

I Structuring of an Outsourcing Agreement – An Overview

Introduction

“More than 53 per cent of the firms in Silicon Valley outsource a part or all of their operations and almost half of the jobs that Silicon Valley outsources comes to India.¹” According to a survey conducted by Santa Clara University, Prof. Mario Belotti, Professor of Economics, said, that though China rules the roost when it comes to outsourcing from the United States’ (US) manufacturing sector², India undoubtedly is way ahead of China when it comes to Information Technology (IT) services outsourcing.

“Frost & Sullivan (F&S), a leading international growth consulting company, has rated India as the choice of partner for the rest of the world for pharmaceutical collaborations.³” In a recent two-day global pharmaceutical partnership summit in Mumbai, Global Pharm Alliance 2005 projected, that India offered a competitive advantage of capital efficiency, process engineering, high quality, qualified chemists and low labour cost, for the pharma industry. This is encouraging, considering that the future estimate of total outsourcing market for pharmaceutical and biotechnology drugs in the world is to reach close to \$60 billion by 2010, with the estimate for pharmaceutical manufacturing outsourcing alone to cross \$25 billion by 2011.⁴

India’s outsourcing industry is growing rapidly. Considering such a rapid development and having already gained recognition, India exemplifies all prospects of being a global lead player in the field of outsourcing for all kinds of services and industry, in the near future.

Every outsourcing project begins with an outsourcing agreement, wherein, the outsourcer and the outsourcee bind themselves keeping their respective interests in mind. The intention is also to make the outsourcing project a profitable business. Therefore, it is pertinent to know the elements, which structures the outsourcing agreement so as to enable smooth functioning of the outsourcing project.

Outsourcing agreement

Outsourcing involves engaging the services of an outsider (the outsourcee) to perform services which have historically been performed in-house. Although, electing to outsource services may be economically advantageous, negotiating an outsourcing agreement often involves resolving a range of complicated issues. An outsourcing agreement is a written agreement that forms the basis of the relationship between the outsourcer and the outsourcee. A well structured outsourcing agreement will have considered issues including jurisdiction, data privacy, employment issues, intellectual property rights (IPR), business continuity challenges, local laws and termination. Therefore, it would not be wrong to say that drawing up a contract is one of the trickiest tasks and also a fundamental one.

Important components in an outsourcing agreement

- Service Level Agreement (SLA):

Structuring SLA while outsourcing is very important, as it helps to measure and monitor performance. Simultaneously, it is pertinent to understand the level of service required for a particular project and maintain a realistic approach. A 100% uptime is a great target while outsourcing, but, because accomplishing

such a target involves huge costs, it is in the interest of both the parties, to consider at initial stages (preferably at the time of drafting the SLA), whether the project requires such an uptime.

The agreement should include specifics of information like duration of service, installation timetable, quality of service, payment terms and issues such as warranties, indemnities, and limitation of liability. The agreement must have details with respect to reporting mechanism, frequency and methodology of performance review and should at the same time be flexible for changes in scope, inclusion of new services and changed business requirements.

Further, it is important that the outsourcer and the outsourcee agree on how future changes will be treated. For example, in case of any change in technology, if an outsourcing agreement has a technology refresh clause, wherein, a time frame is fixed for regular technology update, its compliance will ensure that the outsourcee will not be held liable for technical breach.

Enforceability clause (**EFC**):

In order to ensure enforceability of a particular legal system to international outsourcing contracts, it is important to choose a particular law to govern the contract, during structuring of contract. The aspects which should be considered while entering into international contracts are:

There should be an express choice of law governing the contracts (**LGC**). Ensure that LGC is recognized in the country, where it is proposed to be enforced, (country where contract will be enforced will be herein after referred to as **EC**).

Where LGC does not belong to EC, in such cases it is important that all formal requirements of EC be met with. This is necessary to avoid future probabilities of the contract being rendered illegal or void on account of non-compliance of statutory regulations of the EC.

Where LGC is Indian law, it is important to ensure that the said foreign country has a similar law to that laid down under section 44A⁵ of the Indian Civil Procedure Code (**CPC**).

Where arbitration is chosen as the method of dispute resolution, an arbitration clause (**AC**) must mention the venue, the rules which will govern the arbitration; the number of the arbitrators and the body which is responsible for appointing the arbitrators; provision for appeal. Where a sole arbitrator is to be appointed, there could be disagreement between parties of the contract and therefore, AC must specify as to whose decision will prevail, in such a circumstance. Therefore, it is a common practice to appoint two arbitrators along with a chairman. AC must also state that both parties will be bound by the award, passed by the arbitrators, unless the case is in appeal.

Indemnity Clause (**IC**):

If relevant, IC must state that the outsourcer is the exclusive owner of all rights transferred to the outsourcee. The primary purpose of IC is to financially obligate the outsourcee to pay in part or in full, the outsourcer's costs and legal expenses that are attributable to the outsourcee's breach of representations, warranties or covenants made by the outsourcee. IC must also state that the outsourcee would indemnify the outsourcer for any claims made by third parties, arising out of breach by the outsourcee, as mentioned above. A possible objection by the outsourcee could be that breach of the warranties, representations or covenants could not have possibly been, without the knowledge of the outsourcer and therefore, the financial responsibility due to such a breach lies with the outsourcer. A solution to such a situation is that the outsourcer and the outsourcee take an insurance policy which covers their respective liabilities. Details of such an insurance policy must be mentioned in the outsourcing agreement. It is also important to state that the indemnity clause will survive termination. This is because in all probabilities legal

implications or law suits begin after the agreement is terminated.

Technology Refresh Clause (TRC):

An outsourcing agreement is for a fixed duration. Technology is developing rapidly and undergoing changes. It is, therefore, difficult to know what the technology will be few years from now and if the state of the technology is not cutting edge, the customer will lose a competitive advantage. Therefore, it is crucial that TRC states that the outsourcee will replace its technology with current technology or updated it from time to time (a regular time frame must be agreed upon and specified).

This is not a clause that is mandatory or often used in agreements. But, it is very important to incorporate TRC, in order to maintain the right to refresh the contract or reconsider the terms, in future. Incorporating a TRC is beneficial and in the interest of both the outsourcer and the outsourcee. This is because, on one hand by mandating that the outsourcee updates its technology from time to time, the outsourcer ensures, that it gets efficient services based on the latest technology. On the other hand, compliance of TRC ensures, that the outsourcee will not be held in technical breach in the event that the technology falls behind.

IPR Protection⁶ :

In case an outsourcer owns intellectual property, such as software, a limited license will be required to be granted to the outsourcee to use the intellectual property during the term of the outsourcing agreement. In such a case the agreement should provide that the outsourcee may only use the outsourcer's intellectual property on its behalf. Additionally, the agreement should contain adequate confidentiality provisions.

India is short of specific regulation governing data protection and therefore, protection of data is mostly done through contracts. It is important, therefore, to have a confidentiality clause in a contract which protects the privacy of the information that is outsourced by the outsourcer. The terms of the confidentiality clause must specify, which data is confidential and which is not. The clause must also state the extent to which the confidential data can be accessed by the employees of the outsourcee or third parties in case of sub-contracting. The clause must mandate, permission to be sought by the outsourcee, before extending any confidential data to those other than mentioned in the confidentiality clause. Other laws which help in the process are the IT Act⁷, Copyright Act⁸, IPC⁹, Specific Relief Act¹⁰ and customs and practices developed with the passage of time. Therefore, the confidentiality clause must specify that the parties are open to contractual remedies and the above discussed recourses, in the event of breach of the terms of the said clause.

Where a third-party intellectual property is involved, the licensing agreement under which the outsourcee has been granted license the intellectual property should be examined. This would help to ascertain whether there are any restrictions on the outsourcee's use, limitations on transfers or assignments, or confidentiality provisions. Moreover, if the outsourcee opts to license the intellectual property, any fees associated with assigning the license of such intellectual property to the third party, should be specified in the outsourcing agreement.

Software *per se* is not patentable under the Patent Act, 1970. But, according to section 3 (k) of this act, a technical application to industry or a combination with hardware is patentable.

Employment Clause (EPC):

Primarily, EPC must lay down details with respect to remuneration, other benefits like transportation, food, travel allowance, annual leave permissible, terms or parameters for considering a candidate for promotion and so on.

Contractual terms between an employee and an employer should be specific and devoid of any ambiguity, or else it could become a thorny issue to deal with. Mandatory security provisions must exist in the agreement, for example, checking employee's background, prior employment and qualifications. Employees should be made to agree on the confidentiality terms, wherein, violating the enumerated terms would be considered as clear case of breach. Authoritarian action in case of such a breach must also be clearly specified within the agreement. While structuring the terms of EPC, it is pertinent to consider relevant Indian labour laws like, The Payment of Bonus Act, 1965; The Payment of Gratuity Act, 1972; Maternity Benefits Act, 1961; Employees State Insurance Act, 1948; Employees Provident Fund and Miscellaneous Provisions Act, 1952.

▸ **Subcontracting:**

The issue of subcontracting must be addressed in an outsourcing agreement. In case of subcontracting, the agreement should require procurement of prior consent from the outsourcer. The agreement should specify that the extent of liability of the outsourcee and the subcontractor will be subject to the terms of the agreement entered between these two parties. Also, this clause must mandate a permission to be sought from the outsourcer, before outsourcee subcontracts any information or data to a third party. The clause must also specify circumstances where a license can be issued by the outsourcee to the subcontractor for it to be able to carry out its part of the contract. Further, the clause must also specify circumstances where, the outsourcee will be financially liable in the event of the sub-contractor's default. Further, terms for confidentiality and indemnity must be incorporated and agreed to in the agreement between the outsourcee and the sub-contractor.

Termination Clause (TC):

Termination may either be in terms of the agreement or for convenience. In both cases, it is important that the outsourcing agreement clearly specifies the mode and the ability of termination. It is important that the terms of termination agreed upon at the time of signing a contract are clear and devoid of any vagueness. It is also important that, terms for termination for convenience are also incorporated and agreed upon by parties while entering into an agreement. Such a structure will lessen to a great extent the future probabilities of lengthy and expensive litigation. For example, if termination is on account of breach of contract, the damages and judicial remedy available to the parties to the agreement must be specified in the contract, while bearing in mind that litigation would be a probability. Also, if the termination is on account of convenience of all the parties to the contract, then the method of winding the contract amicably must be specified; if the termination is on account of convenience of one of the parties, then the mode of making good the loss of the other party to the contract must be clearly laid down within TC.

Competent Court:

The sanctity of a contract stems from its enforceability. If the substantive law of the contract is non-Indian, then, a prime concern would be its enforceability. Not every foreign court's judgment is enforceable in India. If the country in which the decree has been passed is not a "reciprocating territory" within the meaning of Section 44A CPC, a suit has to be filed in India to enforce the judgement in India. Enforcing a decree, in India takes around 6-7 years or more, as the duration of enforceability varies on the hearing and disposal rate of the Indian judiciary, which, at most times is slow. As per the Limitation Act, 1963, limitation period of execution of a decree other than that granting a mandatory injunction will be twelve years from the date when the decree is

passed.¹¹

Conclusion

India is a dominant player in the outsourcing business along with China. It is predicted that India will be a lead player by the year 2011. This is possible only when outsourcing business keeps growing at a faster pace without losing the quality of services rendered. Just as a strong spine gives a perfect form to the body, similarly, a well structured agreement is essential for the smooth running of an outsourcing business. The specifications embodied in the outsourcing documents, determine to a large extent the efficient running of the outsourcing project.

The cost involved in constructing a high quality agreement is miniscule compared to the cost of remedying outsourcing issues in terms of management attention and related legal costs.

Structuring a refined document, that is clear and specific yet reasonably flexible is undoubtedly, a critical parameter in deciding the functioning of the outsourcing business. It is, therefore, well worth the effort to devote attention and resources to details of the outsourcing agreement including services proposed to be outsourced.

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"India gets over 50% jobs outsourced by Silicon Valley", Indian Express, 01.10.2005, New Delhi.

According to Accenture, over 23 per cent of US firms and 19 per cent of European companies regard China as their primary sourcing market for manufacturing.
http://www.accenture.com/xd/xd.asp?it=enweb&xd=services%5Cscm%5Cinsights%5Ceast_west.xml#top, http://www.indianexpress.com/full_story.php?content_id=79202 Indian Express, 01.10.2005, New Delhi.

"India seen as business pharma partner: F&S", Business Standard, 03.10.2005, Mumbai.
<http://www.business-standard.com/common/storypage.php?storyflag=y&leftnm=lmnu1&leftindx=1&select=6&chklogin=N&autono=201908>

According to a recent multi-industry survey conducted by Frost & Sullivan, 55% of companies outsource to improve company focus. Nearly as many (54%) rely on outsourcing to reduce or control operating costs, while 38% want to free resources for other purposes and 36% want to gain access to world-class capabilities. Benefits such as reduced time to market and risk sharing rank significantly lower, at 18% and 12%, respectively. Frost & Sullivan estimates the total outsourcing market for pharmaceuticals and biotechnology drugs to reach close to \$ 60 billion by 2010. [Frost & Sullivan is a global growth consulting company with expertise in Integrating growth consulting, growth partnership services and corporate management in order to identify and develop opportunities] <http://www.businesswireindia.com/PressRelease.asp?b2mid=8065>

Section 44A lays down the procedure for executing decrees passed by courts in reciprocating territory. This is an independent provision enabling a person who has obtained a foreign decree to execute the same in India.

"Avoiding outsourcing pitfalls", Jon F. Doyle, <http://www.outsourcing-offshore.com/pitfalls.html>

Section 43 and section 66 of the IT Act come closest for an action against pilferage of data. Also, section 72, IT Act, lays down penalty for breach of confidentiality and privacy which extends to imprisonment upto two years or with fine upto INR100,000 (one hundred thousand Indian rupees) or both.

Section 63B stipulates that, in the event any person knowingly makes use of an infringing copy of the computer programme on a computer, he will be punished with imprisonment for not less than seven days extending up to three years and fine which can vary from Fifty Thousand Indian Rupees to Two Lakhs Indian Rupees.

When a person dishonestly misappropriates or uses or disposes off the property entrusted upon him in violation of any legal contract, he is said to have committed "criminal breach of trust"- section 405 of IPC, which shall be punishable with imprisonment of upto 3 years or with fine which at the discretion of the court, or with both- section 406 of IPC

Temporary and permanent injunctions may be claimed against unauthorized disclosure of confidential information under the Specific Relief Act, 1963.

• Schedule - third division, Entry no. 136 of the Limitation Act, 1963.

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