

Morgan Lewis

together

Key Considerations in Offshore Outsourcing Transactions

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Overview

- Introduction – Drivers and Risks
- Putting it in perspective – the Satyam Fraud
- Choice of contracting party/guarantor
- Pursuing remedies against service providers and the differences between enforcing U.S. court judgments and arbitration awards
- Termination rights, particularly for financial/regulatory reasons
- Key Issues on Termination
 - Intellectual property and data issues
 - Personnel Issues
- Other key topics

Drivers

- Additional drivers particular to offshore transactions:
 - 3-shift work day
 - Cheaper labor
 - Spread risk across geographies
 - Skills shortage

Risks

- Additional risks particular to offshore transactions:
 - Political backlash
 - Anti-offshore outsourcing legislation
 - Global economic slowdown
 - Unknown countries and vendors
 - Lack of infrastructure
 - Inadequate processes
 - Loss of control

The Satyam Fraud

- What Happened?
 - Satyam was India's 4th Largest IT Services Company after TCS, Infosys and Wipro.
 - January 7, 2009, Satyam's Chairman Admitted to Massive Accounting Fraud.
 - Fictitious cash balance of more than \$1 billion (94% of the cash that Satyam had listed as assets in its most recent financial disclosures). Satyam had significantly inflated its revenues, operating margin and accrued interest, and significantly understated its liabilities.
 - Stock Price Crashes
 - Indian government took over the company to prevent damage to India's outsourcing industry and employees left to competitors

The Satyam Fraud

- What Happened?
 - Customers Reviewed Contract Options and some terminated (e.g., State Farm)
 - Sale to Tech Mahindra, a joint venture between the BT Group and the Indian conglomerate Mahindra & Mahindra (\$1.2 billion acquisition of 31% of the company, with an option to purchase an additional 20% at market price at a later date)
 - The two founders, the CFO and four other employees face criminal charges, as do two PriceWaterhouseCoopers former partners
 - Law suits against PriceWaterhouseCoopers by Satyam investors claiming that the fraud should have been found
 - Class action law suits in US

Correct Service Provider Contracting Party or Guarantor?

- A key initial contracting issue: Do you have the “right” party as the service provider contracting party?
 - Is the proposed contracting party a U.S. entity?
 - What is the entity’s financial condition? Where are its assets located? Do consolidating financial statements exist?
- If you do not have the “right” contracting party, do you need a parent guaranty?
 - Is the proposed guarantor a U.S. entity?
 - What is the guarantor’s financial condition? Where are its assets located?
- Main issue: Customer’s ability to effectively exercise a remedy

Guaranties

- Guaranty as additional security for the performance and observance by the service provider contracting party
 - Guaranty of payment only or of payment and performance?
 - Tax issue if performance guaranteed? (Permanent Establishment issue)
 - Guarantor to cause the performance to be made
- Consideration of other security: letter of credit, payment escrow account, source code escrow, lien/security interest, insurance, etc.

Pursuing Remedies

Best Alternative:

- Contracting party or guarantor has sufficient assets in the U.S.
- MSA provides that it is governed by U.S. law
AND
- MSA provides for U.S. dispute resolution (litigation or arbitration)

Pursuing Remedies

- Enforcing U.S. court judgments can be difficult:
 - Depends on the country - for countries recognized as “reciprocating territories,” such as Canada, the process is relatively straightforward.
 - Unfortunately , the U.S. is not recognized as a “reciprocating territory” by India. Therefore, under Indian law, a U.S. judgment (including one for injunctive relief) can only be enforced by filing a new lawsuit in an Indian court based on the U.S. judgment, which will be treated as evidentiary only.

Enforcing Judgments in India

- The U.S. judgment will be disregarded by the Indian court if it determines that the U.S. judgment:
 - was issued by a court without competent jurisdiction.
 - was not issued on the merits of the case.
 - was founded on an incorrect view of international law or failed to recognize Indian law if such law is deemed applicable
 - was obtained by fraud or violates “principles of natural justice”
- Pursuing a case in Indian courts can take years.
- Only when a judgment is obtained from the Indian court may the U.S. customer seek to attach the assets of the Indian contracting party or guarantor that are located in India.

Remedies from Arbitration

- Enforcing U.S. arbitration awards:
 - U.S. customer should consider requiring that disputes under the MSA/Guaranty be resolved by arbitration in the U.S.
 - If an Indian court determines a U.S. arbitration award is enforceable under India's Arbitration Act, it is deemed to be a decree of that court and is enforceable in India.
 - India has signed the 1958 United Nations Convention on the Recognition and Enforcement of Foreign Awards, known as the "New York Convention." The U.S. is a "convention country" and that status results in a U.S. arbitration award being much easier to enforce in India than a U.S. court judgment.

Remedies from Arbitration

- A U.S. arbitration award will be enforced by an Indian court with limited exceptions, including where the Indian court finds:
 - Incapacity of a party to the MSA; invalidity of the arbitration clause under the governing law; lack of due process; arbitration award goes beyond the scope of arbitration clause; underlying issue in the dispute is not subject to resolution by arbitration under India's laws; and enforcement would be contrary to public policy in India
- U.S. customer should consider whether to reserve the right to seek certain injunctive relief in both U.S. and Indian courts as an exception to required arbitration – to preserve the status quo, compel performance, etc

Termination for Cause vs. Convenience

- Termination for Cause
 - Typically No Termination Fees
- Termination for Convenience
 - Typically a Termination Fee and Wind Down Costs
- Termination for Material Breach – Rarely a “clean” right
 - Contributory Causes by Customer
- Solution – Include some rights to terminate for clear “causes” on the part of Vendor

Termination Rights: Bankruptcy

- Automatic stay under U.S. Bankruptcy Code renders termination rights tied to Bankruptcy Events unenforceable in the U.S.
- International bankruptcy laws vary – for example, under Indian bankruptcy law such termination rights may be enforceable.
- On other hand, India's bankruptcy laws are not as modernized as the U.S. Bankruptcy Code and do not provide as much protection or predictability for non-debtor parties (such as Section 365(n) of the U.S. Bankruptcy Code).

Termination Rights: Bankruptcy

- Under bankruptcy law, it is a valuable right of Customer to be able to terminate the MSA prior to a Bankruptcy Event involving Service Provider or Guarantor based upon evidence of pre-bankruptcy financial problems of Service Provider and/or Guarantor.
- Customer must monitor the financial condition of Service Provider and Guarantor.

Termination Rights

- Additional Termination Rights for Customer to Consider:
 - Breach of a specific financial covenant (e.g., maintaining a certain net worth, as determined by accepted methods)
 - Service Provider's or Guarantor's downgrade in credit rating
 - Material adverse change involving Service Provider or Guarantor (excluding changes generally applicable to the industry or geographic region)
 - Service Provider's or Guarantor's financial or regulatory issues

Example Provisions: Termination for Financial / Regulatory Issue

- Breach of Specific Financial Covenant
 - *Customer may terminate this Agreement, in whole or in part, if on the final day of any of Service Provider's [Guarantor's] fiscal quarters Service Provider's [Guarantor's] Tangible Net Worth is less than \$_____.*
 - *Also include covenant of Service Provider to deliver calculation of Service Provider's [Guarantor's] Tangible Net Worth as of the last day of each fiscal quarter, certified by the chief financial officer of Service Provider [Guarantor].*
 - *Need to Define Tangible Net Worth – e.g., consolidated total assets of Service Provider [Guarantor] and its direct and indirect wholly-owned subsidiaries less (a) all liabilities that should, under GAAP, be classified as liabilities on Service Provider's [Guarantor's] consolidated balance sheet, and (b) goodwill, intangible items, notes, obligations owing by officers or other Affiliates, and reserves not already deducted from assets.*

Example Provision: Termination for Financial / Regulatory Issue

- Downgrade in Credit Rating
 - E.g., “a downgrade by one or more of the three leading rating agencies in the [United States at that time (collectively, the “Ratings Agencies”) (which, on the Effective Date, are Standard & Poor’s Ratings Services, Moody’s Investors Service and Fitch Ratings)] that results in any of Service Provider’s [or Guarantor’s] publicly or privately traded securities having a rating below investment grade”

Example Provision: Termination for Financial / Regulatory Issue

- Material Adverse Change Involving Service Provider or Guarantor
 - *E.g., “any material adverse change in or effect on the Service Provider [or Guarantor] [but excluding the effect of changes that are: (i) generally applicable to the IT services industry, the [Indian] economy or the [Indian] securities markets or (ii) a result of the outbreak of major hostilities, a terrorist attack or the declaration by [India] of a national emergency or war].”*
 - Less Definitive

Example Provision: Termination for Financial / Regulatory Issue

- Governmental or Regulatory Action or Investigation
 - *E.g., “Service Provider [or Guarantor] becomes the subject of any action or investigation by any governmental authority or regulatory agency which (A) in Customer’s judgment could render Service Provider unable to provide any of the Services in accordance with the requirements of this Agreement [or Guarantor unable to fulfill its obligations under the Guaranty], or (B) involves material fraud or financial irregularities by or on behalf of Service Provider [or Guarantor] or any illegal activities by or on behalf of Service Provider [or Guarantor].”*

Cause - Other Rights to Terminate

- Change of Control of Vendor/Guarantor
- Vendor's Breach of Service Level Commitments
- Breach of Workforce Turnover Limitations
- Breach of Key Employee Restrictions

Example Provision: Turnover

- Service Provider shall use commercially reasonable efforts to keep the turnover rate of Service Provider Personnel performing the Services to a level comparable or better than the industry average for large, well-managed IT services companies. Service Provider shall implement and maintain a program designed to retain the Service Provider Personnel on the Customer account during the Term. If Customer believes that Service Provider's turnover rate of Service Provider Personnel performing the Services is excessive, Supplier shall provide data to Customer concerning the turnover rate, discuss the reasons for the turnover rate, submit its proposals for reducing the turnover rate, and agree on a program to reduce the rate at no charge to the **[Customer Group]**. For the purposes of this Agreement, the Parties agree that an annual turnover rate at or over is presumptively excessive, and Service Provider shall promptly inform Customer in the event that such a rate is experienced.
- Alternative: Specific right to terminate for cause tied to defined turnover rate.

Key Personnel Provisions

- Named Key Positions
- Commitment to Customer Account; No Removal by Vendor
- Process for Identification and Approval of Replacements
- No Assignment to the Account of any Competitor of Customer During defined Period
- Specific Right to Terminate for Cause Tied to Breach of Any of These Provisions

Alternatives to Termination

- Switch business to another vendor
 - Exclusivity covenant?
 - Deemed termination for convenience upon reduction in volume of services?
- Step-in Rights
 - Customer, or a third party on behalf of Customer, “steps in” and takes over the services for a period of time when there has been a disruption in services or breach of service levels

Key Issues Upon Termination -- IP Rights

- Before terminating or migrating to a new vendor:
 - Confirm possession of copies of all IP
 - How is the IP transmitted, stored, and secured?
 - Is the source code in escrow, if any, up to date?
- Particularly in offshore transactions:
 - Transfer software ownership rights upon development, rather than upon delivery of payment
 - Be sure that applicable IP rights assignments are in place

Key Issues Upon Termination -- IP Rights

- With respect to IP, Indian intellectual property laws will apply with respect to IP authored or created in India, notwithstanding the fact that the MSA is governed by U.S. law.
- Under Indian copyright law, with respect to an assignment of the copyright, if no duration is specified, the term of the assignment will be regarded as five years from the date of the assignment (which is made pursuant to a “Deed of Assignment” in India).
- Moreover, if the territory is not specified, the assignment will extend only within India.
- An assignment and waiver of moral rights may not be enforceable in India.
- Indian counsel needs to be consulted!

Example Provision: IP Rights

- Sample of insert to typical U.S. IP assignment clause in a MSA to address Indian copyright law issues:

The Proprietary Works will be deemed to be a “work made for hire” within the meaning of the U.S. Copyright Act of 1976 and made in the course of the Services rendered hereunder. If for any reason it is determined that title to, or any of the foregoing Intellectual Property Rights in or to, any of the Proprietary Works do not vest in Customer, or that any of the Proprietary Works do not qualify as a “work made for hire” within the meaning of the U.S. Copyright Act of 1976, then notwithstanding any laws to the contrary anywhere in the world, Service Provider hereby irrevocably and unconditionally grants and assigns to Customer in perpetuity all rights, title, and interests whatsoever throughout the world in and to the Proprietary Works, including, but not limited to the Intellectual Property Rights in and to the Proprietary Works. To the extent they may apply now or in the future, Service Provider releases and waives any and all “moral” or similar rights it may have to control use of any of the Proprietary Works. (cont.)

Example Provision: IP Rights

(cont.) Service Provider hereby waives any and all of its rights under (i) Section 57 of the Indian Copyright Act, 1957, as amended, relating to certain “moral rights” that Service Provider may have in any Customer Property or the Proprietary Works and (ii) Section 53A of the Indian Copyright Act, 1957, as amended, relating to rights that Service Provider may have in certain resale proceeds of any Customer Property and/or Proprietary Works that may be deemed to be literary works for purposes of such Section 53A. Service Provider hereby waives any right to and agrees that it will not raise any objection or claims to the Indian Copyright Board with respect to the ownership of the Customer Property and/or the Proprietary Works and all Intellectual Property Rights therein and appurtenant thereto anywhere in the world, under the provisions of Section 19A of the Indian Copyright Act, 1957. In addition, without any prejudice to the generality of the rights to be assigned to Customer under this Agreement, Customer will have the right to reassign the copyright in the Customer Property and/or the Proprietary Works and all Intellectual Property Rights therein and appurtenant thereto anywhere in the world in any manner that Customer may desire. It is further agreed between the Parties that notwithstanding the provisions of Section 19 (4) of the Indian Copyright Act, 1957, the assignment under this Agreement will not lapse nor the rights transferred therein revert to Service Provider for any reason whatsoever, including Customer not exercising the rights assigned to it.

Key Issues Upon Termination – Customer Data

- Customer Data
 - Data retransfer provisions requiring delivery of customer data on demand or periodic data delivery requirements
 - Vendor's obligations to protect data so that it is not improperly disclosed or transferred in any attempts to salvage Vendor or its assets

Key Issues Upon Termination - Personnel

- Non-Solicitation and No Hire Covenants
 - Does the contract prevent the customer (or its designee) from soliciting or hiring some or all of Vendor's personnel working on the account?
 - Right to Hire if only Non-Solicit?
 - Applicable for the duration of the term or only for specified periods of time?
 - Does Covenant Apply Depending upon Type of Termination (e.g., not applicable if Termination for Cause?)
 - Immigration Law Issues

Fees and Payment

- Inflation risks – who bears? Shared?
 - Offshore deals – inflation risks may be significant
 - Which index? Blend of indices?
- Currency risks – Who bears? Shared?
- Taxes – Permanent Establishment Issues

Example Provision: Customer-Mandated Relocation of Service Provider Service Location

- Customer shall have the right to require Service Provider to relocate the applicable Services from the applicable Specified Offshore Site If in Customer's reasonable determination at any time:
 - the risks presented by the performance of Services at the Specified Offshore Site are significantly increased
 - the total cost, including due to compliance with new or modified Laws, currency risk, inflation and tax, to Customer relating to the payment and receipt of the Services in the aggregate [by Statement of Work] increase by **XX%** or more over those costs incurred by Customer as of the signing of the MSA [**or applicable Statement of Work**]
 - A new or modified Law or other act or event outside the control of Customer materially restricts or limits the ability of Customer to operate in or transact business in the country where the Specified Offshore Site is located or to share technologies or data with such country
 - the perception of Customer in its respective marketplaces is negatively impacted, including as a result of the political or social climate or business environment or the enactment, modification or enforcement of any Law affecting Customer or any of the Specified Offshore Sites

Business Continuity

- Does Service Provider have redundant infrastructure?
- What are the DR plans?
- Where is the secondary site?
- Should the Customer have its own plans?
- Escalation procedures

Limitations on Liability

- Cap on Direct Damages
- Exclusion of Consequential and Other Indirect Damages
- Exceptions from the Cap and Exclusion or “Secondary” Caps
 - Indemnities (for third party claims), including infringement indemnity and claims by Service Provider employees/contractors that Customer and Service Provider are co-employers, claims by Governmental Authorities arising from breach of compliance with Laws obligations
 - Breach of confidentiality obligations
 - Breach of data security obligations
 - Willful failure to perform Services, including expiration/termination transition assistance
 - Gross negligence, willful misconduct, fraud

Compliance with Laws

- Allocating responsibility for compliance with laws – US, Local, Data Privacy, etc.
- Monitoring changes in laws
- Right to dictate how to comply (e.g., FDA)
- Regulatory audits
- Right to adjust fees for new or changed regulatory compliance obligation
- Right to terminate for new or changed regulatory compliance obligation
- Customer Policies – drug screening; background checks

Compliance with Laws – Sample Provisions re: Vendor Laws

- “Vendor Laws” means those Laws that:
 - (i) pertain to the operation of the business of Vendor
 - (ii) regulate Vendor in its capacity as a provider of the Services
 - (iii) are applicable to the provision of the Services,
 - (iv) are privacy and data protection Laws applicable to Vendor as the processor of Customer Data or otherwise in its capacity as a provider of the Services, including without limitation in their performance of the Services or the performance of, or adherence to its obligations under this Master Services Agreement, or
 - (v) are promulgated by a country other than the United States and that are applicable to the performance by Vendor of the Services in, or the provision or receipt of the Services from, the Vendor Service Locations where such Services are provided, and such Laws would not have applied but for the outsourcing of the Services from or to such locations (e.g., there are no business operations of Customer in such country that receive or use the Services).
- Vendor shall at its cost and expense monitor and comply with Vendor Laws, including changes to Vendor Laws after the MSA Effective Date (including new Vendor laws)

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Issues Relating to Pursuing Remedies Against Indian Service Providers

- Choice of Law:
 - Indian courts will generally recognize a choice-of-law provision in a MSA except under very limited circumstances, such as if enforcement would violate public policy of India.
 - MSA should provide that the MSA and any disputes arising under the MSA will be governed by U.S. laws.
 - However, an Indian court may apply Indian law to resolve disputes involving intellectual property, labor, insolvency and other issues, regardless of the governing law selected by the parties in the MSA.