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BUSINESS OUTSOURCING AND THE AGENCY COST PROBLEM

*George S. Geis**

INTRODUCTION

In early 2002, I climbed on a plane—along with my pregnant wife and two-year old daughter—for a thirty-hour flight from Los Angeles to India. Our destination was Hyderabad, in the south-central part of the country, where we would be living and working for the next two months. At the other end of the flight we got off, tired and anxious, into a very different part of the world. Cows really did cross the streets. Shabby tent cities littered abandoned lots—sometimes right in front of mansions. Motor scooters loaded with husband, wife, and kids darted between bicycles, three-wheeled taxis, pedestrians, and trucks. There were people everywhere, dressed in bright reds, greens, pinks, and oranges, and they scurried among small roadside shops and cafes that seemed to be open all the time. It was eleven-and-a-half hours later back in L.A. but, if anything, all of our senses seemed sharpened.

I had accepted a teaching position at a prominent new business school, started in conjunction with several Western universities, and it was the

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perfect place to take the pulse of economic trends in India. Most of the students and faculty were excited about technology—software development, networking, and the telecommunications industry in particular. Y2K fears had put Indian software programmers to work, and IT budget pressures in the wake of the dot-com implosion kept them there. A handful of students were talking about outsourcing beyond call centers and software maintenance, but for the most part the focus seemed to be elsewhere—on things like finance, consumer marketing and, above all, technology.

Nearly four years later, I took the same flight (actually a shorter one this time since there was a direct route into Hyderabad) and returned for another teaching visit at the business school. It is hard to describe the economic transformation that had occurred while I was away. The people and cows were still everywhere, but now they competed with Hondas and Hyundais more than with bicycles. Gigantic new shopping malls dominated the city center; several were multi-level stores specializing in just wedding apparel. Work crews demolished decrepit roadside shops to widen the streets, and many of the shanty-towns were replaced with sparkling new office buildings.

Most strikingly, the signs of business outsourcing were everywhere. Loud explosions interrupted the late afternoon, as Microsoft built a massive campus for thousands of workers.¹ People argued over the effects of English accent training on Indian culture—the buzz of conversation was now peppered with a Manhattan staccato or southern drawl from some call-center workers. I asked my class of a hundred students whether they had worked on an outsourcing transaction, and nearly seventy percent raised their hand. Everyone was looking for the next wave—was it legal services outsourcing,² pharmaceutical R&D outsourcing, animation, or something else? You could almost feel the exuberance in the air. And it wasn't just Hyderabad; even the Communist governments in West Bengal and Kerala were aggressively courting foreign investment.³ Business outsourcing had

1 In fact, the Hyderabad facility will apparently become Microsoft's second-largest campus after its Redmond, Washington headquarters. See Saritha Rai, *Microsoft Expands Operations in India*, N.Y. TIMES, Nov. 16, 2004, at W1.

2 For a discussion of the possibilities here, see Jayanth K. Krishnan, *Outsourcing and the Globalizing Legal Profession*, 48 WM. & MARY L. REV. (forthcoming May 2007).

3 For example, on a recent trip to Kolkata I was invited to meet with the Minister for Information Technology for the State of West Bengal—an area reputed to have taken a slow approach to outsourcing. I expected to discuss some basic questions related to attracting foreign business, but was treated, instead, to a very sophisticated PowerPoint presentation on why the Communist-led state was the ideal place to establish an offshore project. And, indeed, Kolkata has built some of the best roads in India, cleared massive areas of land, amended labor laws, and sponsored elaborate conferences to court foreign investment.

saturated the Indian economy.

And India is certainly not the only country—although perhaps it is the most prominent one—affected by business outsourcing. By 2008, an estimated 4.1 million jobs in the service sector will have moved from developed economies to places like China, India, Russia, Brazil, and the Philippines.⁴ According to the McKinsey Global Institute, this is just a tiny proportion of the jobs that could theoretically be outsourced—it estimates that nearly 160 million jobs in the service economy, about eleven percent of total employment, could be performed anywhere in the world.⁵ No one expects this many positions to move overseas, but analysts do project the size of the total offshoring market to grow rapidly.⁶

Firms keep some of this relocated activity under their own control by building “captive” offshore facilities that become, in essence, foreign subsidiaries of the parent firm.⁷ But many of these projects are moving economic production beyond a firm’s borders—as companies contract with third party vendors to do something that they have historically done themselves. In short, we are witnessing a significant realignment in the scope of the firm.

Interview with Shri Manabendra Mukherjee, Minister for Info. Tech. & Env’t, Gov’t of W. Bengal, India, in Kolkata, India (Dec. 8, 2005).

4 DIANA FARRELL ET AL., MCKINSEY GLOBAL INST., *THE EMERGING GLOBAL LABOR MARKET: PART 1—THE DEMAND FOR OFFSHORE TALENT IN SERVICES* 23–25 (2005), available at http://www.mckinsey.com/mgi/reports/pdfs/emerginggloballabormarket/part1/MGI_demand_fullreport.pdf. As of 2003, India controlled about a third of the offshore services market; Ireland, Canada, the Phillipines, Israel, and other parts of Asia were other large offshore service suppliers. *Id.* at 13 exhibit 1.

5 *Id.* at 22. McKinsey estimated this figure by examining business activities in eight industry sectors and extrapolating these results to the entire service economy. *Id.* at 22–23. The report does not suggest, however, that the actual number of jobs outsourced will come close to 160 million, citing a wide variety of industrial, organizational, regulatory, and social factors that will limit the number of jobs transferred out of developed economies to roughly 2.5% of this 160 million figure. *Id.* at 25–28.

6 See, e.g., FARRELL ET AL., *supra* note 4, at 29; NASSCOM-MCKINSEY REPORT 2005: *EXTENDING INDIA’S LEADERSHIP IN THE GLOBAL IT AND BPO INDUSTRIES* 13 (2005), http://www.mckinsey.com/ideas/articles/Nasscom_3_Executive_summary.pdf [hereinafter NASSCOM-MCKINSEY REPORT 2005] (estimating that offshore services will grow to \$60 billion by 2010). A large collection of reports and statistics related to the growth of offshore outsourcing can also be found at RTTS, *Statistics Related to Offshore Outsourcing*, <http://www.rttsweb.com/outsourcing/statistics> (last visited Dec. 19, 2006). But see DELOITTE CONSULTING, *CALLING A CHANGE IN THE OUTSOURCING MARKET* 25 (2005), available at http://www.deloitte.com/dtt/cda/doc/content/us_outsourcing_callingachange.pdf (warning that outsourcing is not working for many firms and that growth is likely to wane).

7 For a more precise categorization of business outsourcing, and the important distinction between outsourcing and offshoring, see *infra* note 42.

This Article addresses an obvious set of questions: Why has business outsourcing grown so far so fast? What is causing so many firms to move economic activity beyond their corporate and country borders?

The question is important for corporate law scholars because it raises foundational issues underlying the theory of the firm. Indeed, the decision to pool resources under centralized control presents *the* fundamental tension in corporate law literature.⁸ The issues date back at least seventy years—to the celebrated work of Ronald Coase⁹ and of Adolf Berle and Gardiner Means.¹⁰ On the one hand, it's nice to be big. Assembling property under the discretionary control of a small management team can certainly create economies of scale, save transaction costs, and lead to other benefits.¹¹ But on the other hand, it is now well established that the separation of ownership and control can unleash a wide variety of bad manager behavior, such as shirking, lavish compensation, entrenchment, and excessive risk-taking—collectively referred to as agency costs.¹²

This friction between size and sloth permeates the study of corporate law, especially in discussions of executive compensation and corporate capital structure.¹³ The extensive literature in these fields debates the magnitude of agency costs and wrestles with ideas for mitigating these problems—using things like executive stock options,¹⁴ management

8 See, e.g., HOWELL E. JACKSON ET AL., *ANALYTICAL METHODS FOR LAWYERS* 227 (2003) (“[T]he tension between the value of retaining managerial discretion (to promote efficiencies in the corporate form, as outlined in Coase’s *Nature of the Firm*) and the dangers of unchecked managerial discretion . . . is *the* central issue in corporate law.”); Roberta Romano, *After the Revolution in Corporate Law* 9–10 (Yale Law Sch., Ctr. for Law, Econ. & Pub. Policy, Research Paper No. 323, 2005), available at <http://ssrn.com/abstract=824050> (sketching the historical tension between transaction cost and agency cost theories of the firm).

9 R.H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937).

10 ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

11 Specific benefits of the corporate form and centralized managerial discretion are discussed *infra* Part I.B.

12 See BERLE & MEANS, *supra* note 10, at 112–16; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305, 312–13 (1976). The agency cost problem is discussed *infra* Part II.A.

13 For recent synthesis of work in these areas, see LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE* (2004) (exploring the tension in executive compensation); JEAN TIROLE, *THE THEORY OF CORPORATE FINANCE* 68–73, 154–56 (2006) (collecting work on transactional economics and agency theory related to corporate capital structure decisions).

14 See, e.g., Jensen & Meckling, *supra* note 12, at 308–13, 323–25 (discussing the use of options and equity compensation as a tool to reduce agency costs); Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 *J. POL. ECON.* 225,

performance targets,¹⁵ leveraged buyouts,¹⁶ debt covenants,¹⁷ and shareholder access initiatives.¹⁸ But the tension has hardly been explored in business outsourcing¹⁹—which is surprising because outsourcing has received such widespread public attention in recent years.²⁰ This Article

261–62 (1990) (arguing that executive salary is not linked to performance); David M. Schizer, *Executives and Hedging: The Fragile Legal Foundation of Incentive Compatibility*, 100 COLUM. L. REV. 440, 452–59 (2000) (analyzing hedging transactions used by managers to undermine the effectiveness of options as a technique for combating agency costs).

15 See, e.g., Lucian Arye Bebchuk et al., *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 801 (2002) (discussing how linking compensation grants to performance targets can avoid “windfall” compensation and better align manager incentives); Marcel Kahan, *The Limited Significance of Norms for Corporate Governance*, 149 U. PA. L. REV. 1869, 1879 (2001) (same).

16 See, e.g., Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 16 AM. ECON. REV. 323, 323–25 (1986) (“[L]everaged buyout (LBO) transactions . . . are creating a new organizational form that competes successfully with the open corporate form because of advantages of controlling the agency costs of free cash flow.”).

17 See, e.g., Yakov Amihud et al., *A New Governance Structure for Corporate Bonds*, 51 STAN. L. REV. 447, 453–56 (1999) (discussing the agency costs that arise with the use of debt and various bond covenants); Daniel R. Fischel, *The Economics of Lender Liability*, 99 YALE L.J. 131, 133–40 (1989) (discussing agency distortions in the lending relationship); Marcel Kahan & David Yermack, *Investment Opportunities and the Design of Debt Securities*, 14 J.L. ECON. & ORG. 136, 138 (1998) (raising problems with the use of bond covenants as a mechanism for mitigating creditor agency risk).

18 Compare Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 835, 908 (2005) (“[M]aking shareholder intervention possible would operate to reduce agency costs between management and its shareholders and to enhance shareholder value.”), with Stephen M. Bainbridge, *The Case for Limiting Shareholder Voting Rights*, 53 UCLA L. REV. 601, 603–12 (2006) (arguing that increasing shareholder intervention would undermine the value of centralized decisionmaking in large corporations).

19 Previous legal and economic scholarship has recognized the agency costs of business outsourcing, but most articles deal with theoretical models of optimal contract design or with technical, practitioner-oriented advice. See *infra* notes 126–27 and accompanying text. I am unaware of previous work offering a detailed analysis of the contractual methods used in a typical outsourcing transaction to mitigate agency risk.

20 See, e.g., THOMAS L. FRIEDMAN, *THE WORLD IS FLAT* (2005) (offering a bestselling account of the outsourcing phenomenon). Business newspapers and magazines publish a constant stream of stories on the growth of outsourcing. For a few typical examples, see Pete Engardio et al., *Is Your Job Next?*, BUS. WEEK, Feb. 3, 2003, at 50 (“Outsourcing experts say the big job migration has just begun. . . . The really big offshore push won’t be until 2010 or so . . . when global white-collar sourcing practices are standardized.”); Justin Fox, *Where Your Job is Going*, FORTUNE, Nov. 24, 2003, at 84 (“Where Your Job is Going: a visit to Bangalore, India, a city where tech is hot, the drinks are cold, work is plentiful, and the salaries are a whole lot lower than yours.”); *The Next Wave: India’s IT and Remote-Service Industries Just Keep on Growing*, ECONOMIST, Dec. 17, 2005, at 57 [hereinafter *The Next Wave*] (“So strong are the forces driving this shift that what seemed improbably rosy

suggests that the business outsourcing phenomenon offers a valuable, but previously neglected, context for analyzing the fundamental tradeoffs that occur when ownership is parted from control. Essentially, it considers theories of the firm from an opposite perspective: why does activity move outside the firm, rather than why activity is placed inside it.

So let me come back to my earlier question: why have we seen such a notable shift in the optimal balance between intrafirm activity and interfirm contracts over the past decade? The conventional explanation for the outsourcing explosion runs something like this. Relatively high transaction costs have historically prevented firms from tapping into the global supply of labor. As these costs drop, however—through improvements in communication, digitization, standardization, and the like—it becomes economical for firms to embrace overseas production.²¹ In essence, falling interaction costs have unlocked a massive supply of labor, driving down the price of economic inputs, realigning business processes, and tempting (or forcing²²) managers to move production outside the firm.²³ This

projections . . . back in 1999, are coming true.”).

21 Much of this analysis occurs in the business management and marketing literature. See, e.g., Erik Brynjolfsson et al., *Does Information Technology Lead to Smaller Firms?*, 40 MGMT. SCI. 1628, 1630–33 (1994); Eric K. Clemons et al., *The Impact of Information Technology on the Organization of Economic Activity: “The Move to the Middle” Hypothesis*, J. MGMT. INFO. SYS., Fall 1993, at 9, 11–14; Vijay Gurbaxani & Seungjin Whang, *The Impact of Information Systems on Organizations and Markets*, 34 COMMS. OF ACM, Jan. 1991, at 59, 63–66; Ramesh Sankaranarayanan & Arun Sundararajan, *Electronic Markets, Search Costs and Firm Boundaries* 3 (Ctr. for Digital Econ. Research, Working Paper No. CeDER-05-22, 2005), available at <http://ssrn.com/abstract=785914>. The popular press gives similar accounts of the rise in globalization and business outsourcing. See, e.g., LOWELL BRYAN ET AL., RACE FOR THE WORLD 14–29 (1999); FRIEDMAN, *supra* note 20, at 126–36.

22 A central debate over offshoring and outsourcing involves macroeconomic cultural, distributional, and social effects. See, e.g., *The Offshoring of High-Skilled Jobs, Part II: Hearing Before the House Comm. on Small Business*, 108th Cong. 1 (2003) (opening statement of Don Manzullo, Chairman, House Comm. on Small Business) [hereinafter *House Comm. on Small Business Hearing*] (questioning whether “the offshoring of high-paying, high-skilled jobs . . . has serious consequences for the long term economic viability of this country”); JAGDISH BHAGWATI, IN DEFENSE OF GLOBALIZATION (2004) (advocating open markets); JOSEPH E. STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS 214–52 (2002) (presenting policy concerns related to globalization); Douglas A. Irwin, ‘Outsourcing’ Is Good for America, WALL ST. J., Jan. 28, 2004, at A16 (arguing the benefits of free trade and labor flexibility); Charles Schumer & Paul Craig Roberts, Op-Ed., *Second Thoughts on Free Trade*, N.Y. TIMES, Jan. 6, 2004, at A23 (arguing that more restrictive trade policies are required to deal with the fact that large workforces can now be easily located anywhere in the world). These issues, while certainly important, are not a focus of this Article, and I will concentrate on microeconomic, firm-level decisions related to the organization and location of production—not on the collective macroeconomic and social impact of these decisions.

23 See Vivek Agrawal et al., *Offshoring and Beyond*, MCKINSEY Q., 2003 SPECIAL

explanation comports with intuition and empirical observation, and certainly there must be some truth to the story.

This Article argues, however, that there is a second important catalyst for the rise of business outsourcing—one rooted in the agency cost problem. For while business outsourcing can bring interesting opportunities, it also introduces some familiar anxieties. Just as a CEO may slack off, build a fancy office, or make risky bets with shareholder dollars, an outsourcing vendor may abuse its power to conduct economic activity that impacts another firm.²⁴ Essentially, a company outsourcing an activity faces the same dilemma where control is divorced from ownership.²⁵ The outsourcing vendor controls the activity, while the outsourcing firm “owns” the result. These agency costs raise a significant impediment to business outsourcing and are a major reason why firms elect to keep economic activity within their borders.²⁶

The thesis of this Article is that business outsourcing has thrived in recent years not only because globalization has unlocked inexpensive production markets, but also because it is becoming easier for firms to monitor and prevent the agency costs of outsourcing. Over the past decade, firms have undertaken a variety of intriguing tactics for mitigating agency problems in the business outsourcing context. Drawing upon a detailed analysis of outsourcing contracts, I will explore several strategies to minimize agency costs—including the use of staged contractual commitment, redundant agents, incentive-compatible compensation, exit rights, and other techniques. To be sure, the issues here can arise in any long-term or relational contract.²⁷ But the recent explosion in business

EDITION: GLOBAL DIRECTIONS, at 25; Thomas H. Davenport, *The Coming Commoditization of Processes*, HARV. BUS. REV., June 2005, at 100, 107–08 (discussing the use of process standards to facilitate efficient outsourcing); *supra* note 21.

24 See, e.g., Jensen & Meckling, *supra* note 12, at 310 (“Contractual relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, etc. The problem of agency costs and monitoring exists for all of these contracts . . .”).

25 Throughout this Article I use the agency vocabulary in an economic sense—and not in a legal sense. The difference is that legal creation of an agency relationship requires a showing of control by the principal and gives rise to an elevated collection of agent responsibilities. See RESTATEMENT (SECOND) OF AGENCY § 1, §§ 376–98 (1958); RESTATEMENT (THIRD) OF AGENCY § 1.01 (Tentative Draft No. 2, 2001).

26 See *infra* Part II.B.

27 The relational contracting literature typically explores situations where parties rely on long term relationships or private ordering—rather than the law—to govern business affairs. See, e.g., Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1092–95 (1981); Morten Hviid, *Long-Term Contracts and Relational Contracts*, in 3 ENCYCLOPEDIA OF LAW AND ECONOMICS § 4200, at 46–72 (Boudewijn Bouckaert & Gerrit de Geest eds., 2000) (reviewing the relational contracting literature); Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CAL. L. REV. 2005,

outsourcing offers a fresh perspective on the ways that private parties take strategic and contractual steps to minimize agency risks.

For example, it is certainly more expensive to manage several outsourcing vendors who perform the exact same activity. But these increased costs might reduce agency risk through benchmarking or other means—and the use of multiple vendors is becoming a popular outsourcing strategy.²⁸ I argue that firms are increasingly willing to trade greater monitoring activity for reduced agency risk because it is becoming cheaper to do so. In essence, the same forces that are opening overseas markets are also making it more cost-effective to detect and prevent misbehavior by outsourcing partners. And I believe that this ability to reduce the agency costs of outsourcing is another important factor in the rapid movement of activity beyond firm borders.

The Article proceeds as follows. Part I explores the recent rise of business outsourcing and relates outsourcing to foundational academic literature on the theory of the firm. Part II briefly discusses the agency cost problem and demonstrates how it arises in the outsourcing context. Part III then presents and analyzes strategies that firms are using to detect and prevent these agency costs of outsourcing—shedding new light on the structure and terms of a typical outsourcing project. It continues by discussing the more general proposition that falling interaction costs are making it easier, at least in some cases, to contain the agency risks of outsourcing—and that this is contributing to increased relocation of economic activity from firm to market. A brief conclusion summarizes these claims.

I. THE RISE OF BUSINESS OUTSOURCING

A. *The Offshoring and Outsourcing Explosion*

Relocating economic production is nothing new. As transportation, communication, and other interaction costs fall, companies have continually sought to move business activity to areas with cheaper, and less restrictive, labor markets.²⁹ Historically, firms focused mostly on domestic or nearby international expansion. Manufacturing activity, for example,

2009–12 (1987). The lasting nature of these contracts will present agency risk if one party controls economic activity that affects the other party's wealth. Jensen & Meckling, *supra* note 12, at 308–13.

²⁸ See *infra* Part III.A.2.

²⁹ BRYAN ET AL., *supra* note 21, at 11–35; FARRELL ET AL., *supra* note 4, at 12; William I. Huyett & S. Patrick Viguerie, *Extreme Competition*, MCKINSEY Q., Jan. 2005, at 47, 49–52.

slowly migrated from the northeastern United States to the South and Southwest to take advantage of nonunionized labor and tax benefits.³⁰ Similarly, Hollywood started filming and editing movies in Canada, instead of at expensive studios in Los Angeles, as early as the 1940s.³¹

Lately, however, the relocation of economic activity has moved much further afield. Millions of jobs are flowing to India, China, and other low-cost producers.³² The total size of the offshore services market³³—recently estimated at \$12.2 billion for India, \$8.6 billion for Ireland, and over \$3.4 billion for China³⁴—is expected to jump to \$110 billion by 2010.³⁵ And economic globalization has also taken a new spot in our public consciousness. According to a recent report by the McKinsey Global Institute, “Offshoring has rapidly become part of the everyday social lexicon. Conflicting and sensational reports of developed-world companies moving jobs to emerging markets . . . are now a staple of the news media and political debate.”³⁶

This transformation spans all sectors of the economy. Perhaps the highest profile areas of change involve customer call centers, information technology services, and back-office support. But the business outsourcing phenomenon is not just about tedious paper-shuffling efforts or mindless computer programming slots. Overseas analysts process sophisticated derivative contracts for Wall Street.³⁷ Doctors interpret digital CAT scans and x-rays for Western hospitals.³⁸ And molecular biology PhDs discover

30 FARRELL ET AL., *supra* note 4, at 12.

31 See, e.g., Audrey Drosch, *Hollywood North: The Impact of Costs and Demarcation Rules on the Runaway Film Industry 4* (May 20, 2002) (unpublished manuscript), available at <http://www-econ.stanford.edu/academics/honors%5Ftheses.bak/Drosch.pdf>; *BPO Goes to Hollywood*, KNOWLEDGE@WHARTON, Oct. 31, 2006, <http://knowledge.wharton.upenn.edu/india/article.cfm?articleid=4110>.

32 See *supra* note 4 and accompanying text.

33 While a great deal of outsourcing has involved manufacturing activity, this Article focuses on the more recent phenomenon of services-based outsourcing.

34 FARRELL ET AL., *supra* note 4, at 13 exhibit 1.

35 NASSCOM-MCKINSEY REPORT 2005, *supra* note 6, at 14.

36 FARRELL ET AL., *supra* note 4, at 11. The 2004 presidential campaign, in particular, positioned outsourcing as an important issue, with John Kerry berating “‘Benedict Arnold’ bosses” on the campaign trail. See, e.g., *The Great Hollowing-Out Myth*, ECONOMIST, Feb. 21, 2004, at 27. According to Kiran Karnik, president of the Indian business lobby NASSCOM, the outsourcing outrage has faded greatly since then—although renewed political backlash remains a risk to outsourcing vendors. Interview with Kiran Karnik, President, NASSCOM, in Kolkata, India (Dec. 9, 2005).

37 *The Next Wave*, *supra* note 20, at 57 (“J.P. Morgan Chase . . . is to double, to about 9,000, its staff [in India]. One task for the new recruits is to settle complex structured-finance and derivative deals, what one insider calls ‘some of the most sophisticated transactions in the world.’”).

38 Jay Solomon, *Traveling Cure: India’s New Coup in Outsourcing: Inpatient Care*,

new drugs for pharmaceutical firms.³⁹ Information technology continues to play a major role in offshore projects, but the work is spreading throughout most industry sectors.⁴⁰

Some of this relocated activity is kept under firm control through “captive offshoring” facilities.⁴¹ But there has also been a rapid increase in “offshore outsourcing”—the movement of activity beyond the borders of the firm.⁴² A host of successful companies now take on the product development, marketing, manufacturing, information technology, and

WALL ST. J., Apr. 26, 2004, at A1.

39 *Good Chemistry: Mere Copycats No Longer, Indian Firms are Flaunting Their Research Skills*, *ECONOMIST*, Feb. 4, 2006, at 58 (“Many analysts . . . see a big opportunity for India as a place for the outsourcing of drug discovery.”).

40 In fact, information technology services and packaged software are not the sectors of the economy where the most jobs can theoretically be outsourced. While a very high percentage of technology jobs can be performed remotely—due, in large part, to the digital nature of this work—these sectors of the economy are relatively small. Other industry sectors, such as retail or healthcare, may have a fewer percentage of jobs that can be performed remotely (it’s hard to outsource a store clerk, for example), but these industries are so large that the total number of jobs impacted is theoretically higher. *See FARRELL ET AL.*, *supra* note 4, at 22 exhibit 1.

41 *See id.* at 15 exhibit 3.

42 Thus, two decisions arise when a firm chooses to perform an activity remotely. First, should the firm perform the work onshore—in the country where the product or service is sold—or should it move the activity to an offshore location? Second, what organizational form should the remote activity take? Should the firm continue to perform the work within its corporate umbrella, or should it move the activity beyond its borders through an outsourcing contract? Putting together these two decisions leads to four possible ways to structure a remote activity: (1) shared services; (2) onshore outsourcing; (3) captive offshoring; and (4) offshore outsourcing. *See id.* at 15 exhibit 3, 16. Let me give a quick example of each—borrowed from McKinsey’s work in this area. Shared services are simply the onshore centralization of a business activity conducted in several, disparate locations. A bank in the Northeast, for example, might centralize call center operations for 100 branches in its large New Jersey headquarters. *See id.* at 300–01. Onshore outsourcing occurs if the same centralized activity is conducted by a different firm—the New Jersey call center, for example, might be run by a different company that services several banks. *See id.* Captive offshoring moves business activity to another country, but keeps it within the legal borders of the firm. Microsoft’s large software development site in Hyderabad, India is a good example of this. *See supra* note 1. And finally, offshore outsourcing transfers the work to another company overseas. A host of service vendors in India—firms like TCS, Infosys, Wipro, Cognizant, and others—are booming as Western companies export work in this manner. *See Now for the Hard Part: A Survey of Business in India—Virtual Champions: India’s IT Stars Are Still Rising Fast*, *ECONOMIST*, June 3, 2006, at 4 [hereinafter *Virtual Champions*]. This Article is primarily concerned with the organizational axis and the decision by firms to shift activities out of the corporate fold. The offshore axis is important only as a driver of change—although it would be interesting to consider how agency costs might differ according to the geographic location of an outsourcing project.

support needs of others.⁴³ In short, there is a significant realignment underway in the optimal scope of the firm.

Of course, sending jobs abroad does not always work. Some firms seem to regret their actions, explaining that they are being forced against their desire—perhaps by Adam Smith’s invisible hand—to move work overseas.⁴⁴ Other companies report, after launching an outsourcing project, that the result is abject failure.⁴⁵ One recent study argued that “[i]n the near future, with structural risks that cannot be fully mitigated, . . . and a multitude of components to manage, . . . outsourcing will likely lose luster for large organizations.”⁴⁶ And even when an outsourcing project succeeds, the vendor may soon request higher pay to keep workers from hopping jobs.⁴⁷

Nevertheless, despite this turmoil, business outsourcing continues to flourish, and most observers expect even greater growth. A recent report estimates that offshore services will rise to \$110 billion by 2010.⁴⁸ In India, outsourcing generates nearly five percent of the country’s GDP, and revenues are expected to increase at a compound annual growth rate of

43 Estimates from 2001 suggest that outsourcing (both onshore and offshore) far outweighs captive offshoring (although the estimates also suggest that offshoring alone is closely divided between the two organizational forms). The volume of outsourcing transactions approached \$240 billion in 2001; captive offshoring volume was roughly one-tenth as large, at \$22 billion. See FARRELL ET AL., *supra* note 4, at 15 exhibit 3. Domestic shared services are excluded from these estimates. *Id.*

44 For example, Larry Ellison, CEO of Oracle Corporation, has publicly worried that Silicon Valley will become another Detroit by 2008. *House Comm. on Small Business Hearing, supra* note 22, at 2. Andy Grove, former CEO and Chairman of Intel, has expressed similar sentiments: “Given cost and productivity pressures [Intel] has no choice but to continue sending work abroad The US could lose the bulk of its information technology jobs to overseas competitors in the next decade.” Michael Schroeder & Timothy Appel, *Skilled Workers Mount Opposition to Free Trade, Swaying Politicians*, WALL ST. J., Oct. 10, 2003, at A1.

45 Deloitte Consulting, for example, recently published a provocative report claiming that “outsourcing is an extraordinarily complex process, and the anticipated benefits often fail to materialize.” DELOITTE CONSULTING, *supra* note 6, at 2. According to this study, the leading causes of failure include hidden costs, inferior quality, a loss of flexibility, poor planning, and high vendor employee turnover. *Id.* at 5.

46 *Id.* at 3.

47 Some of the most popular outsourcing destinations report annual attrition rates near fifty percent. See, e.g., *Busy Signals: Too Many Chiefs, Not Enough Indians*, ECONOMIST, Sept. 10, 2005, at 60; *Growing Pains: At Both High and Low Ends of the Industry, the Problems of Success*, ECONOMIST, Aug. 23, 2003, at 51. The attrition is largely driven by a rapid increase in wages; workers in the hottest parts of India and Russia, for example, have seen their salaries grow fifty percent over the past few years. See Diana Farrell, *Smarter Offshoring*, HARV. BUS. REV., June 2006, at 85, 86.

48 See NASSCOM-MCKINSEY REPORT 2005, *supra* note 6, at 14. Many other studies estimate similarly high levels of growth. See sources cited *supra* note 6.

thirty-seven percent through 2010.⁴⁹ Ninety-five percent of Fortune 1000 companies allegedly have an offshore outsourcing strategy,⁵⁰ and professional advisors continue to midwife the change. The top outsourcing vendors amass tremendous financial gains and are hiring thousands of employees each year.⁵¹ One commentator has claimed, more generally, that “[t]he low costs and low risk of outsourcing will accelerate the flow of jobs offshore, force companies to look differently at their strategies, and change the basis of competition.”⁵² It is very likely that offshore outsourcing will continue as a major economic trend.

What is causing this growth? And why are the changes occurring so fast? To understand the traditional explanation for the rise of outsourcing, it is necessary to go back to Ronald Coase and the theory of the firm.

B. *Outsourcing and the Theory of the Firm*

The decision to outsource is just the flip-side of the decision to conduct a given activity within the firm. The notable feature of an outsourcing project, over other market transactions, is simply that it moves an activity previously conducted within the firm beyond the corporate borders. How, then, should a company decide whether to perform the activity internally or to farm it out through an external contract?

This, of course, is the question famously posed by Coase in 1937 and debated by legal and economic scholars ever since.⁵³ The literature on the theory of the firm is vast, and I will not try to review it here.⁵⁴ But a few points are worth raising in relation to business outsourcing. First, it is important to recognize that in a world with perfect markets and costless contracting there would be no need to organize economic activity within a

49 *Virtual Champions*, *supra* note 42, at 4; *Now for the Hard Part: A Survey of Business in India—If in Doubt, Farm It Out: But Outsourcing Firms Are Having Increasing Trouble Finding Suitable Workers*, *ECONOMIST*, June 3, 2006, at 6 [hereinafter *If in Doubt, Farm it Out*].

50 PHILLIP J. HATCH, VENTORO OFFSHORE 2005 RESEARCH 12 (2005), available at <http://www.ventoro.com/Offshore2005ResearchFindings.pdf>.

51 In India, for example, leading IT outsourcing vendors recently announced annual revenue growth rates of thirty percent or more and annual hiring plans of up to 30,500 employees. See *Virtual Champions*, *supra* note 42, at 4–5. Nandan Nilekani, CEO of Infosys Technologies, says it took his firm “23 years to become a \$1 billion company, and 23 months to double that.” *Id.* at 5.

52 Davenport, *supra* note 23, at 102.

53 Coase, *supra* note 9, at 390 (“Our task is to attempt to discover why a firm emerges at all in a specialised exchange economy.”).

54 For an excellent review of scholarship in this area, including a comprehensive bibliography through 1999, see Nicolai J. Foss et al., *The Theory of the Firm*, in 3 *ENCYCLOPEDIA OF LAW AND ECONOMICS*, *supra* note 27, § 5610, at 631–58.

firm.⁵⁵ It would be better to write a series of detailed contracts on the open market for the inputs and activities needed to create new goods—thus enabling a producer to tap into the decentralized and disciplined price system of the market.⁵⁶ Essentially, an entrepreneur could simply stitch together a “virtual” business venture by grabbing inputs and services through complete contracts covering every possible state of the world.

But we do not live in a world of perfect markets or costless contracting, and one of Coase’s great insights was that performing some activities within a firm might reduce the transaction costs of using external market pricing mechanisms.⁵⁷ Production costs are likely to be higher when business is conducted within the firm—because the activity is walled off from the relentless pricing pressure that comes with well-functioning markets.⁵⁸ Yet these greater production costs might nevertheless be worth paying if a firm can save even more by avoiding other costs related to arms-length transactions.

Coase was a little vague on the exact nature of these other costs,⁵⁹ however, and much of the literature since then discusses the transaction costs (broadly defined) of using a market and how these costs might be avoided when an activity is conducted within a firm. Scholars have developed a range of cost possibilities, and I will trace just a few ideas here. First, and perhaps most obviously, forming an agreement costs money. It can be expensive to negotiate and draft detailed contracts—especially if parties need to include clauses that govern arcane contingencies.⁶⁰ One potential benefit of centralized firm control, then, is

⁵⁵ *Id.* at 633–34.

⁵⁶ *Id.*

⁵⁷ Coase, *supra* note 9, at 390–91.

⁵⁸ In other words, a firm that does everything itself will probably pay more for most of its economic inputs—after all it is unlikely to be the lowest cost producer of everything. Nevertheless, the firm may still choose to keep control of many activities to guarantee a source of supply (thus protecting against a form of market failure) or to cut the transaction costs (broadly defined) of securing the input. The retailer 7-Eleven, for example, was famous for owning the cows used to make milk that it sold in its stores. Mark Gottfredson et al., *Strategic Sourcing: From Periphery to the Core*, HARV. BUS. REV., Feb. 2005, at 132, 135.

⁵⁹ See Foss et al., *supra* note 54, § 5610, at 640 (describing Oliver Williamson’s claim that Coase’s basic story long awaited “operationalization”).

⁶⁰ These costs arise, most obviously, from the time and effort required to work through contractual details. See, e.g., ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 211–14 (4th ed. 2004); STEVEN SHAVELL, *FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW* 299–301 (2004); Richard Craswell, *Contract Law: General Theories*, in 3 *ENCYCLOPEDIA OF LAW AND ECONOMICS*, *supra* note 27, § 4000, at 1–2; Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 *YALE L.J.* 541, 594–95 (2003). But the parties may face other expenses if bounded rationality at the time of contracting prevents them from delineating how certain issues should be handled, even though it would be in

the reduction of price discovery, negotiation, and contracting costs arising under market transactions. As the theory goes, moving economic activity into a firm might reduce some transaction costs by replacing them with ex post governance mechanisms.⁶¹ Instead of bothering to write a detailed contract, a firm maintains enough discretion over the activity to make the optimal decision later—if and when a future uncertainty emerges.⁶² Thus, depending on the exact nature of the economic activity, and the likely complexity of transaction costs, a firm will choose between markets and firm “hierarchies” to secure the input.⁶³

Over time, more nuanced descriptions of contracting transaction costs have emerged, providing additional rationales for the decision to place economic activity within the firm. Oliver Williamson developed a theory involving relation-specific investments—or assets that have high value to a specific user but lower value to everyone else.⁶⁴ Sanford Grossman, Oliver

their joint interests to do so. *See, e.g.*, Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 214–16 (1995); Herbert A. Simon, *A Formal Theory of the Employment Relationship*, 19 ECONOMETRICA 293, 294–95 (1951).

61 *See* Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 700–09 (1986).

62 Coase’s early work on the subject similarly recognized that keeping control of an activity might allow firms to capitalize on future uncertainty. *See* Coase, *supra* note 9, at 391–92.

63 *See* Foss et al., *supra* note 54, at 635–42. This distinction between firms and markets faces some criticism, however, because it fails to account for the fact that workers within a firm can often exercise market power by exiting the organization. *See* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 782–83 (1972).

64 In a series of important articles, Williamson demonstrated how placing these assets into a single firm could remove costs that might arise through opportunistic behavior. More specifically, if the economic activity involving these assets is not lumped into a firm, a contractual counterparty might seek to expropriate some of the unique economic surplus from the relation-specific investment. *See* OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES* 82–105 (1975); Oliver E. Williamson, *The Logic of Economic Organization*, 4 J.L. ECON. & ORG. 65, 76–83 (1988); Oliver E. Williamson, *The Vertical Integration of Production: Market Failure Considerations*, 61 AM. ECON. REV. 112, 115–17 (1971). More recent work has linked the rise of the corporate entity to its ability to allow joint owners (shareholders) to “lock-in” or commit assets to a venture without facing a risk that their co-owners will behave opportunistically. *See* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 423–41 (2003); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 259–65 (1999). *But see* Larry E. Ribstein, *Should History Lock In Lock-in?*, 7–9, 17–19 (Ill. Law and Econ. Working Paper Series, Working Paper No. LE06-005, 2006), *available at* <http://ssrn.com/abstract=883648> (arguing that there are economic costs to lock-in and questioning this historical account for the rise of the corporation). Similar logic involving relation-specific assets and investments has also been used to demonstrate the need for contract law to provide a mechanism for parties to

Hart, John Moore, and others developed a “property rights theory of the firm,” under which assets should be owned by the entity making the most important, relation-specific investment.⁶⁵ More recently, Raghuram Rajan and Luigi Zingales have extended this theory beyond physical assets by arguing that firms can control access to all assets—including specialized human capital.⁶⁶ And certainly there are other possible ways to articulate the benefits of using firm hierarchies over markets.⁶⁷

While these theories differ in their exact specification of the costs or distortions that might arise with market transactions—and thus the rationale for placing production within a firm—they all provide an explanation for the rise of outsourcing in a dynamic world. Each theory implies that the optimal location of economic activity is the result of a careful balance between production cost savings from using markets, and transaction cost savings (again, broadly defined) from using firms. Thus, for instance, under a property rights theory of the firm, production will continue to take place within a firm until the marginal benefit from avoiding counterparty opportunism is outweighed by higher production costs. In other words, we would expect a firm to optimize the cost of producing each input against the transaction costs of a market contract in order to decide exactly where to erect the firm’s borders.⁶⁸ In a static world, this balance should hold, and the division of activity between firm and market would be roughly constant.

But because we live in a dynamic world, both production costs and transaction costs for various activities can increase or decrease as new technologies or suppliers come online. This suggests that the borders of a firm will continue to change as the underlying tension between production costs and transaction costs oscillates.⁶⁹ And indeed, we do observe a constant stream of corporate reorganization through buyouts, mergers, spin-offs, and long term outsourcing contracts.

inexorably bind themselves through promise—when they do choose to incur the transaction costs of a market exchange. See, e.g., Schwartz & Scott, *supra* note 60, at 559–62.

⁶⁵ As the theory runs, this allows the economic actor with the most to lose to retain residual control—and thus guard against opportunism by the other parties—when it is difficult or prohibitively expensive to write contracts that govern key contingencies. See Grossman & Hart, *supra* note 61, at 700–10; Oliver Hart, *An Economist’s Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757, 1771–74 (1989); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119, 1131–39 (1990).

⁶⁶ See Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q.J. ECON. 387, 388 (1998).

⁶⁷ For instance, firms may wish to produce critical inputs on their own to protect against monopoly or oligopoly supply markets.

⁶⁸ See Coase, *supra* note 9, at 395.

⁶⁹ See JACKSON ET AL., *supra* note 8, at 227.

Viewed in this light, incomplete contracting theories of the firm provide a logical explanation for the growth of business outsourcing. If barriers to securing economic inputs via remote markets drop rapidly—perhaps due to technological, regulatory, or other factors—then we would expect the historical balance between firm and market to change. Increased supply will boost the gains from procuring inputs on the market, causing some firms to outsource activity beyond the corporate borders.⁷⁰ And certainly there is plenty of evidence that shifting activity to overseas markets can result in significantly cheaper production costs.⁷¹

The unlocking of remote production, and the corresponding rise in economic globalization, has been linked to a variety of factors. First, communication costs have plummeted in response to new technologies and a rapidly expanding infrastructure.⁷² Other technological advances—including faster processing power, better compression algorithms, and cheaper data storage—make it easier to digitize economic activity.⁷³ This digitization allows firms to carve off business processes from the value chain and perform them anywhere in the world. And finally, the very nature of these business processes may also be changing as companies and industry consortiums push for greater standardization.⁷⁴ Common standards make it easier for firms to choose the sequence of their business processes, measure how well each activity is performed, and manage how these processes are conducted over time.⁷⁵ In short, there are reasons to believe that it is becoming easier to source production around the world.

There is also ample evidence that production costs are much lower in developing economies. For example, a software programmer earning sixty dollars per hour in the United States may earn just six dollars in India.⁷⁶ Similarly, a data entry worker earning twenty dollars in the United States

70 The analysis is, admittedly, a little more tricky than this because a firm might still enjoy some of these cost savings by setting up captive offshoring ventures where they can keep control of the activity. *See supra* note 42. Thus the relevant question is whether the transaction costs of using the market have fallen faster than the costs of conducting captive offshoring. Recent growth in outsourcing deals suggest that this might be true in some contexts. *See, e.g.*, Sankaranarayanan & Sundararajan, *supra* note 21, at 9–12 (modeling the effects of lower interaction costs on interfirm and intrafirm activity). For a specific example where this appears to be the case, *see infra* notes 212–18 and accompanying text.

71 *See infra* notes 76–82 and accompanying text.

72 *See, e.g.*, BRYAN ET AL., *supra* note 21, at 22–28; FARRELL ET AL., *supra* note 4, at 14; FRIEDMAN, *supra* note 20, at 59–76.

73 BRYAN ET AL., *supra* note 21, at 23–24.

74 *See* Davenport, *supra* note 23, at 107.

75 *Id.* For greater discussion of these benefits, *see infra* notes 206–11 and accompanying text.

76 *See* MCKINSEY GLOBAL INST., OFFSHORING 1 (2003), available at http://www.mckinsey.com/mgi/publications/win_win_game.asp.

commands two dollars in India.⁷⁷ Raw wage differences probably exaggerate the cost savings because offshoring requires higher communications costs and greater management infrastructure.⁷⁸ But even taking these new costs into account, it has been estimated that using emerging labor markets can cut some costs in half.⁷⁹

And the economic benefits of offshoring go beyond labor arbitrage. Cheaper production gives firms new options for structuring the flow of business activities. This may open opportunities to improve efficiency by making different trade-offs between labor and capital inputs. Changing the sequence of business processes, for example, may increase overall labor costs but lower total costs through higher capital productivity.⁸⁰ Similarly, firms may also use outsourcing as a way to increase revenues. For example, cheaper labor allows some companies to pursue delinquent accounts receivable balances that they have previously been forced to ignore.⁸¹ Finally, firms may be able to develop new products for lower income countries or offer new support services that were previously uneconomical.⁸²

According to the conventional story, then, a variety of forces have shifted the tipping point between in-house activity and external market activity by opening remote sources of supply. These low cost markets unlock economic gains, most immediately through price arbitrage, but also via new revenue opportunities or reengineered business processes. This story makes economic sense, it is the one given by most firms when they announce an outsourcing decision, and I certainly would not dispute that

⁷⁷ *Id.* These estimates may not reflect recent wage inflation. See Farrell, *supra* note 47, at 92.

⁷⁸ *Id.* at 2.

⁷⁹ *Id.* Of course, the cost of production in each location must also be adjusted for any difference in quality. Some firms refuse to move work overseas, claiming that the lower quality of the work more than offsets any cost savings. See, e.g., FRIEDMAN, *supra* note 20, at 36–38 (presenting examples where firms insist on using domestic outsourcing). On the other hand, in certain contexts, the quality of offshored work may be higher than that of developed economies. For example, the United States Department of Defense (DOD) has created the Capability Maturity Model (CMM) standard as a quality standard for information technology work. Firms who do not conduct business with the DOD largely ignore the standard, but many IT firms in India have seized upon CMM ratings as a way to demonstrate their quality—and have successfully obtained level five awards (the highest level of certification). See Ravi Aron, *A View From the Developing World*, KNOWLEDGE@WHARTON (Mar. 25, 2004), <http://knowledge.wharton.upenn.edu/article.cfm?articleid=862>. Some regions have recently developed reputations for very high quality work in certain industries—such as China in wireless communications and Bangalore, India in software development.

⁸⁰ See Agrawal et al., *supra* note 23, at 30–33.

⁸¹ *Id.* at 34.

⁸² *Id.* at 34–35.

lower production costs are a major factor underlying the rise of business outsourcing.

But if the economic benefits of offshore outsourcing are so great, then why haven't we seen even more business activity move overseas? A recent estimate suggests, after all, that fewer than three percent of eligible jobs have been outsourced.⁸³ One answer, as many executives can tell you,⁸⁴ is that moving economic activity out of a firm often creates some problems of its own. It becomes harder to ensure that the work is being performed correctly, or that vendors are expending adequate effort. Or vendors may be taking unknown risks as they conduct operations, risks that an outsourcing firm would never feel comfortable taking itself. More generally—and as the next Part will discuss—business outsourcing projects give rise to an agency cost problem.

II. A BRIEF REVIEW OF THE AGENCY COST PROBLEM

Many decades ago, Adolf Berle and Gardiner Means famously argued that economic centralization comes with a price.⁸⁵ It is often costly—and not fully possible—to prevent parties from taking self-interested actions when they are empowered to make decisions that affect other people's property. In other words, the very act of deputizing someone else to run your affairs raises incentives for suboptimal behavior. This Part briefly summarizes these economic distortions, collectively termed agency costs, and demonstrates how they can occur in a business outsourcing transaction.

A. *Shirking, Gluttony, Entrenchment, and Risk*

The agency cost problem arises whenever one party (the agent) has discretionary power to make decisions that affect the wealth of another (the principal).⁸⁶ The trouble can really be blamed on asymmetrical information. If it cost nothing for a principal to observe and understand how an agent's actions link to ultimate economic outcomes, then the agent

⁸³ See FARRELL ET AL., *supra* note 4, at 25–28; *supra* note 5 and accompanying text.

⁸⁴ See *supra* notes 45–46 and accompanying text.

⁸⁵ BERLE & MEANS, *supra* note 10, at 310.

⁸⁶ The agency cost problem has been discussed extensively in the legal and economic literature. The foundation for much of this work can be found in *id.* and Jensen & Meckling, *supra* note 12. A full bibliography is beyond the scope of this Article; additional background on agency theory can be found in Kenneth J. Arrow, *The Economics of Agency*, in PRINCIPALS AND AGENTS 37 (John W. Pratt & Richard J. Zeckhauser eds., 1985); Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, 14 ACAD. MGMT. REV. 57 (1989); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Sanford J. Grossman & Oliver D. Hart, *An Analysis of the Principal-Agent Problem*, 51 ECONOMETRICA 7 (1983).

would have no reason to behave differently than the principal.⁸⁷ But it is often difficult to know whether a poor outcome is caused by an agent's behavior or by external conditions. The world is complex, and results cannot necessarily be inferred from inputs. Agents may therefore choose to capitalize on this haziness by using discretionary power to benefit themselves—at the expense of uninformed principals.

What type of behavior underlies the agency cost problem? There are at least four broad areas of concern: (1) insufficient effort or shirking; (2) lavish compensation or self-dealing; (3) entrenchment; and (4) poor risk management.⁸⁸

The easiest way to illustrate each type of distortion is to consider an agent hired to invest a billionaire's money. How might she personally benefit at the rich principal's expense? First, the agent might shirk by making investment decisions without conducting adequate due diligence. For example, she may just throw a dart at a list of stocks instead of performing careful research on the best place to invest the money.⁸⁹ Second, in the absence of legal protection, the agent may take a variety of self-dealing actions to boost her compensation—things like investing in firms that kick-back bribes or traveling to exotic investor conferences.⁹⁰ Third, the agent might make bad decisions solely to protect her job. For instance, she may invest in arcane derivative contracts—not because these are a sound investment for the principal, but rather because the net position is complicated, making it difficult for the billionaire to fire the agent.⁹¹ Finally, the agent may take action that is either too conservative or too risky in order to achieve personal aims. For example, she may invest the money in a risk-free savings account, instead of in stocks or bonds, to protect her job by never losing money.⁹² On the other hand, in certain

87 Arrow, *supra* note 86, at 43–45.

88 See TIROLE, *supra* note 13, at 16–17.

89 In the literature, shirking is understood to occur not only when agents work few hours, but also when they spend time on less important, but easier to perform, activities. *Id.* at 16.

90 This category of agency costs is beloved by the business media, which thrives on reports of business excesses. Yet some have theorized that excessive compensation and self-dealing may actually be one of the smaller categories of agency costs. See *Beyond Irrelevance: Why Companies' Financial Structure Matters After All*, *ECONOMIST*, Feb. 11, 2006, at 74.

91 In the corporate context, notable entrenchment strategies involve manipulating performance metrics to obscure poor results or resisting mergers that might lead to management turnover. See TIROLE, *supra* note 13, at 17; Andrei Shleifer & Robert W. Vishny, *Management Entrenchment: The Case of Manager-Specific Investments*, 25 *J. FIN. ECON.* 123, 134–36 (1989).

92 Similarly, corporate agents are often criticized for steering decisions toward excessively safe projects. TIROLE, *supra* note 13, at 17.

situations, an agent may engage in extremely risky behavior that harms the principal. For example, if the money manager faces the threat of imminent termination for poor investment performance, she might be willing to place a net present value negative bet in order to juice her returns, or “gamble for resurrection.”⁹³

Principals are often aware of these problems, and they may take steps to counter potential abuses. For example, they may demand frequent meetings or reports in order to understand how an agent uses her discretion. Or a principal may hire an independent third party to monitor an agent in an attempt to safeguard that the agent acts in the principal’s best interest.⁹⁴ The principal may also negotiate contract provisions that seek to align the interests of both parties.⁹⁵ In some cases, agents may also wish to make bonding expenditures to prove that they will not behave opportunistically.⁹⁶ But all of these actions cost money, and ultimately they will not fully remove the information asymmetries that exist between agent and principal.⁹⁷ A complete understanding of the agency cost problem, therefore, includes these incremental monitoring and bonding expenses, along with the foregone economic value from suboptimal agent decisions.⁹⁸

Agency cost theories have been raised most often in the corporate context, and they have come to dominate much of the scholarship in this

93 *Id.* For example, in desperate times, the agent may be tempted to take the billionaire’s money to Las Vegas and place it on the roulette wheel (a negative net present value transaction—a wager on black, for instance, earns an expected ninety-four cents for every dollar bet). If the gamble pays off, she may keep her job; and if it fails, she would have been fired anyway. In analogous contexts, an agent might be willing to take much more risk than a principal.

94 Jensen & Meckling, *supra* note 12, at 325.

95 See Arrow, *supra* note 86, at 43–44; Eisenhardt, *supra* note 86, at 59–60; Fama, *supra* note 86, at 292.

96 See Jensen & Meckling, *supra* note 12, at 308 (“[I]n some situations it will pay the agent to expend resources . . . to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions.”). Examples of these bonding costs include contractual promises to hire third party auditors, explicit insurance against malfeasance by the agent, or contractual limits on the agent’s decision making power. *Id.* at 323.

97 This is true because there are an infinite number of potential contingencies, each of which might provide an avenue for agents to steer decisions in their favor. Indeed, the only way to remove these distortions completely is to transfer full ownership of the property to the controlling agent. See, e.g., *id.* at 312–13, 316–17; Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 637 (2005).

98 See Jensen & Meckling, *supra* note 12, at 308 (defining agency costs as the sum of the principal’s monitoring costs, the agent’s bonding costs, and the residual loss measured as the “dollar equivalent of the reduction in welfare experienced by the principal” as a result of divergent agent interests).

area.⁹⁹ This work models the corporation as a “nexus of contracts” between many different economic participants, including equity investors, debt investors, directors, officers, employees, suppliers, and customers. It then considers how agency distortions might affect the actions of these different parties.

Following the lead of Jensen and Meckling, the typical focus is on agency costs arising from the relationship between shareholders and managers.¹⁰⁰ Shareholders, with a residual equity interest, are viewed as the principals. The various executives running the firm—primarily the directors and top managers—are viewed as agents. The analogy is not perfect,¹⁰¹ but it does have some explanatory and predictive power.¹⁰² In fact, balancing the Coasean benefits of centralized corporate control¹⁰³ against the resulting agency costs has become a pivotal tension for corporate law scholars.¹⁰⁴ Important work has also surfaced in the debt financing context—where the lender is viewed as principal and the

99 See Robert P. Bartlett, *Managing Risk on a \$25 Million Bet: Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 48 (2006) (noting that agency cost models “define[] the primary analytical framework used in contemporary corporate scholarship”); Sitkoff, *supra* note 97, at 623 (“Agency cost theories of the firm dominate the modern literature of corporate law and economics.”).

100 For example, Frank Easterbrook and Daniel Fischel take this angle in their 1991 analysis of corporate law—essentially arguing that corporate stakeholders will take agency cost distortions into account when structuring their economic relationships. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 1–39 (1991).

101 Recent work has argued that the principal-agent paradigm is problematic in the corporate context. For example, corporate directors are not agents of the shareholders—at least not in the legal sense of the term—because shareholders lack the power to control or fire directors. See Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law* 27–28 (Vanderbilt Law Sch., Law & Econ. Research Paper Series, Working Paper No. 05-26, 2005), available at <http://ssrn.com/abstract=819365> (suggesting that the principal-agent model of the corporation should be replaced with a theory that a primary role of the firm is to “lock-in” investor capital); Blair & Stout, *supra* note 64, at 290–91. But this argument does not mean that agency cost theories of the firm are no longer relevant. Blair & Stout, *supra* at 38 (“[T]he principal-agent model still has great influence”); Ribstein, *supra* note 64 (using agency theory to assess capital lock-in in a corporation).

102 See TIROLE, *supra* note 13, at 15–43. For example, the work here has supported (and later critiqued) the use of stock options and other incentive-based compensation schemes for corporate executives. See BEBCHUK & FRIED, *supra* note 13, at 121–32; Jensen & Meckling, *supra* note 12, at 310–11; Jensen & Murphy, *supra* note 14, at 243; Schizer, *supra* note 14, at 448–49. Agency theory has also led to extensive normative debate about the appropriate division between board and shareholder control. See Bainbridge, *supra* note 18, at 616–27; Bebchuk, *supra* note 18, at 850–92.

103 See *supra* notes 57–67 and accompanying text.

104 See JACKSON ET AL., *supra* note 8, at 227.

borrowing firm is viewed as agent¹⁰⁵—and in other capital structure decisions.¹⁰⁶

Agency costs might also arise, however, between other corporate stakeholders.¹⁰⁷ And business outsourcing, in particular, offers an intriguing perspective on the problem.

B. The Agency Costs of Business Outsourcing

A business outsourcing project will sometimes transfer corporate assets and employees to an outsourcing vendor—who will continue to use these resources to conduct economic activity on behalf of the client.¹⁰⁸ In other cases, the existing assets and workers are replaced with those of the vendor. But the defining feature of an outsourcing transaction is that a firm contracts with another entity to take over activity that was previously produced inside the firm.

Outsourcing deals thus generate agency risk under a very familiar logic: the entity that controls a business activity does not ultimately “own” the economic result. Just like a CEO manages the property of shareholders—or like a borrower manages the money of a lender—an outsourcing vendor manages the business activity of an outsourcing firm.¹⁰⁹ This places the vendor in an agency position, where it might have

¹⁰⁵ Much of the discussion focuses on the distortions that arise when a borrowing firm (the agent) controls the money of a creditor (the principal). Problems arising between a principal-lender and manager-agent are also explored. See Jensen & Meckling, *supra* note 12, at 337–39. In both contexts, the analysis differs from shareholder-CEO agency models because borrowers are not legally required to extend fiduciary duties to lenders. Thus most of the techniques for mitigating agency costs are contractual in nature. See Amihud et al., *supra* note 17, at 454–56; Kahan & Yermack, *supra* note 17, at 138.

¹⁰⁶ The structure of venture capital finance, for instance, offers a rich context for transaction cost economics and agency theory. See, e.g., PAUL GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE* 174–75 (2004); Bartlett, *supra* note 99, at 48–61; Michael Klausner & Kate Litvak, *What Economists Have Taught Us About Venture Capital Contracting*, in *BRIDGING THE ENTREPRENEURIAL FINANCING GAP* 59 (Michael Whincop ed., 2001); William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473, 493–503 (1990).

¹⁰⁷ See Jensen & Meckling, *supra* note 12, at 309.

¹⁰⁸ For example, a large outsourcing project in 2002 transferred about 4000 employees from JP Morgan (the client) to IBM (the outsourcing vendor). See Charles Forelle, *Bank Scraps Dollars 5bn IBM IT Deal*, FIN. TIMES, Sep. 16, 2004, at 32. When the project collapsed a few years later, all 4000 employees were moved back to JP Morgan. *Id.*

¹⁰⁹ Jensen & Meckling, *supra* note 12, at 325. The analysis differs slightly from the typical corporate model because the outsourcing firm, as a whole, is viewed as principal and the outsourcing vendor is seen as agent. This is analogous to the agency framework used in lending transactions, which also views entire firms as agent and principal: the lending party is viewed as principal, and the borrowing firm is viewed as agent. See *supra* note 17. It is interesting to note that more sophisticated models might consider agency distortions arising

incentives to cut corners, take excessive risks, or engage in other forms of self-dealing. Unless resources are spent on monitoring, bonding, or other contractual protection, business outsourcing breeds a host of distorted incentives.

For example, in a typical call center outsourcing project, the vendor decides who to hire and how it will train these employees. Similarly, it decides when to replace aging capital with more efficient technology. And the vendor takes charge of quality control to ensure that employees are polite on the phones and adept at solving callers' problems. But the outsourcing client takes the fallout from many of these choices. If the vendor hires rude callers who chase away loyal customers, then the client loses business. If the caller misses obvious sales opportunities, then the client foregoes the revenue.

Of course, the outsourcing vendor might ultimately be accountable for shoddy work if the client decides not to renew a contract or if word gets out to other potential clients that this vendor shirks.¹¹⁰ But punishment will only be meted out if clients become aware that the vendor is engaged in selfish behavior. Most outsourcing relationships are rife with asymmetrical information, and the client is unlikely to guard against—or even know about—every potential abuse.

Indeed, any of the previously mentioned agency problems might occur in an outsourcing relationship.¹¹¹ Shirking may be the most obvious risk; when the principal is far away, vendors may be tempted to ease off just a little bit.¹¹² But an outsourcing vendor might also pursue excessive

between multiple corporate stakeholders—including suppliers, owners, managers, and the like. Robert Bartlett, for example, has recently demonstrated how agency distortions can occur simultaneously in the corporate context—between shareholder and manager, and between shareholder and shareholder. *See* Bartlett, *supra* note 99, at 56–61. One possible extension of this Article, therefore, would involve a more detailed look inside outsourcing firms and vendor firms to consider agency distortions among other stakeholders. For example, an outsourcing firm's managers might have distorted incentives to outsource too much activity (as a form of shirking) or too little activity (as a way to preserve corporate complexity and their jobs). Similarly, there are likely to be complex incentives between an outsourcing vendor's employees and managers.

110 The corporate agency literature considers similar questions by asking whether a CEO's desire to renew her contract, or to take a CEO position at another firm, might serve as a check on opportunistic behavior. *See, e.g.,* Fama, *supra* note 86, at 292 (“The manager of a firm, like the coach of any team, may not suffer any immediate gain or loss in current wages from the current performance of his team, but the success or failure of the team impacts his future wages, and this gives the manager a stake in the success of the team.”).

111 *See supra* notes 88–93 and accompanying text.

112 Jamie Dimon, the high-profile CEO of JP Morgan Chase, has been known to criticize business outsourcing for this reason. In his words, “when you're outsourcing . . . people don't care that much. We want patriots, not mercenaries.” Shawn Tully, *In This Corner! Jamie Dimon*, *FORTUNE*, Apr. 3, 2006, at 64.

compensation through a myriad of techniques. For example, it might write cost-plus contracts and buy fancy equipment. Or it might write fixed-price contracts yet hire unskilled labor. Similarly, a vendor may try to avoid meaningful competition for contract renewals—perhaps by setting up excessively confusing documentation of their business processes.¹¹³ Finally, vendors may incur unwarranted risks in their project execution—risks that the outsourcing principal would never tolerate if it kept control of the activity.

Consider, for example, a recent incident at the prestigious University of California San Francisco (UCSF) Medical Center. Near the end of 2003, an employee at UCSF was startled by a threatening email from a woman in Pakistan named Lubna Baloch.¹¹⁴ Ms. Baloch wanted help collecting money from someone named Tom Spires, who had apparently hired her to transcribe verbal doctor notes for UCSF patient medical files. “Your patient records are out in the open to be exposed,” the email started. “[S]o you better track that person and make him pay my dues or otherwise I will expose all the voice files and patient records of [two different] UCSF campuses on the Internet.” As a chilling exclamation point, she attached voice recordings and full text copies of private discharge summaries for two UCSF patients.¹¹⁵

The message was both disturbing and puzzling. Disturbing for the obvious reasons, and puzzling because UCSF had outsourced the transcription of medical records to a nearby company in the Bay Area—not to an overseas vendor.¹¹⁶ No one had heard of Tom Spires, and UCSF wondered whether these threats were for real.

As UCSF investigated the situation, it found that the medical transcription work had been subcontracted from the Bay Area vendor to a woman in Florida.¹¹⁷ She had passed it on to Tom Spires,¹¹⁸ who had finally sent the assignment on to Ms. Baloch in Pakistan. When Tom Spires stopped paying for the work, Ms. Baloch decided to threaten UCSF to recover her fees. Ultimately, UCSF paid her for the work, Ms. Baloch

113 Outsourcing clients often seek to minimize this problem by negotiating cooperation clauses requiring vendors to help transition projects to new firms in the event of termination. But these terms are not freely given, and presumably a vendor will charge more—or demand some other benefit—in exchange for cooperation rights.

114 See David Lazarus, *Looking Offshore: Outsourced UCSF Notes Highlight Privacy Risk*, S.F. CHRONICLE, Mar. 28, 2004, at A1.

115 *Id.*

116 *Id.*

117 *Id.*

118 Complicating matters even further, it is uncertain whether Tom Spires really exists or whether he is a fictional person established by the woman in Florida to hide her efforts to send the medical information outside of the United States. See *id.*

rescinded her threats, and the sensitive medical files were not exposed.¹¹⁹

Yet while the worst outcome was avoided, the Lubna Baloch story still offers a haunting collection of outsourcing agency costs. First, the woman in Florida—and perhaps also the Bay Area vendor—shirked on their performance responsibilities by sending the work elsewhere instead of transcribing the medical files themselves.¹²⁰ Similarly, both agents seemed negligent in their subcontractor selection process and failed to supervise the work as closely as UCSF would have preferred. In addition, the Florida vendor engaged in self-dealing by sending the work overseas and pocketing the wage arbitrage herself. And this introduced risks that UCSF appeared unwilling to take: The medical center was comfortable sharing sensitive information with domestic outsourcing vendors, but it may not have wanted to release medical records to a small, international vendor.¹²¹

Of course, agency problems of this sort might arise in any long-term contract involving asymmetrical information.¹²² The regular supplier of raw materials for a manufacturing company, for instance, could be viewed as an agent because the quality of its inputs will affect the manufacturer's final product. Similarly, a firm signing a long-term sales or distribution contract faces risks that the distributor will not take sensible efforts to move its products.¹²³ It is particularly interesting to study agency problems in the outsourcing context, however, because it sheds new light on the way that firms are organizing their economic activity in a rapidly changing world.¹²⁴

119 *Id.*

120 Apparently the Bay Area vendor's contract with UCSF allowed it to subcontract the work to other firms—as long as it was performed in the United States. *Id.* Thus, any shirking by the Bay Area vendor would come from their failure to manage where the work was conducted—that is, spending its time on easy actions instead of important ones. See *supra* note 89.

121 Part of UCSF's reluctance to move work overseas may have been caused by federal legislation affecting the use and treatment of personally identifiable health care information. Health Insurance Portability and Accountability Act of 1996, 42 U.S.C. § 1320a-7c (2000).

122 Jensen & Meckling, *supra* note 12, at 327–29.

123 This is one reason why large food companies sometimes hire their own employees to stock and organize grocery store shelves. Or, to take a related example, the agency problem is sometimes illustrated by the relationship between a principal who is selling a home and the realtor marketing the property. See EASTERBROOK & FISCHER, *supra* note 100, at 91; Sitkoff, *supra* note 97, at 636–37. Selling agents may refuse to take worthwhile efforts to increase the final selling price of a home because they are compensated with just a small percentage of the profits. *Id.*

124 A further reason to study agency costs in the outsourcing context relates to the fact that agents take over chunks of business activity formerly conducted by their principals. This means that principals might be especially mindful of agency risk—especially if previous experience in the activity reduces cognitive biases that limit recognition of potential agency distortions. If so, outsourcing principals may have a better sense of what

Previous scholarship has recognized the agency costs of business outsourcing,¹²⁵ but most research deals with theoretical models of optimal contract design¹²⁶ or with technical, practitioner-oriented advice.¹²⁷ There has been surprisingly little work offering a descriptive account of outsourcing contracts and the strategies that parties take to mitigate agency risk.

Yet this analysis is important because outsourcing firms do find it worthwhile to seek contractual protection against agent misbehavior. As in other agency contexts, an outsourcing principal will negotiate a variety of structures and terms to monitor and prevent vendor abuses. And, as the next Part will illustrate, these methods can be especially intriguing because firms often seem willing to make exceptional efforts to solve the agency cost problem.

III. MITIGATING AGENCY RISK IN THE BUSINESS OUTSOURCING RELATIONSHIP

No matter how hard they try, parties establishing an outsourcing

good agent behavior looks like, allowing them to structure a contract more carefully or to keep a sharp eye open for suboptimal decisions. See Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCI. 1124, 1130 (1974). For general discussions of cognitive biases in the economic analysis of law, see Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1489–1508 (1998); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1084–102 (2000).

¹²⁵ Jensen and Meckling even alluded to supplier agency risk in their seminal 1976 article. See Jensen & Meckling, *supra* note 12, at 310.

¹²⁶ See, e.g., Sankaranarayanan & Sundararajan, *supra* note 21, at 3 (modeling outsourcing agency costs as one factor in the decision to conduct activity within the firm in light of falling interaction costs); O. Zeynep Aksin et al., *Call Center Outsourcing Contract Design and Choice* (Oct. 2004), available at http://faculty.fuqua.duke.edu/~fdv1/bio/OUT31_10_04.pdf (formally exploring several co-sourcing structures in the call-center context); Francis Xavier, Abstract, *Determinants of Inter Firm Contractual Relations: A Case of Indian Software Industry* (2005), <http://ssrn.com/abstract=858344> (assessing theories of optimal outsourcing contract terms); Conglei Zhang et al., *Outsourcing Software Development: A Contract Theoretic Analysis* (15th Annual Workshop on Info. Techs. & Sys. (WITS) 2005), available at <http://ssrn.com/abstract=883114> (modeling agency problems in software outsourcing contracts under a fixed price or time and materials arrangement).

¹²⁷ See, e.g., Peter Brown, *Crisis Management in Outsourcing Deals*, 859 PLI/PAT 169 (2006); John F. Delaney, *Outsourcing Transactions: Strategies for Success*, 844 PLI/PAT 85 (2005); Rebecca S. Eisner, *Wake Up and Smell the Privacy Issues: Recognizing and Managing Privacy Issues in Outsourcing (Including Offshore)*, 866 PLI/PAT 95 (2006); Karen K. Harris, *Issues for Healthcare Companies When Contracting with ASPs*, 19 J. MARSHALL J. COMPUTER & INFO. L. 569 (2001).

relationship cannot write a perfect contract. Asymmetrical information will persist, and agents might take advantage of unexpected events to secure personal gains at the principal's expense. But the firms can—and do—take steps to detect and prevent agency risk. This Part first shows how the structure and terms of a typical outsourcing project operate to mitigate the agency cost problem. It then discusses the more general proposition that falling interaction costs are making it easier to pursue these strategies to drive down the agency costs of outsourcing. Taken together, this work offers a secondary explanation—beyond garnering access to cheap production markets—for the contemporary rise of business outsourcing.

A. *Strategies to Minimize Agency Costs*

Outsourcing projects are exceptionally complex, and, as with other major corporate transactions, it can be difficult to generalize broad principles from specific deals. Nevertheless, many contracts are structured in a similar manner—perhaps because these arrangements prove effective for defining and aligning an outsourcing relationship, and perhaps because the lawyers drafting the deals rely on the precedent of contractual boilerplate.¹²⁸ In any case, as with other financial contracts,¹²⁹ it is possible to study a basic structure common to most outsourcing transactions and to draw upon representative deals to illustrate interesting terms.¹³⁰ Furthermore, some firms have pursued notable steps to mitigate

128 For a recent discussion of the benefits and concerns presented by contractual boilerplate, see “Boilerplate”: *Foundations of Market Contracts Symposium*, 104 MICH. L. REV. 821 (2006).

129 For analogous work in other business contexts, see, for example, Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 EMORY L.J. 929, 931 (2004) (analyzing sovereign bond contracts); Kahan & Yermack, *supra* note 17, at 138–48 (analyzing bond indentures); Steven N. Kaplan & Per Stromberg, *Characteristics, Contracts, and Actions: Evidence From Venture Capitalist Analyses*, 59 J. FIN. 2177, 2208 (2004) (analyzing venture capital contracts); Klausner & Litvak, *supra* note 106, at 56–58 (same); D. Gordon Smith, *The Exit Structure of Strategic Alliances*, 2005 U. ILL. L. REV. 303, 313–16 (2005) [hereinafter Smith, *Strategic Alliances*] (analyzing business alliances); D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 337–55 (2005) [hereinafter Smith, *Venture Capital*] (analyzing venture capital contracts).

130 Most of the analysis in this Part is based on a review of contracts released in public SEC filings. Specifically, I reviewed 830 contracts for services, collected by an online aggregator of SEC contracts (ONECLE). From this large collection of service contracts, approximately eighty-nine documents involved outsourcing projects (including amendments and supplemental work orders), and this subset of agreements was analyzed in more detail. These contracts date from 1996 to 2006 and are available at <http://contracts.onecle.com/type/4.shtml>. I believe that this collection of business outsourcing contracts offers a meaningful basis for qualitative analysis of the typical efforts

agency risk, and these efforts are worth analyzing in some detail—even if they differ somewhat from a typical outsourcing contract.

More specifically, I will consider five major strategies that firms take to mitigate the agency costs of outsourcing: (1) staged commitment through an interlocking, multi-contractual framework; (2) the use of redundant agents or the retention of duplicate activity within the firm; (3) incentive compatible compensation; (4) explicit monitoring and control rights; and (5) “for cause” and “for convenience” exit rights.

1. Staged Contractual Commitment

Outsourcing projects are typically structured as a complicated array of overlapping contracts. In part, this may be because it is costly to negotiate and draft detailed contract terms.¹³¹ Outsourcing relationships are known to take frequent twists and turns, and this uncertain path progression makes it difficult to spell out the entire scope of commitment up front. Parties may be better off waiting until important contingencies play out before fully documenting their relationship.

There is a second reason, however, why an outsourcing firm may wish to proceed in this manner. Multiple, asynchronous contracts allow firms to stage their commitment, freeing them to reduce the scope of a project if hints of vendor opportunism arise. In this way, the use of sequential commitment parallels a technique used by venture capital firms to mitigate agency risk by staging their investment in target companies.¹³² Just as a

taken to deal with the agency cost problem. I have also supplemented this analysis with other research to illustrate some specific risk mitigation strategies. I have resisted, however, the urge to draw quantitative conclusions from this sample (such as the percentage of firms employing various risk mitigation techniques) due to potential selection biases. In particular, SEC disclosure requirements in this area are not clear, and I believe that some firms seek to keep their outsourcing transactions secret because they fear that public announcement might lead to internal morale problems, customer revolt, or political pressures. Furthermore, the fact that these agreements span multiple contracts is problematic. *See infra* notes 131–41 and accompanying text. Parties will often disclose only a few of the interlocking contracts, and it is difficult to know when the complete transactional framework is compiled.

¹³¹ *See* Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581 (2005) (describing the costs involved in contract drafting and interpretation); Schwartz & Scott, *supra* note 60, at 594–95 (discussing how all contracts are incomplete because it is costly to specify every potential contingency). I have contended elsewhere that parties may also draft vague or incomplete contracts for other reasons. *See* George S. Geis, *An Embedded Options Theory of Indefinite Contracts*, 90 MINN. L. REV. 1664, 1669 (2006) (arguing that a vague term may confer an embedded option to either party).

¹³² *See* Bartlett, *supra* note 99, at 52–53; Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons From the American Experience*, 55 STAN. L. REV. 1067, 1078–81 (2003); Klausner & Litvak, *supra* note 106, at 59.

VC investor commits slowly via multiple funding rounds—each round contingent upon the achievement of business milestones¹³³—an outsourcing firm can stage its contractual commitment by delaying detailed specification of scope and performance requirements. To understand how this staged commitment works, consider the interactions between the four primary contracts used in an outsourcing project: the confidentiality agreement, the master agreement, the statements of work, and the service level agreement.

First, during the initial negotiations, the parties will often sign a confidentiality agreement to protect business information of both client and vendor. This is typically structured as a stand-alone contract, signed in advance of the other deal documents.¹³⁴ These confidentiality agreements do not differ significantly from those used in other business transactions, and I will not discuss them in detail.¹³⁵

The second deal document is called the master agreement, sometimes referred to as the framework agreement. This contract provides an overview of the anticipated relationship and describes the business goals in fairly broad strokes. Typically, it will also set a timeline for moving the project forward and provide a governance structure—including a schedule for joint meetings between high-level and operational-level personnel. It may also include other important terms, such as a mechanism for resolving disputes and termination rights and obligations. But while the master agreement can be quite lengthy, it is usually silent on the exact work to be performed.¹³⁶

A third collection of contracts, the statements of work, is subsequently negotiated to flesh out the project details. These documents are numerous and often fairly short—sometimes just a few pages—and they will include

¹³³ Gilson, *supra* note 132, at 1073.

¹³⁴ Confidentiality agreements are often signed first because it takes a long time to write an outsourcing contract—and because the very process of negotiating the deal will often reveal sensitive information. Furthermore, the outsourcing firm may be bargaining simultaneously with several vendors, and everyone will want proprietary information protected even if the deal falls through. Sometimes, however, confidentiality provisions are (unwisely) bundled into the master outsourcing agreement and are not legally effective until the parties execute this contract.

¹³⁵ The only obvious thing to note is that a confidentiality agreement protects against the risk of an agent expropriating enumerated proprietary information as a form of self-dealing. For further discussion of confidentiality agreements, primarily in the employment context, see Carol M. Bast, *At What Price Silence: Are Confidentiality Agreements Enforceable?*, 25 WM. MITCHELL L. REV. 627, 633–61 (1999).

¹³⁶ See, e.g., Rosemary L. Gullikson, *Statement of Work—The Road-Map of Services Delivery*, 880 PLI/PAT 173, 177 (2006); William A. Tanenbaum, *Revisiting Key Provisions in Software and Outsourcing Agreements*, J. INTERNET L., Mar. 2003, at 1.

detailed work orders and project functionality requests.¹³⁷ The usual procedure is to have mid-level managers from both parties, those closer to the nuts and bolts of the project, draft the statements of work in accordance with the general guidelines and timeline set by the master agreement. And because the scope of an outsourcing project may change frequently over time, it is also common to have many amendments and modifications to the statements of work.

Finally, a fourth contract, the service level agreement (SLA), is usually signed to govern the ongoing quality of project execution.¹³⁸ The SLA provides concrete performance metrics for the outsourcing vendor to maintain during the life of the contract. It is usually quite detailed; many SLAs run hundreds of pages.¹³⁹ Thus, while the statements of work govern what will be done, the SLA governs how well the work will be performed.¹⁴⁰ Like the statements of work, the SLA may be amended as the scope of the project evolves.¹⁴¹

It may be easier to see how these four outsourcing contracts fit together with a short example. In 1999, the energy giant BP Amoco decided to outsource much of its human resources management services to

137 *Id.* A nice example of the connection between the master agreement and statement of work is found in a project where the John Wayne Cancer Institute outsourced data processing for clinical drug trials of a melanoma vaccine to a company named Synteract. See Master Services Agreement Between CancerVax, The John Wayne Cancer Institute, & Synteract, Inc., Jan. 22, 2002, available at <http://contracts.onecle.com/cancervax/wayne.svc.2002.01.22.shtml>. The master agreement provides a high level framework for the relationship, while a subsequent work order describes the work to be performed: data input, quality control, database creation, adverse event notification, statistical analysis, and other specific services. *Id.*

138 Like the other deal documents, the SLA is sometimes bundled with the master agreement. But over time, as the project's scope changes with the statements of work, SLAs will typically evolve to support these changes.

139 *E.g.*, Amended and Restated Global Master Services Agreement Between Coors Brewing Company & EDS Information Services, L.L.C., Jan. 1, 2004, available at <http://contracts.onecle.com/coors/eds.svc.2004.01.01.shtml> [hereinafter Coors / EDS Contract] (running approximately 28,000 words).

140 For example, an agreement to outsource the storage and management of Internet networking equipment (a "hosting" contract) may have statements of work describing the type of servers and the space that will be allotted to the client. See Robert D. Austin, *Web and IT Hosting Facilities*, Harvard Business School Technology Note 9-601-134, at 7-8 (2003). It is the SLA, however, that typically guarantees specific performance measures, such as packet transmission rates, bit-loss frequency, response times for service calls, and so on. *Id.*

141 Similarly, the parties may plan to renegotiate service levels over time. For instance, the contract between EDS and Coors Brewing Co. provides that "[a]t the following intervals the Parties shall jointly review all then-applicable Service Levels . . . and adjust them to reflect any improved performance capabilities associated with advances in the technology and methods used to perform the Services." Coors/EDS Contract, *supra* note 139, § 4.2(a).

a firm called Exult,¹⁴² and the SEC filings surrounding this transaction contain a particularly large amount of information.¹⁴³ The master agreement provides a general description of the project, which includes ambitious, though nebulous, goals such as “[a]utomation of relevant transactional processes and employee access through the implementation of web-enabled human resources support,” “[c]onsolidation and integration of human resources transactional processing support into Client Service Centres,” and “[r]ationalization and integration of third party service providers.”¹⁴⁴ The master agreement also sets out a timetable for Exult to submit detailed plans to provide this human resources support and for both parties to conduct due diligence of these plans.¹⁴⁵ It then goes into great detail on how Exult will be paid, how the project will be governed, how disputes will be resolved, which employees will be transferred to Exult, and other general terms.¹⁴⁶

But the master agreement is exceptionally vague on the exact activities that Exult will perform for BP Amoco. One appendix rattles off about twenty different services—things like training, HR strategy, labor relations, managing employee records, payroll, recruiting, severance, and so on—and provides a two or three paragraph description of how each activity will be divided between Exult and BP Amoco.¹⁴⁷ These descriptions are remarkably ambiguous,¹⁴⁸ and the true scope of the project

142 For an excellent overview of human resources outsourcing and further background on the BP Amoco deal, see generally Paul S. Adler, *Outsourcing: A Framework and the Case of Human Resource Management* (Oct. 2, 2002) (unpublished manuscript), available at <http://ssrn.com/abstract=317502>. Exult was subsequently acquired by Hewitt Associates in 2004. *Hewitt Associates to Acquire Exult, A Rival*, N.Y. TIMES, June 17, 2004, at C4.

143 See Framework Agreement Between BP Amoco P.L.C. & Exult, Inc., Dec. 7, 1999, available at <http://contracts.onecle.com/exult/bpamoco.svc.1999.12.07.shtml> [hereinafter BP Amoco / Exult Framework Agreement]. Very similar master service agreements were also executed on the same day between Exult and subsidiaries of BP Amoco in the United States and the United Kingdom. See US Country Agreement Between BP America, Inc. & Exult Inc., Dec. 7, 1999, available at <http://contracts.onecle.com/exult/bpamerica.svc.1999.12.07.shtml>; UK Country Agreement Between BP International, Ltd. & Exult, Ltd., Dec. 7, 1999, available at <http://contracts.onecle.com/exult/bpintl.svc.1999.12.07.shtml>.

144 BP Amoco / Exult Framework Agreement, *supra* note 143, at 1.

145 *Id.* §§ 2, 4.

146 *Id.* §§ 2, 8, 9, 16, 25, 28. The master agreement also contains confidentiality provisions. *Id.* § 14. I do not know whether the parties signed a separate confidentiality agreement before negotiating this master agreement.

147 *Id.* at 63 sched. A.

148 For example, under the heading for the first service, training, the agreement runs as follows:

Training as a process includes training needs assessment, course/materials development, logistics co-ordination, conduct of training and training leader

will only come to light when the detailed statements of work and the SLAs are subsequently negotiated by project managers at BP Amoco and Exult.

It is this delay between high-level master agreements and actionable statements of work that allows an outsourcing firm to stage its commitment—and thereby mitigate the risk of vendor opportunism. The master agreement may set out the contemplated scope of a project, but the devil is always in the details. A principal detecting any sign of poor performance, or losing trust in the vendor, will usually have ample leeway to scale back commitment as additional statements of work are drafted.

In addition, the parties will sometimes use more direct contractual methods to stage their commitment. For instance, many outsourcing contracts have a limited life, typically five to ten years.¹⁴⁹ This provides another check on vendor opportunism: an imminent renewal decision by the principal may keep some agents from misbehaving.¹⁵⁰ Other outsourcing projects use contracts that are limited in geographic scope but dangle the possibility of future expansion. In its deal with Exult, for example, BP Amoco agrees to initially outsource human resource services only in the United States and the United Kingdom.¹⁵¹ But it also sets up procedures for expanding the project to other countries at a later time.¹⁵² These types of provisions are explicit mechanisms for reducing agency risk through staged commitment.

There is one obvious problem, however, with using a staged commitment strategy to mitigate agency risk: It may be hard for the principal to detect poor performance. The hallmark of agency costs, after

selection, training effectiveness assessment and post training follow-up. Delivery of training materials includes traditional classroom, self-study, computer-aided training and third party training delivery mechanisms.

[BP Amoco] shall develop training strategies and policies, develop and deliver training programs based on needs analyses and assess the cost/benefit of training programs. Exult shall administer course schedules, registration, confirmations and training materials. Exult shall also administer attendee evaluations of training programs and tuition reimbursement.

Id. at 64–65.

¹⁴⁹ For an example of this, see *infra* note 187 (describing a contract with an anticipated seven-year term).

¹⁵⁰ On this note, IBM, one of the largest technology outsourcing vendors, has recently announced that “smaller and shorter contracts are more profitable and preferred by customers.” Charles Forelle, *IBM Turns to Smaller Service Deals*, WALL ST. J., Feb. 24, 2005, at A3. If so, one possible explanation for the greater profitability of shorter contracts is that they create less costly agency problems—thereby decreasing the need for IBM to discount prices for this risk.

¹⁵¹ BP Amoco / Exult Framework Agreement, *supra* note 143, § 2.

¹⁵² *Id.*

all, is asymmetric information,¹⁵³ and it can be difficult to determine whether an agent is doing anything wrong. Even when there are obvious signs of poor performance, the agent vendor may blame the problems on external market conditions. Thus, there must be some way to measure, at the back end of a period, whether to move on to the next stage of commitment.

Venture capitalists typically address this problem by placing performance expectations on future funding.¹⁵⁴ In an outsourcing project, the service level agreement can act in a similar manner. As mentioned, the parties will typically take great efforts to define the exact scope of duties in the work statements and to spell out metrics for acceptable performance in the SLA. If SLA performance measures fall short of expectations, then the principal will have a basis for abandoning the next stage of an outsourcing project.¹⁵⁵

Nevertheless, it can be challenging to set the right benchmarks in the first place. And even with detailed performance metrics, it may be hard for a principal to detect all forms of agent self-dealing. To counter these concerns, outsourcing principals might turn to other strategies, such as the employment of multiple agents or co-sourcing.

2. Multiple Agents and Co-Sourcing

A second way to manage agency risk involves the use of multiple agents and co-sourcing—that is, keeping some of the outsourced activity within the firm.¹⁵⁶ By dividing a project into pieces and awarding each piece to different agents, principals can, in theory, introduce an element of competition that will help them monitor the agents' performance. Further, the agents will often be aware of this scrutiny, and this knowledge may also prevent some misbehavior.

For instance, a firm outsourcing the hosting and management of its networking infrastructure might divide the company in half and award part of the project to one vendor and the rest to another. This tactic gives the principal an automatic way to benchmark the performance of both agents: it can directly compare packet transmission rates, bit-loss frequency, service call response rates, and the other relevant metrics.¹⁵⁷ This might help the

153 See *supra* note 86 and accompanying text.

154 See Bartlett, *supra* note 99, at 64–80; Klausner & Litvak, *supra* note 106. These financial benchmarks may need to be adjusted with common sense, however, or they will prove over- and under-inclusive.

155 Further, failure to meet SLA performance requirements may trigger financial penalties or “for-cause” exit rights. See *infra* Part III.A.5.

156 See Aksin et al., *supra* note 126, at 2 (defining co-sourcing).

157 For an explanation of these metrics, see Austin, *supra* note 140, at 3–4.

principal identify hidden risks or uncover agency distortions.

Consider the approach taken by one of India's largest mobile phone companies, a firm named Bharti Airtel. As part of a fascinating transition over the past few years, Bharti has outsourced nearly all of its business activities—including technology infrastructure, IT services, billing, provisioning, and so on—to other firms.¹⁵⁸ Recently, it also decided to outsource its customer service centers, following this strategy of multiple agents. After dividing operations into four regions, Bharti hired a different vendor to handle the inbound service calls of customers in each region.¹⁵⁹ This strategy gives Bharti a basis for comparing the efficiency of each vendor. In some cases, Bharti also assigned two vendors to a geographic region—to counter the potential excuse that an agent's poor performance should be blamed on market conditions.¹⁶⁰

Related to this strategy of using multiple agents, a principal will sometimes benchmark performance by co-sourcing a project.¹⁶¹ Under this approach, the principal simply outsources part of the work, keeping a share of the activity within the firm. Co-sourcing also allows the principal to pace the performance of agents, and it may have added strategic benefits.¹⁶²

Continuing with the previous example, Bharti supplemented its call center outsourcing strategy by keeping an in-house division to perform the same work.¹⁶³ It uses the company-owned call center to manage particularly important customers by performing an initial screen on all incoming calls. High-value customers are routed to the in-house service center, while all other customers are automatically transferred to one of the four outsourcing vendors.¹⁶⁴ This strategy allows Bharti to retain control of the high-end customer experience, and it also provides a reliable,

¹⁵⁸ Bharti's strategy is particularly interesting, because many of its deals have involved "reverse offshore outsourcing," the movement of business activity from an Indian principal to agents in the United States. See Rebecca Buckman, *Outsourcing with a Twist: Indian Phone Giant Bharti Sends Jobs to Western Firms in a Multinational Role Switch*, WALL ST. J., Jan. 18, 2005, at A1; Ray Marcelo & Paul Taylor, *IBM Turns Tables on Indian Outsourcing*, FIN. TIMES, Mar. 27, 2004, at 1.

¹⁵⁹ See Balaka Baruah Aggarwal, *Bharti's Outsourcing Innovation*, DATAQUEST, Sep. 27, 2005, <http://www.dqindia.com/content/industry/2005/105092702.asp>.

¹⁶⁰ *Id.*

¹⁶¹ See Aksin et al., *supra* note 126, at 2.

¹⁶² See, e.g., Noshir F. Kaka, *Running a Customer Service Center in India: An Interview With the Head of Operations for Dell India*, MCKINSEY Q., May 2006, http://www.mckinseyquarterly.com/article_abstract.aspx?ar=1779&L2=13&L3=13 (discussing Dell Computer's co-sourcing strategy).

¹⁶³ See Aggarwal, *supra* note 159.

¹⁶⁴ *Id.*

internal benchmark on the performance of call-center agents.¹⁶⁵

Unfortunately, the use of multiple agents or co-sourcing comes with a price. A firm may lose economies of scale by splitting an outsourcing project into several smaller chunks. Often, outsourcing vendors can bargain for higher fees when the size of the contract is smaller.¹⁶⁶ In addition, the principal will need to incur extra transaction costs to stitch together the outsourcing project. Instead of dealing with just one big partner, it will need to manage a collection of smaller relationships and divide project responsibilities among the vendors. Thus, like all other monitoring investments, there is a fundamental tension in the use of this strategy: adding more vendors increases competitive pressure and mitigates agency risk, but it also raises transaction and coordination costs. Furthermore, it may be impossible to break up some outsourcing projects into meaningful pieces. Some assignments may not have parallel processes—or may not be divisible and measurable in a sensible way.

Nevertheless, under the right circumstances, it may be worth trading additional monitoring costs for reduced agency distortions. And if it is indeed becoming cheaper to coordinate activity between multiple vendors—as I will soon argue¹⁶⁷—then we might expect to see more outsourcing principals using these structures.

3. Incentive Compatible Compensation

A third strategy for mitigating outsourcing agency risk is to set a compensation scheme that seeks to align vendors' economic interests with those of the principal. Just as a corporation issues options to top managers to focus their efforts on boosting stock prices,¹⁶⁸ an outsourcing principal might negotiate incentive compatible compensation structures to narrow the agency gap. While these tactics may help at the margins—and are thus worth understanding—it is important to note that they will never fully solve the agency problem. Anything short of transferring a complete ownership interest to the agent will leave room for economic distortions.¹⁶⁹

Before turning to a few of these compensation strategies, let me quickly point out the problems with standard ways of paying for outsourcing services. Consider two extreme compensation paradigms: a time and materials contract, and a fixed price contract.¹⁷⁰ Time and

¹⁶⁵ *Id.*

¹⁶⁶ See Forelle, *supra* note 150.

¹⁶⁷ See *infra* Part III.B.

¹⁶⁸ See Jensen & Meckling, *supra* note 12, at 312–13; Jensen & Murphy, *supra* note 14, at 232–35.

¹⁶⁹ See Sitkoff, *supra* note 97, at 637.

¹⁷⁰ For additional discussion of the agency problems presented by time and materials

materials compensation, where the agent simply adds a markup to the project's input costs, presents obvious agency problems. The vendor has no incentive to tackle a project in a cost-effective manner because she will be paid for shirking or other inefficient behavior.¹⁷¹ A fixed price contract, by contrast, transfers the pain of excessive input costs to the vendor. But this paradigm raises other incentives to perform shoddy work; the vendor might, for example, take excessive risks and still get paid in full. Sometimes, an outsourcing principal will try a compromise approach—by imposing a time and materials contract with a maximum price cap—but this strategy just presents the concerns of both payment schemes.¹⁷²

In place of these standard pricing strategies, some outsourcing contracts are substituting incentive compatible compensation terms. For example, they might award half of all cost savings below a specific target to agent vendors or impose other “earn-out” requirements.¹⁷³ Other contracts require annual negotiation of compensation (a strategy similar to staged commitment) or impose fines if service levels miss contractual requirements. In the outsourcing contract between BP Amoco and Exult,¹⁷⁴ for example, a project manager at Exult admitted that “[w]e are obligated to certain performance levels . . . and we'd have to pay big penalties if we missed those levels.”¹⁷⁵ Still other contracts will pay vendors with the principal's stock to directly align agent incentives. Many other compensation schemes might serve similar purposes; the key is simply to focus the attention of both parties on the same goals. But at the end of the day, these strategies will never eliminate agency risk

and fixed price contracts, see Alexander J. Triantis & George G. Triantis, *Timing Problems in Contract Breach Decisions*, 41 J.L. & ECON. 163, 187–93 (more formally exploring agency costs in a fixed price contract).

171 Laura A. Dickinson, *Government for Hire: Privatizing Foreign Affairs and the Problem of Accountability Under International Law*, 47 WM. & MARY L. REV. 135, 203–04 (2005) (discussing both types of arrangements in government contracting).

172 For example, a contract using this hybrid fee arrangement might pay the vendor a twenty percent markup on all time and material expenses—but limit the annual payments to one million dollars at a maximum. Such an arrangement might encourage the vendor to engage in excessive activity early in the year and to slash activity later on (perhaps via excessive risk) as it approaches the one million dollar cap. Neither incentives are in the principal's best interest. Similarly, the Bharti Airtel deal, described *supra* notes 158–60 and accompanying text, pays call center vendors on a per call basis, rather than on a per employee basis. Aggarwal, *supra* note 159. This structure encourages vendors to focus on operating efficiency—rather than just scaling up employees—but it may also reduce the quality of service by imposing more time pressure on each call.

173 See David Craig & Paul Willmott, *Outsourcing Grows Up*, MCKINSEY Q., Feb. 2006, http://www.mckinseyquarterly.com/article_abstract.aspx?ar=1582.

174 See *supra* notes 142–52 and accompanying text.

175 Adler, *supra* note 142 (manuscript at 20).

completely—they can only influence vendor behavior at the margins.

4. Explicit Monitoring and Control Rights

Perhaps the most direct way to mitigate the agency costs of business outsourcing is to write contracts with explicit monitoring or control rights. Many transactions require vendors to participate in extensive business audits that allow principals—or their designated third parties—to come on site and inspect financial records and operating procedures.¹⁷⁶ In theory, these monitoring provisions should reduce an agent's temptation to make self-interested decisions because the principal will have a better chance at uncovering the bad behavior.¹⁷⁷

Explicit control rights work in a similar, but *ex ante*, manner by giving principals power over decisions that are typically delegated to the agent. The scope of these rights will differ from transaction to transaction, but a major outsourcing client may hold sway over important decisions such as employee hiring and training, equipment upgrades, managerial ratios, the selection of subcontractors, and other operating activities.¹⁷⁸ Sometimes this control comes through contractual carve-outs allowing principals to veto particularly important decisions rather than make direct decisions.¹⁷⁹

The principal might also seek to exert control at a higher level by taking an ownership interest in the agent. For example, in the BP Amoco-Exult deal, BP bought eight percent of Exult's stock as a "sign of good faith."¹⁸⁰ Minority equity ownership will not give a principal explicit control of the agent, but it may allow the principal to exert considerable influence.¹⁸¹ This type of control is similar to that enjoyed by a venture

176 *E.g.*, Master Services Agreement Between Exult, Inc. & Bank of America Corp., Nov. 21, 2000, § 17, available at <http://contracts.onecle.com/exult/bofa.svc.2000.11.21.shtml>.

177 *See* Arrow, *supra* note 86, at 45–46; Fama, *supra* note 86, at 293; Jensen & Meckling, *supra* note 12, at 323–25.

178 *E.g.*, Master Agreement for Outsourcing Call Center Support Between Priceline.com LLC and Calltech Communication Inc., §§ 1, 3, available at <http://contracts.onecle.com/priceline/calltech.svc.1998.shtml> [hereinafter Priceline.com / Calltech Agreement] (dictating hours of operation, training requirements, and other operating procedures). Contracts providing extensive principal control, sometimes termed "virtual captive offshoring" arrangements, are discussed *infra* notes 212–18 and accompanying text.

179 Similar veto provision are often used in debt contracts. *See* Amihud et al., *supra* note 17, at 464–65; Fischel, *supra* note 17, at 145.

180 Adler, *supra* note 142 (manuscript at 16). The quote is curiously ambiguous on whether BP is demonstrating "good faith" to Exult or purchasing it from the vendor.

181 *See, e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 524, 585–89 (1990); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 473–74 (1991); *see also* MARK ROE,

capital investor—although VC firms will often use preferred stock and other methods to exert influence even beyond their proportional ownership in a firm.¹⁸² Such extensive control rights are much rarer in the business outsourcing context.

5. Exit Rights

The last strategy for managing agency costs that I will discuss involves exit rights, the legal power to terminate an outsourcing contract before the contemplated term expires. Exit rights raise an interesting tension—as they do in other corporate contexts¹⁸³—because of two competing concerns. On the one hand, allowing an outsourcing principal to exit at will provides a check on vendor opportunism.¹⁸⁴ If the principal detects poor quality work, excessive costs, or any other problem, it can simply end the deal. In this sense, liberal exit rights serve as the ultimate check on agency cost problems, and even the threat of early termination may keep vendors in line.¹⁸⁵

But, on the other hand, an outsourcing vendor will often need to incur relation-specific investments to take on new work, and it may worry about writing an open-ended put option on the project.¹⁸⁶ For example, IBM, one of the world's largest technology outsourcing vendors, recently experienced a devastating loss when JP Morgan Chase cancelled a five billion dollar outsourcing project just eighteen months into a seven year contract.¹⁸⁷ Easy exit rights thus raise another potential problem:

STRONG MANAGERS, WEAK OWNERS 169–86 (1994) (discussing governance practices in countries with a preponderance of equity blockholding).

182 For example, venture capital investors might seek dedicated board seats or greater voting power than other shareholders. See Bartlett, *supra* note 99, at 53–54.

183 The right to exit an economic relationship—and the flip side of exit rights, the power to “lock in” capital—has been discussed extensively in the legal literature. See, e.g., Blair, *supra* note 64, at 441–55 (corporations); Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357, 389–92 (1987) (partnerships); Smith, *Strategic Alliances*, *supra* note 129, at 311–12 (business alliances); Smith, *Venture Capital*, *supra* note 129, at 337–56 (venture capital finance).

184 See Smith, *Strategic Alliances*, *supra* note 129, at 311.

185 See *id.*

186 For those less fluent in options terminology, a put option is the right—but not the obligation—to sell something at a given price. See RICHARD A. BREALEY, STEWART C. MYERS, & FRANKLIN ALLEN, *PRINCIPLES OF CORPORATE FINANCE* 544 (8th ed. 2006); JOHN C. HULL, *FUNDAMENTALS OF FUTURES AND OPTIONS MARKETS* 263–81 (5th ed. 2005). Thus, granting unrestricted termination rights to an outsourcing firm essentially gives them a put on the project.

187 JP Morgan Chase was free to do so under the contract because IBM was pursuing a new services “on demand” strategy, under which it hoped to turn information technology into a utility like gas or electricity using pay-as-you-go arrangements. JP Morgan Chase

outsourcing principals might use, or threaten to use, these exit rights opportunistically to extort a better deal.¹⁸⁸

Because of these competing tensions, exit rights are often one of the most heavily negotiated provisions in an outsourcing contract. Parties typically take great pains to define when and how a firm may walk away from the project—and to set the financial consequences of an early exit. The typical compromise involves dual exit rights: termination for cause and termination for convenience.¹⁸⁹ Under the “for cause” track, a principal is entitled to exit the relationship if the agent does not live up to service level requirements or if other problems arise.¹⁹⁰ Under the “for convenience” track, a principal is entitled to cancel the project without proof of bad service, but it may need to reimburse the agent for upfront asset purchases or pay other financial penalties.¹⁹¹ Under both tracks, the agent is usually required to support transition to another vendor, although the obligations may differ between the two types of exit.

An outsourcing partnership between Priceline.com, the online travel firm, and Calltech, a call center vendor, provides a nice example of a typical exit arrangement. In 1998, Priceline decided to outsource all of its

signed up for the service in 2002 as a marquee client for IBM. See Daniel Golden, *IBM Gets J.P. Morgan Outsourcing Pact*, WALL. ST. J., Jan. 15, 2004, at A10 (quoting a top IBM executive that the JP Morgan deal was “by far the largest and most comprehensive on-demand deal we’ve signed” and quoting a Goldman Sachs analyst that the contract was “very high-profile” and a key “reference account” for evaluating the on-demand approach). Under the agreement, IBM would manage most of the bank’s core technology functions, including data centers, help desks, data and voice networks, and distributed computing. Forelle, *supra* note 108. The deal was structured, however, so that JP Morgan could halt the outsourcing project at any time—although the contract was contemplated to last for at least seven years. IBM incurred large upfront investments to support JP Morgan’s technology needs, and the partnership moved forward. But when Jamie Dimon took over the leadership of JP Morgan, his team soon decided to pull the plug on the IBM project—pointing to the high cost of the contract, the strategic importance of IT ownership, and to excess technology capacity at BankOne. *Id.* More recently, IBM has deemphasized its “on-demand” strategy and has been pushing shorter projects that shift termination risk back to clients. See *supra* note 150.

188 See Smith, *Strategic Alliances*, *supra* note 129, at 311.

189 *Id.* at 346–50.

190 *Id.* at 304.

191 Without financial penalty, liberal exit rights of this sort might raise mutuality of obligation concerns in contract law—although a good faith requirement would most likely be read into the exit terms to skirt the problem. See E. ALLAN FARNSWORTH, *CONTRACTS* §§ 2.13, 3.2 (4th ed. 2004); JOHN EDWARD MURRAY, JR., *MURRAY ON CONTRACTS* 249–50 (4th ed. 2001); JOSEPH M. PERILLO, *CALAMARI AND PERILLO ON CONTRACTS* § 4.12 (5th ed. 2003). I am unaware of any situation where a party has attacked the validity of an outsourcing contract along these lines.

inbound call center work to Calltech.¹⁹² The deal would last for a year with automatic annual renewal unless notice was provided prior to the end of a term.¹⁹³ Priceline then secured “for cause” termination rights, allowing it to cancel the agreement if Calltech failed to meet performance obligations—as defined in the statements of work and the SLA—or if Calltech suffered financial problems.¹⁹⁴ Priceline also negotiated “for convenience” exit rights, allowing termination with just ninety days notice. But if Priceline triggered these rights, it would incur an early termination fee designed to “compensate CALLTECH for all costs and expenses actually and reasonably incurred by CALLTECH for personnel and equipment engaged in providing Services to PRICELINE”¹⁹⁵ The agreement goes on, however, to require Calltech to make good faith efforts to discharge this fee by redeploying these assets—and, interestingly, that the termination fee will be capped at the total bill charged by Calltech during the month prior to termination.¹⁹⁶ The exit structure of this deal thus stages a complicated dance to mitigate dual opportunism: Priceline can threaten to leave if it thinks Calltech is behaving badly, but it must pay a termination fee to do so, but the termination fee is limited by agent redeployment requirements.

Of course, the complexity of a large outsourcing project can sometimes make it hard to determine whether termination is “for cause” or “for convenience.” A principal might unjustifiably claim “for cause” termination in order to avoid the financial penalties of a convenience exit. And conversely, an agent may refuse to accept evidence that bad behavior amounts to cause.¹⁹⁷ Because language is ambiguous and context-

192 For general background on this deal, see Marcia Pledger, *Netting New Business*, CLEV. PLAIN DEALER, Feb. 17, 2000, at 1C.

193 Priceline.com / Calltech Agreement, *supra* note 178, § 5.1 (between Priceline.com LLC and Calltech Communication Inc.).

194 *Id.* § 5.2. The financial problems triggering for cause termination include bankruptcy, liabilities in excess of assets, and other indicators of financial distress. *Id.*

195 *Id.* § 5.3.

196 *Id.* This clause illustrates, perhaps, Priceline’s clout in negotiating the deal. It is likely that the financial pain to Calltech from termination would exceed one month in billings.

197 This problem surfaced recently in litigation between Sears and Computer Sciences Corp. (CSC), a large outsourcing vendor. When Sears sought to cancel the project for cause, CSC countered that the exit was really for convenience and that Sears was attempting to dodge large financial penalties. See Joseph R. Perone, *Possible Fort Closing and Lawsuit Dog Computer Sciences*, STAR LEDGER (Newark, N.J.), May 23, 2005, at 24; Robert Weisman, *Technology Outsourcing Comes Home*, BOSTON GLOBE, May 29, 2005, at E3. Unusually, CSC also tried (unsuccessfully) to seal the appellate court record of this lawsuit as a trade secret. See Carol Silwa, *Sidebar: CSC Tried, Failed to Seal Court Records on Appeal*, COMPUTERWORLD, May 23, 2005,

dependent, parties will never be able to set upfront exit rights to govern every possible distortion.¹⁹⁸ And the exact contours of these rights will differ according to the needs and bargaining power of both parties. But the overall framework of dual track termination does make economic sense when it is viewed as a technique for mitigating agency risk.

In summary, then, firms have a large menu of strategies for monitoring the agency costs of outsourcing. They might draft detailed service level requirements, stage contractual commitment, employ redundant agents, secure broad control provisions, negotiate liberal exit rights, or take other steps. What is to be made of these collected techniques for detecting and preventing agency risk?

B. Falling Monitoring Costs as a Catalyst for Outsourcing

It is tempting to conclude that contractual efforts to mitigate outsourcing agency risk are nothing out of the ordinary. Parties will, after all, usually take steps to protect their interests when forming an important economic association. Many agency relationships—including those of shareholder and manager, creditor and manager, manager and employee, and promisee and promisor (of which outsourcing is simply a variant)—use detailed contracts to define performance obligations, allocate risks, set control rights, and divide profits.

Furthermore, there is nothing novel about the specific contracting devices used in an outsourcing transaction. Some of the strategies, such as staged investment¹⁹⁹ or minority equity investment,²⁰⁰ have been borrowed directly from the world of venture capital.²⁰¹ Other techniques are common in long-term supply contracts,²⁰² employment agreements (including high-level executive compensation contracts²⁰³), bond indentures,²⁰⁴ and other financing arrangements. And while the interplay between a master outsourcing agreement, a service level agreement, and the statements of work can be quite elaborate, I want to resist the argument

http://www.computerworld.com/action/article.do?command=viewArticleBasic&articleId=101909&intsrc=article_pots_bot.

198 See *supra* note 131. Another concern presented by the cause-convenience exit framework is that a large for-convenience fee might give an agent incentives to perform poorly—although not so poorly that the principal can prove cause—in order to induce the principal to terminate and pay the agent the convenience fee.

199 See *supra* Part III.A.1.

200 See *supra* notes 180–82 and accompanying text.

201 Bartlett, *supra* note 99, at 52–56; Gilson, *supra* note 132, at 1078; Klausner & Litvak, *supra* note 106, at 59–69.

202 See, e.g., Hviid, *supra* note 27, § 4200, at 47; Scott, *supra* note 27, at 2012–15.

203 BEBCHUK & FRIED, *supra* note 13; Jensen & Murphy, *supra* note 14, at 227–42.

204 See Amihud et al., *supra* note 17, at 453–56; Fischel, *supra* note 17, at 135–37.

that these contracts are uniquely complex.

But it is worth considering whether it has become easier for outsourcing parties to use these contractual techniques to mitigate agency risk—and if so, whether this has served as an additional catalyst for outsourcing. I would contend that the same forces opening global markets are also making it easier and cheaper to monitor and prevent the agency costs of outsourcing. Specifically, technology, standardization of business processes, and plunging communication costs are changing the cost-effectiveness of investments to monitor agency risk.

I am not claiming that outsourcing trends are driven only by falling monitoring costs. Certainly a large part of the change has arisen from a firm's desire to enjoy cheaper production. But there are really two effects in play: a carrot and a stick. The conventional explanation for the rise of business outsourcing focuses on the carrot—that is, on the economic gains from moving business activity to cheaper market-based production.²⁰⁵ I am simply contending that the exact same forces that have increased the size of the carrot are also increasing the ease with which a principal can wield the stick to ward off agency costs.

Consider, at least briefly, how macroeconomic forces are making it easier for firms to employ contractual strategies that mitigate the agency cost problem. First, cheaper communication costs and standardized business processes simplify the drafting of detailed work descriptions and performance obligations. Obviously, it will cost less to write a comprehensive (though still incomplete²⁰⁶) agreement when expensive international phone calls and business trips are replaced with distributed voice and video networks.

Second, the standardization of business processes allows parties to pull performance criteria “off the rack” instead of haggling over the right way to assess execution of the business activity. For example, the metrics to appraise performance in an internet hosting project are now routinely defined to include packet transmission rates, bit-loss frequency, response rates for service calls, and so on.²⁰⁷ This makes it easier to draft a service level agreement to govern this type of outsourcing project. Furthermore, in addition to economizing drafting costs, standardized metrics simplify efforts to monitor compliance with these SLAs once they are in place. Firms need not design customized monitoring processes for every project. Of course, most business processes are not fully commoditized—and even when they are, it still costs something to monitor performance—but there

205 See *supra* notes 69–82 and accompanying text.

206 See *supra* note 60 and accompanying text.

207 See Austin, *supra* note 140, at 3–4.

are signs of increasing standardization in many activities.²⁰⁸

Third, cheaper communication, better technology, and standardized business processes make it easier to design and coordinate multiple agent structures or to leave part of an outsourced activity under the principal's control. Bharti Airtel, for example, would find it more difficult to divide India into four different service regions if technology did not exist to identify a call's origin and quickly route it to the optimal destination.²⁰⁹ Similarly, plunging interaction costs make it easier to chop a software project, a human resources support project, or a drug discovery project into many different pieces, to give each piece to a different agent, and to stitch the pieces together again on the back end. As described earlier, this use of multiple agents allows firms to reduce agency risk through competition and benchmarking.²¹⁰

Finally, falling interaction costs help principals use incentive compatible compensation, control rights, and exit provisions more effectively. For example, standardized metrics make it easier to choose the key performance indicators that will align compensation with agent incentives. To continue with the internet hosting example, fees will often be adjusted when packet transmission rates or bit-loss frequencies fall short of stated performance requirements. Similarly, principals will find it easier to draft and use "for-cause" termination clauses when the relevant metrics can be taken off the shelf. And they will find it easier to exercise control rights—and make thoughtful decisions—as information transmission costs drop.

While there are plenty of qualitative empirical examples, I, unfortunately, do not have quantitative evidence that these falling interaction costs have led to a surge in monitoring activity. Such a study would be fascinating, but I am not sure whether it is possible to gather meaningful data—or indeed, even what the relevant metrics would be. Furthermore, business outsourcing has only grown rapidly in the past decade, and if falling monitoring costs are partly responsible for this trend, we should expect most significant outsourcing contracts to have extensive risk-mitigation provisions.

Yet I do not think that it is too controversial to suggest that interaction costs are falling²¹¹—or to argue that these changes will increase the

208 See Davenport, *supra* note 23, at 104. Standardization also helps to increase the supply of a given activity—and thus drives down production costs—by facilitating the entry of new vendors to perform the activity. *Id.* at 102.

209 This project is described *supra* notes 158–64 and accompanying text.

210 See *supra* Part III.A.2.

211 Cf. Yochi Benkler, *Coase's Penguin, or, Linux and The Nature of the Firm*, 112 YALE L.J. 369 (2002) (discussing factors underlying collaborative models of production); Frank H. Easterbrook, *Contract and Copyright*, 42 HOUS. L. REV. 953, 966–67 (2005)

effectiveness of monitoring investments. If all this is indeed true, then the conventional explanation for the rise of outsourcing—that falling interaction costs are allowing firms to access inexpensive production markets—may be only half of the story. Firms may be turning to outsourcing not only to capture the gains of remote trade, but also because they are finding it easier to contain the hazards of outsourcing.

Consider, as a final illustration, a recent outsourcing project launched by Wachovia, a large US bank long known for its aversion to offshoring and business outsourcing.²¹² Under competitive pressure, and tempted by an intriguing new structure, Wachovia eventually decided to move some operations overseas. Unlike many financial institutions, however, Wachovia did not wish to start a captive offshore facility—one remaining within its corporate borders—because the bank felt that it was too expensive to manage a division on the other side of the world.²¹³ Furthermore, Wachovia thought it would be too difficult to attract the best talent because it had no reputation overseas.²¹⁴

Instead, Wachovia signed an outsourcing contract with Genpact, a large Indian vendor who had recently been spun off from General Electric. Genpact took over a wide variety of business processes for Wachovia,²¹⁵ although the exact details of the contract have been kept confidential.²¹⁶ It is understood, however, that the deal is structured to provide Wachovia with a “virtual captive” unit—one where it can retain tremendous control over the hiring and firing of employees and other key decisions.²¹⁷ The goal is to retain the control of a captive unit while also realizing greater

(“Technology is moving us toward the world where transaction costs are close to zero . . .”); Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 844–45 (2006) (“[C]ontinued improvements in financial technology are likely to drive down transaction costs.”); Lynn A. Stout, *Technology, Transactions Costs, and Investor Welfare: Is a Motley Fool Born Every Minute?*, 75 WASH. U. L.Q. 791, 806–12 (1997) (discussing the link between technology and falling transactions costs in securities regulation).

212 For example, Ken Thomson, CEO of Wachovia, has said “There is nothing I would rather do than turn back the clock and say, ‘We will not offshore,’ but we don’t have that luxury.” Dean Foust, *Wachovia’s Change of Heart*, BUS. WK. ONLINE, Jan. 30, 2006, http://www.businessweek.com/magazine/content/06_05/b3969422.htm.

213 *Id.*

214 *Id.*

215 Wachovia also signed outsourcing contracts with Hewitt Associates in the United States and with Infosys Technologies and Cognizant Technologies in India. *Id.*

216 See Press Release, Wachovia, Wachovia and Genpact Announce Outsourcing Agreement, (Nov. 30, 2005), available at http://www.wachovia.com/small_biz/page/printer/0,,447_647%5E1280,00.html.

217 See *If in Doubt, Farm it Out*, *supra* note 49, at 7.

cost savings and flexibility from outsourcing.²¹⁸ Exercising these control rights will certainly prove more expensive for Wachovia than leaving everything to Genpact's discretion. But, then again, falling interaction costs may make it easier for Wachovia to make important decisions from afar, thereby narrowing agency cost risk. It is interesting to ask whether Wachovia would have even undertaken this project if it could not retain this control.

It is important to point out that the monitoring tactics discussed in this Article cannot fully eliminate the agency costs of outsourcing. Information asymmetry will persist—even in an age of cheap communication—and principals will never be able to guard against every possible problem. Furthermore, the incremental expense of these labors must also be added to the agency cost toll.²¹⁹ But falling interaction costs might allow firms to establish an interesting array of hybrid structures and governance terms—ones that straddle the traditional distinction between markets and hierarchies.²²⁰ The Wachovia deal is an intriguing example of this. Joint ventures and alliances between firms have always existed as a middle-of-the-road approach,²²¹ but the momentum may be increasing in the outsourcing context.

In summary, then, I would argue that a complete understanding of the outsourcing explosion needs to consider the exogenous forces impacting the global economy—and the dual impact of these forces on the benefits and costs of outsourcing. The exogenous forces—technology, standardization, communication, transportation, and probably others—collectively lower interaction costs, which, in turn, has two effects. First, it opens new supply markets where firms can obtain the benefits of cheaper production. And second, lower interaction costs grease the gears of outsourcing by making it easier to detect and prevent agency cost distortions. The conventional explanation for the rise of business outsourcing focuses mostly on the first effect. I contend, however, that we must also include the second.

CONCLUSION

Near the end of 2005, I flew to Kolkata, India to speak at a weekend conference on business outsourcing. I arrived just in time to give the talk

218 *Id.*

219 See Jensen & Meckling, *supra* note 12, at 308–10.

220 This distinction is discussed *supra* Part I.B. It would be interesting to consider whether similar changes are taking place in other economic relationships that present an agency cost problem. If so, we might expect that improved monitoring effectiveness will lead (or has led) to contractual innovations in these other contexts.

221 See, e.g., Smith, *Strategic Alliances*, *supra* note 129, at 304.

and was not sure what sort of crowd to expect. To my surprise, I was ushered into a large ballroom and marched up to a stage in front of a thousand people. There were huge video screens on either side of the stage, and my ten-foot face was broadcast for the next half hour like the President's on Inauguration Day. After the talk was over, dozens of newspaper reporters and eager entrepreneurs flocked up to interview me, and I was filmed for the nightly television news. I thought the speech was pretty good—but not *that* good.

Later, as I wandered through the conference exhibit halls, I saw thousands of vendors fervently pushing their services—and hundreds of thousands of participants trying to ride the outsourcing wave. I had studied all the statistics and projections, but it finally sunk in just how differently firms are organizing their economic activity. The obvious question is why.

This Article has argued that the rise of business outsourcing can be explained, at least in part, by viewing an outsourcing project as an agency relationship. Such an approach sheds new light on the contractual framework placed around a typical outsourcing transaction. Specifically, it shows how firms seek to mitigate agency risk through the use of interlocking contracts, detailed service level agreements, staged contractual commitment, redundant agents, broad control provisions, and liberal exit rights. Furthermore, macroeconomic forces may be making it easier for principals to monitor agents with these tools. If so, the conventional explanation for the astonishing growth of outsourcing—that falling interaction costs are allowing firms to access cheaper production markets—may be only half of the story. There can be economic gains when business activity is moved to low-cost markets. But a greater ability to mitigate the dark side of outsourcing may also be behind this unprecedented march toward economic globalization.