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Managing Risk with Third-Party Contractors: Minimizing Liability in the Outsourcing of Goods and Services

Structuring Agreements to Limit Exposure and Responding to Third-Party Breaches

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Today's faculty features:

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Essential Commercial, Process and Legal Considerations for Getting Outsourcing Transactions Right

Strafford Webinar
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Agenda

- Outsourcing Overview
 - The Outsourcing Process
 - Managing Corruption and Trade Risk (Margaret Cassidy)
 - The Role of In-House Counsel
 - Personal Information, Data Security and Liability



THE OUTSOURCING PROCESS



What We Hope to Accomplish Today

- What we hope to accomplish today:
 - Help you visualize what an outsourcing agreement looks like
 - Describe the typical process for concluding a successful negotiation
 - Identify the key issues unique to outsourcing transactions
 - Identify and mitigate the risks of working internationally (Margaret Cassidy)
 - Describe typical liability constructs for these agreements in the context of personal information and data security

The Outsourcing Model

- Outsourcing is the transfer of internal business processes and capabilities to an external service provider
- The basic commercial proposition is that the service provider will do:
 - What the customer currently does
 - At the same or a better level of performance
 - For the same or a lower price
- After outsourcing the customer typically has little or no retained capability to accomplish outsourced activities

Customer Expectations

- Outsourcing is usually about financial results
 - Financial savings including decreasing corporate overhead and expenses
 - Scale services to fluctuating demand
 - Unambiguous and predictable pricing
 - Predictable consequences of change
 - Responsive to changing business needs (scalability, requirements, corporate events)

Customer Expectations (Cont'd)

- Shift risks from the customer to the service provider:
 - Performance/delivery risks
 - Pricing risks
 - Legal risks
- Ability rely on service provider's scale and expertise:
 - Management skills (especially project management)
 - Capabilities and experience
 - Trained personnel

The Outsourcing Paradox

- A successful outsourcing requires trust, understanding and alignment, yet the interests of the customer and the service provider are not naturally aligned.
- A successful outsourcing must strive to be a partnership, yet the nature of the transaction can produce complex agreements, lengthy deal cycles and adversarial negotiations.

Compliance Conundrum

- You can transfer the work, day-to day management control and some risks to the services provider,
- But not ultimate responsibility for compliance
- So –
 - How do you align the interests of your service provider with yours so that the services provider is incentivized to ensure that you are compliant?
 - What obligations can you impose on your services provider?
 - What are the consequences of doing that?
 - What are the financial consequences that a services provider will absorb?
 - What will those cost you?



THE OUTSOURCING PROCESS



Proceed Carefully

- This transaction is VERY different
 - Outsourcing services are NOT commodity services
 - No “product” at the end of the process
 - Long-term relationship
 - Exiting or reversing any outsourcing decision is always difficult, expensive and time consuming
 - No natural leverage once the contract is signed

Alternatives and Flexibility

- Competitive procurement
- Sole-source
- Hybrid approach
- Remain open to alternatives:
 - Including not outsourcing
 - Even in sole source situations

Basic Steps

1. Develop a realistic and flexible schedule
 - A. Customers usually need more time than service providers
 - B. Do not compromise the process to save time — this is a false economy
2. Develop and submit to several service providers an RFP that:
 - A. Specifies your company's requirements; and
 - B. Requests the service providers to submit a proposal that meets those requirements
3. Evaluate the service providers' proposals
 - A. Conduct Q&A
 - B. Facilitate the service providers' presentations
 - C. Take as much time as you need at this stage

Basic Steps (Cont'd)

4. Develop a business case
5. Establish teams and understand the level of effort needed to complete the transaction
 - A. Subject matter experts
 - B. Financial resources
 - C. Human resources
 - D. Legal
6. Identify your objectives, **WRITE THEM DOWN** and **USE THEM**

Basic Steps (Cont'd)

7. Define detailed requirements with respect to services, service levels, pricing and key business terms
8. Further evaluate and down-select to finalists
 - A. Convert the negotiated term sheet to final contract documents
 - B. Conduct final negotiations
9. Complete negotiations and execute the agreement

Benefits of Competition

- Customer education and learning
- Exposure to alternative technical and commercial solutions
- Identification of scope / price mismatches
- More flexible terms and conditions; better approach to handling change
- Less contentious negotiations
- Shorter transaction times
- Lower price?



HOW TO CONDUCT A SUCCESSFUL OUTSOURCING PROCESS



Internal Alignment

- Senior management involvement and buy-in are critical
- Address internal tensions sooner rather than later
- Avoid and prevent:
 - Inconsistent messages (internal and to service provider)
 - Divide and conquer negotiating
 - End-runs to senior management
 - Making commitments that compromise the overall process

Organization and Communication

- Establish roles and responsibilities for team members
- Organize regular meetings and coordinate activities closely
- Constantly communicate among team members and between teams
- Have a single point of contact with the service provider
- Keep the staff that may be outsourced regularly updated
- Avoid public announcements until the deal is done

Set a Realistic Schedule

- Develop the right “infrastructure”
 - Modeling tools
 - Performance measures
 - Relationship management capabilities
- Customers usually need more time than service providers
- Understand the tasks, then set the schedule

Timing

- Artificial or unrealistic deadlines limit your flexibility
- There are no simple rules of thumb
 - Depends on the condition of the organization
 - Culture
 - Corporate courage
- Do not compromise the process to save time — this is a false economy

Leverage

- Customer's natural leverage is front-loaded (sales cycle)
- Once the deal is signed, natural leverage shifts to the service provider
- Use your natural up-front leverage wisely to build leverage into the agreement for the duration of the term
- **BECAUSE**

Leverage (Cont'd)

- On day 1 after cutover, you have:
 - No employees
 - No equipment
 - No direct control
 - No experience
- All you have is a contract!



ROLE OF IN-HOUSE COUNSEL



Defining the Role

- Outsourcing deals are very time-intensive for lawyers and may be full time for in-house counsel
- Coordinate with other in-house counsel (e.g., HR, privacy) as well as other key disciplines (e.g., finance, tax, HR, communications)
- Engage and oversee outside counsel:
 - Cost control and oversight
 - Helping outside counsel understand your company's organization and environment
 - Helping them navigate through your own culture and political structure

Defining the Role (Cont'd)

- Specific goal in an outsourcing: To learn and understand about what makes these transactions different from other deals and to effectively use that understanding and knowledge
 - Getting educated at the same time that your client needs to be educated
- Being a team member
- Ensuring that the company's (as opposed to individual) interests are addressed



PERSONAL INFORMATION, DATA SECURITY AND LIABILITY



Privacy and Data Protection - Generally

- Implementing privacy protection in an outsourcing agreement
 - Compliance with law obligations
 - Which legal standard?
- Confidentiality provisions
- Specific requirements re protecting PII and other customer data
- Security breaches
 - Investigation
 - Remediation
 - Responsibility

Privacy and Data Protection – Generally (Cont'd)

- Notification
 - Legally required notification
 - Related costs
 - Customer communications
 - Public relations
 - Legal and accounting costs
 - Credit reporting services
- Liability limits

Data Security Obligations

- Confidentiality Obligations
- Limits on Use of Customer Data
 - Compliance with Customer security policies
 - Segregation of customer data
 - Encryption
- Security Breach
 - Service Provider obligations
 - Investigate and remediate
 - Cooperate
 - Prevent recurrence

Compliance With Law Obligations

- “Service Provider’s shall perform the Services in accordance with the Service Provider Laws and the Customer Compliance Directives such that Customer will not violate any of the Service Provider Laws or Customer Laws, respectively, as a result of the acts or omissions of Service Provider.”
- “Service Provider will promptly implement such Changes to the Services as may be necessary to correct any non-compliance with Service Provider Laws or Customer Compliance Directives.”

Compliance With Law Obligations (Cont'd)

- “If such non-compliance is caused by Service Provider’s failure to comply with Service Provider Laws or Customer Compliance Directives, such Changes shall be a Non-chargeable Change. Otherwise, the Charges for such Changes, if any, shall be determined in accordance with the Change Procedures.”
- “Service Provider shall be responsible for fines and/or penalties imposed on Service Provider or Customer resulting from Service Provider’s failure to comply with Service Provider Laws or Customer Compliance Directives.”

Compliance With Law Obligations (Cont'd)

- “Data Protection. Without diminishing Service Provider’s obligations in this Section 12:”
 - “Each Party shall at all times comply with its obligations under all Laws in relation to data protection, safeguarding, privacy or the interception, recording or monitoring of communications (“Data Protection Laws”) in connection with the Services.”

Reimbursement of Notification Related Costs

- Reimbursement of Notification Related Costs (i.e., Customer's internal and external costs associated with addressing and responding to the Security Breach, including:)
 - preparation and mailing or other transmission of legally required notifications;
 - preparation and mailing or other transmission of such other communications to customers, agents or others as Customer deems reasonably appropriate;
 - establishment of a call center or other communications procedures in response to such Security Breach (e.g., customer service FAQs, talking points and training);
 - public relations and other similar crisis management services;

Reimbursement of Notification Related Costs (Cont'd)

- legal and accounting fees and expenses associated with Customer's investigation of and response to such event;
- costs for commercially reasonable credit reporting services that are associated with legally required notifications or are advisable under the circumstances; and
- court costs, reasonable fees and expenses of attorneys, accountants and other experts and all other reasonable fees and expenses of litigation or other proceedings.

Service Provider Indemnification

- Fines and penalties in respect of Service Provider's failure to obtain, maintain or comply with the approvals, licenses, consents, permits or authorizations required to be obtained, maintained or complied with by Service Provider pursuant to the Agreement
- A breach by Service Provider of Service Provider's obligation to comply with Laws under the Agreement
- Any breach by Service Provider of Service Provider's confidentiality, customer data use and security breach obligations under the Agreement

Service Provider Indemnification (Cont'd)

- Acts or omissions of Service Provider, its Subcontractors or any Service Provider Personnel other than in accordance with the terms hereof, which cause loss or disclosure of Customer Data, including all Notification Related Costs arising out of or in connection therewith

Liability

- **General Intent:**
 - A party is liable to other for any actual damages suffered or incurred by the other party's failure to perform its obligations in the manner required by the Agreement
 - Each party shall have a duty to mitigate damages for which the other party is responsible
- **Common Service Provider-requested Limits on Liabilities:**
 - Limits on Liability Amount: Not to exceed 12 month's worth of charges
 - Limits on Liability Type: Not liable for consequential damages

Liability (Cont'd)

- Common Carve-outs: The limits on liabilities do not apply to damages attributable to or occasioned by:
 - A party's willful misconduct or gross negligence
 - A party's breach of its confidentiality obligations
 - Government fines and penalties levied against Customer in respect of Service Provider's breach of its compliance with Laws obligations under the Agreement
 - A party's violation of law
 - Losses that are the subject of indemnification
 - Carve outs do not apply to "speculative" damages (lost revenues, lost profits and reputational harm)
- Separate and Stretch Caps
 - Covers all liability regarding personal information and/or data breach and/or data security



SUPPLEMENTARY MATERIALS





THE OUTSOURCING AGREEMENT



The Contract – Key Documents

- The key contract documents typically consist of
 - Terms and conditions: the “legals”
 - Services schedule: a description of the scope of services
 - Service level schedule: a selective set of performance standards
 - Pricing schedule: the mechanisms to calculate the service provider’s charges
 - Transition schedule: details regarding the transfer of assets to the service provider, and preparation for “go-live”
 - Governance schedule: the methodology for managing the relationship

Full Contract Document Set

- **Terms and Conditions**
- **Exhibits**
 - *Exhibit 1 (Definitions)*
 - *Exhibit 2 (Statement of Work)*
 - *Exhibit 3 (Service Levels)*
 - *Exhibit 4 (Charges)*
 - *Exhibit 5 (Transition)*
 - *Exhibit 6 (Governance)*
 - *Exhibit 7 (Change Procedures)*
 - *Exhibit 8 (Business Continuity/Disaster Recovery Plans)*
 - *Exhibit 9 (Service Provider Locations)*
 - *Exhibit 10 (Customer Facilities)*
 - *Exhibit 11 (Key Service Provider Positions)*
 - *Exhibit 12 (Reports)*
 - *Exhibit 13 (Disengagement Assistance)*

Full Contract Document Set

- **Terms and Conditions**
- **Exhibits**
 - *Exhibit 14 (Pre-Approved Subcontractors)*
 - *Exhibit 16 (Transitioned Personnel)*
 - *Exhibit 17 (Form of Acknowledgement of Commencement Date)*
 - *Exhibit 18 (Guaranty)*
 - *Exhibit 19 (Current and Planned Projects)*
 - *Exhibit 20 (Form of Work Order)*
 - *Exhibit 21 (Managed Contracts)*
 - *Exhibit 22 (Security)*
 - *Exhibit 23 (Substance Testing and Background Checks)*

Terms and Conditions – Table of Contents

1. Background, Objectives and Structure
2. Term
3. Services
4. Transition to Service Provider Solution
5. Service Provider Performance and Service Levels
6. Facilities
7. Resources and Customer Systems
8. Customer/Service Provider Relationship
9. Customer Responsibilities
10. Charges
11. Auditing and Record Retention
12. Compliance with Laws

Terms and Conditions – Table of Contents

- 13. Customer data and Confidentiality
- 14. Proprietary Rights
- 15. Representations and Warranties
- 16. Insurance
- 17. Indemnities
- 18. Liability
- 19. Force majeure
- 20. Disputes
- 21. Termination
- 22. General

Scope of Services

- Describe “Services” in broad terms
- Services “evolve”
- Scope ties to pricing
- “Projects” v. “New Services”
- Change control

Performance Standards

- General performance measures
- Service Levels
 - Documented vs. actual service levels
 - Measurable and achievable
 - Flexibility and weighting
 - Continuous improvement
- Service level credits and priorities
 - Allow for periodic evaluation and adjustment

Performance Standards (Cont'd)

- Reporting
- Root cause analysis
- Correction
- Service Level credits
 - Clearly understandable calculation formula
 - Based on priorities
 - Not designed to punish; it is an incentive for better performance

Charges

- To capture in writing a charging mechanism that
 - Allows the customer to meet its financial objectives for the outsourcing over a multi-year term
 - Allows the service provider an opportunity to realize a reasonable return
 - Aligns risk and responsibility between the service provider and the customer
 - Allows the customer to retain leverage during the term
 - Establishes flexibility to deal with changing business climate
- Pricing models
- Repricing events
- Benchmarking

Term and Termination

- Term
 - Today typically ranges from 3 to 5 years
- Termination for
 - Cause
 - Convenience
 - It may be the only effective way out of a deal
 - Change of control (service provider; customer)
 - Changes in law
 - Force majeure
 - Failure to agree on implementing a benchmarker's recommendation
 - Bankruptcy / Precarious financial condition

Term and Termination (Cont'd)

- Termination Charges
 - Break Fees
 - Stranded Costs
 - Demobilization Costs

Exit Strategy

- The goal is to maintain flexibility to transition or restructure all or part of the services during the term at reasonable transition costs
- Protecting the business upon any cessation of service or any termination or expiration of the Agreement
 - Disengagement assistance – orderly migration of services
 - Return of data

Exit Strategy (Cont'd)

- Transfer of resources back to customer or customer's designees:
 - Service provider personnel (employees and contractors)
 - Equipment owned or leased
 - Software owned or licensed
 - Third party agreements
 - Intellectual property rights

Offshore Unique Legal Issues

- Import-Export controls
- Privacy
 - GDPR
- Security
- Risk mitigation
- Reputational issues
 - Financial services
- Presence in foreign jurisdictions
 - Tax presence
- Third-party software: licenses and required consents

Offshore Unique Legal Issues

- Employment related issues
 - Co-employment considerations
 - Acquired Rights Directive & TUPE (Europe and beyond)
 - Inbound and outbound
 - Contractors
- Dispute resolution
 - Arbitration
 - Enforcement of rights offshore



TAKE AWAYS



Before Negotiations...

- Assess whether the company lends itself to outsourcing
- Set realistic goals
- Obtain buy-in from senior management, IT service units and internal customers
- Understand key aspects of outsourcing, especially pricing

Before Negotiations... (Cont'd)

- Assemble as much information as possible about your environment (e.g., budgets, performance levels, assets, people)
 - Do not measure too many service levels

Before Negotiations...

- Assemble the right negotiation team
 - Have at least one person with on-going responsibility for managing the agreement on the negotiation team
- Engage appropriate consultants/resources with necessary expertise
- Anticipate and understand amount of time and resources needed to negotiate a complex deal
 - Failure to do so almost always advantages the service provider

During Negotiations...

- Show strong leadership by senior management
- Empower your negotiation team
- Encourage senior management to control the service providers' access to them outside of the negotiation channels
- Follow a disciplined acquisition process
- Openly bid and keep bidding open long enough
- Keep competition open as long as possible

During Negotiations... (Cont'd)

- Do NOT grant exclusive rights to the service provider
- Control the process and timelines
- Hold service provider to timelines and deliverables during negotiations

During Negotiations...

- Address all aspects of the relationship
 - Define scope with precision
 - Do not evaluate and negotiate piecemeal
 - Do not delay due diligence
- Put a contingency plan in place
 - Important to have the ability to “walk-away” and to convince the service provider you mean it
 - Competition helps (including “in-sourcing”)

During Negotiations... (Cont'd)

- Select a service provider with the values and rapport needed to maintain and enhance an effective relationship over time
- Address all substantial issues before the agreement is signed
- Do not allow re-openers

After Negotiations...

- Assemble and empower the right implementation and management team
 - Have the team that will manage the service provider in place early, with necessary processes and procedures fully developed and ready to go
- Provide appropriate knowledge transfer and ongoing education for hand-off (and to new employees hired to oversee the service provider)

After Negotiations... (Cont'd)

- Anticipate resources needed to implement and oversee service provider post execution and migration
- Consider whether the internal organization will have the knowledge and stature to properly manage the service provider

Factors Contributing to Post-Transition Problems

- Lack of alignment between the service provider and customer goals and objectives
 - “Too good” a deal on either side
- Customer inability to maintain surrogates for competition post implementation
- Unwillingness to hold the service provider accountable to the provisions of the agreement

Control and Governance

- Control and Governance
 - Implement a robust measurement, reporting and meeting timetable
 - Do not unnecessarily limit your audit rights
 - Audit as often as needed
 - Do not fail to consider taking all service level credits earned
 - You can always give back the money in exchange for something else

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