on the back burner. Today's outsourcing deals are intensely, singularly concerned with reducing head count and saving money – the sooner, the better. In an environment where Fortune 500 companies have disappeared overnight, a successfully executed outsourcing deal could make a difference in a company's ability to ride out these challenging times.

It's all about Costs

The management of costs through outsourcing is achieved not only through cost-cutting measures via, for example, offshore labor arbitrage, but also by enabling companies to shed fixed operating costs in favor of vendor-offered variable pricing. Variable pricing based upon usage enables companies to reduce expenditures when their internal requirements for operational resources decrease as demand for their own goods and services decrease. Conversely, as demand increases, external vendors are typically better equipped to increase provision of outsourced services, thereby enabling companies to meet fluctuations in the marketplace without consistently carrying bloated overhead costs.

The ability to offer flexibility is particularly critical in these times of current economic uncertainties. Companies must be prepared to change course dramatically as they undergo mergers and divestitures, and those vendors which can offer not only lower costs and variable pricing, but also the ability to assist companies in tackling operational upheavals, are finding increasing favor amongst sophisticated customers.

Of course, outsourcing does not necessarily guarantee cost savings. The important point for the outsourcing customer is to ensure that, contractually, it has indeed secured the pricing terms, flexibility, and other expectations that it anticipated during negotiations. To accomplish this, companies must take care to avoid potential pitfalls in common offshore outsourcing destinations such as India and, increasingly, China.

Offshoring to Reduce Costs

Onshore and offshore vendors are able to offer lower costs through economies of scale facilitated by shared services or the ability to allocate resources across various customers. Offshore vendors in particular are able to offer attractive pricing terms in light of their significantly lower labor costs. This has been particularly true with labor-intensive services, such as application development and management services and other similar operations, where the service provider has limited fixed costs associated with the services offered to customers. U.S.- and European-based providers have also taken advantage of the labor arbitrage by including offshore services as a significant portion of their service offerings.

While India has traditionally been the most popular offshoring destination, in recent years offshore vendors from other jurisdictions have made increasing headway into the marketplace. Chinese software development companies, in particular, have won significant engagements, particularly on projects for the development and maintenance of applications for use in, for example, the financial industry. In addition, many Indian vendors have established operations in China as they seek ways around increasing Indian labor costs and labor shortages in the high-tech industry.

India Considerations

In negotiating contracts with Indian or Chinese vendors, however, customers should seek advice from advisors and attorneys well-versed in negotiating outsourcing contracts with vendors of those jurisdictions. In India, specific copyright and other intellectual property ("IP") issues, as well as dispute resolution concerns, require expert navigation. For example:

- Any copyright assignment, such as with respect to software code, will be deemed territorially limited to India and temporally limited to a period of five years, unless the assignment specifies otherwise. Accordingly, any assignment executed by a vendor who may be developing software in India should specify that worldwide rights in and to the software are assigned, and that such rights are being assigned in perpetuity.

- In order for a company to secure patent rights in an invention, a written assignment must be secured from the inventor/employee. Accordingly, customers who anticipate that inventions may be developed under a vendor contract should require that the vendor secure written assignments from their employees in form satisfactory to the customer.

- In the event of a contract dispute, a judicial award issued by a U.S. court is unlikely to be enforceable in India. India is, however, a signatory to the New York Convention (the United Nations 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards), which requires courts of contracting states to enforce awards made in other states, subject to specific limited exceptions. Accordingly, a U.S. customer may wish to consider the alternative of including an arbitration clause in its contracts with Indian vendors.

China Considerations

In China, the technology transfer regime can pose particular obstacles to outsourcing arrangements that require the import and export of proprietary software or other IP, such as application development and management services. For example:

- Certain technologies are prohibited or otherwise restricted from being imported into China. The Ministry of Commerce ("MOFCOM") publishes catalogs, but not in English. If the technology is not listed in the catalogs it can be imported into China, provided the technology contract (or license agreement) is registered with MOFCOM.

- While registration is a fairly simple process, the technology transfer regulations do require the importing party (i.e., the customer) to give fairly onerous warranties regarding the fitness and completeness of the licensed technology, as well as non-infringement of third-party IP rights.

- Moreover, the regulations also severely limit the importing party's ability to restrict the Chinese party's ability to make and use improvements to the imported technology in the import/outsourcing contract.

- Attempts to circumvent these regulatory requirements (for example by inclusion of U.S.-style disclaimers), or the failure to register a technology contract, may result in difficulties in enforcing the contract against the Chinese party. In order to mitigate these issues, Chinese outsourcing arrangements are often structured such that the customer contracts with an offshore affiliate of the Chinese service provider who then sub-contracts the service onshore.

- As with India, a judicial award issued by a U.S. court is unlikely to be enforceable in China as no reciprocal enforcement treaties currently exist. China is a signatory to the New York Convention and it is, therefore, commonplace for offshore parties to include arbitration clauses in contracts with Chinese vendors. It should be noted that, notwithstanding China's participation in the New York Convention, experience dictates that arbitral awards made in regional jurisdictions such as Hong Kong and Singapore tend to be easier to enforce in China than those made in the U.S.

A customer should bear in mind that contracts with Indian vendors using facilities in both India and China may, in some cases, necessitate multi-party contracts, with the inclusion of the Chinese subsidiary, in order to secure contract enforceability against the Chinese party and to secure IP rights in China.

Other Financial Considerations

In dealing with foreign vendors, customers should also consider the extent to which currency fluctuation risks should be allocated between the parties. In this regard, it should be noted that it is common for foreign vendors to bear 100% of any such risks in exchange for having the right to enjoy 100% of any upside benefits that may result from any currency fluctuations. Currency fluctuation risks have historically not presented an issue for outsourcing agreements in China. The Chinese renminbi yuan (RMB) is not a freely convertible currency and, therefore, cross-border payments to the Chinese service provider must necessarily made in another currency (usually U.S. dollars).

Historically the value of the RMB has been effectively pegged to the U.S. dollar. However, it should be noted that such arrangements have come under considerable international scrutiny in recent years and it may be prudent to provide for an adjustment in pricing based on currency fluctuation in China outsourcing contracts, particularly those of lengthy duration. With regard to Indian vendors, there has been a shift away from a past willingness to bear currency risk. But given the U.S. dollar's recent strength against the rupee and other currencies, that shift may reverse course.

In addition, in the event of any cost of living price adjustments, customers may wish to seek a ceiling above which the vendor would not have the right to increase prices. In this regard, parties to contracts involving services provided from India should bear in mind that the government of India recently announced that the Central Statistical Organisation of the Ministry of Statistics and Programme Implementation would cease publication of the commonly used consumer price index entitled "The All-India Consumer Price Index for Urban Non-Manual Employees CPI (UNME)." Accordingly, parties may wish to consider alternative indices. Furthermore, consideration should be given to the extent to which any price indexing should apply. In other words, parties should review whether 100% of the fees should be subject to indexing or whether a smaller portion should be subject to fluctuation based upon the relative portion of the vendor's costs that may be susceptible to inflation – e.g., wages and costs of other resources.

Flexibility of Terms

Flexibility is of particular importance to customers facing potential divestitures, mergers, or other reorganizations. Indeed, the ability of customers to significantly increase or decrease the volume of services or to otherwise vary the terms of their contractual relationship with their outsourcing vendors is particularly important in these uncertain times. With mounting economic pressures and increased competition amongst providers, we are seeing a greater willingness by vendors to adapt to client requirements for flexibility. But vendors will consider what impact granting such flexibility may have on their bottom line – for example, whether a customer is likely to be acquired by another customer, and any resulting cannibalization of fees. It is, however, more critical than ever that contractual terms be crafted to allow the customer to change course mid-stream as necessary to meet the challenges posed by the current economic environment.

Issues to consider include whether the contract:

- requires the vendor to cooperate with other vendors to transition services to a merged entity;
- requires extensive transition assistance;
- includes pricing terms that are sufficiently flexible to enable the customer to significantly increase or decrease services without unwarranted penalties;
- permits the customer to share software code or other materials developed by the vendor with new affiliates;
- permits the customer to assign the agreement in connection with a divestiture, merger, or other reorganization; and
- allows the addition of additional service recipients without the prior approval of the vendor.

These are a few of the many questions that must be addressed when negotiating sourcing contracts to prepare customers for the uncertainties that may lie ahead. In addition, customers should negotiate robust change control provisions.

For further information regarding flexibility, please see the Morrison & Foerster LLP Legal Updates & News, dated January 2008, entitled *"Because Change Happens – How to Ensure Flexibility in Your Outsourcing Arrangements."*

Financial Engineering

In addition to the increasing attractiveness of outsourcing – and especially offshoring – to cut costs outright, companies are also likely to push their chosen service providers to consider "financial engineering" in the charging mechanisms of their outsourcing arrangements. Effectively, if you can't get your bank to extend credit to you at the moment, is it possible to use a service provider's balance sheet and facilities to get credit on some element of the outsourcing service fees?

Particularly in longer term deals there is often a capability to spread up-front costs over the term of the agreement and therefore allow the customer to defer paying for items such as transition, asset acquisition or initial take-on costs. Or in BPO projects, revenues may be tied to the outcomes of those processes. Of course, this sort of structuring means that the outsourcing service provider needs to bear these costs potentially well before its gets paid and, ultimately, it will need charge back for them as part of its overall service charge – presumably with a financing charge plus margin and overhead on top. However, depending upon the choice of structuring identified and upon the relative strength of the parties' bargaining positions, that may be a viable alternative.

In the past, it has been some of the Tier 1 outsourcing service providers who have been more proactive in constructing financed outsourcing deals. But in the current climate a number of other outsourcing service providers may be prepared to do the same. The issue of whether financial structuring can be offered may become a differentiating factor between service providers. The problem is, of course, that service providers can't do so for all their clients; so this may be a true test of how important a customer is to a particular outsourcing service provider.

Conclusion

As companies are faced with ever-mounting pressure to cut costs, outsourcing may be an option that becomes more broadly attractive. Nevertheless, companies must be diligent to ensure that outsourcing relationships, and the contracts that govern them, are structured to provide the desired cost savings, along with high service quality and appropriate flexibility. The current climate of fear may offer opportunities to negotiate terms and pricing that were previously unobtainable. That said, companies should keep in mind that the upward trend in wages in offshore locations are likely to continue for some time, and that, ultimately, companies may be disappointed if cost savings are the sole motivation for outsourcing.