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Risk Mitigation Strategies in Offshore Business Process Outsourcing

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Companies can realize substantial benefits by outsourcing business processes to low-cost offshore locations. Offshore business process outsourcing transactions, however, also present a host of significant risks that go hand in hand with the incentives these transactions offer. This article discusses the key risks associated with the outsourcing by a U.S.-based company of its business processes to offshore locations and proposes strategies for managing and mitigating those risks.

Through advances in information technology (IT) and telecommunications, companies today move data across borders seamlessly, quickly, and inexpensively and can efficiently leverage offshore locations through outsourcing to achieve significant cost savings without business disruption. As the realities of globalization continue to take hold, companies increasingly recognize the potential rewards of outsourcing not just IT functions but also recurring business processes such as procurement, human resources, benefits administration, payroll, tax compliance, claims administration, collections, logistics, finance and accounting functions, and consumer relations. More and more companies are turning to business process outsourcing (BPO) as a means of reducing costs and increasing efficiencies without sacrificing quality of service. BPO routinely involves an offshore counterpart in a location that offers the combined benefit of a skilled or trainable workforce available

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at wages significantly lower than those demanded by U.S. or European counterparts, but still sufficiently attractive relative to the local labor markets so as to attract and retain high quality employees. The BPO trend is expected to grow more than 20 percent annually in the coming years.

Any outsourcing involves risk and requires a customer to relinquish control over the outsourced function. And, true to classic risk-reward analysis, while a successful offshore BPO transaction can yield substantial economic benefits and competitive flexibility, it also demands more complex and robust risk assessment and management because of the unique, and heightened, operational and legal risks inherent in the transfer of important business functions overseas. Indeed, the business processes and associated data to be outsourced can be, and often are, mission critical and potential BPO customers face serious, business-affecting, decisions involving security, quality assurance, intellectual property protection, operational support, regulatory compliance, dispute resolution, and actual realization of predicted cost savings, to name just a few concerns. This article raises some of the key issues that any potential BPO customer should carefully assess so as to mitigate the risks associated with offshore BPO transactions.

**DUE DILIGENCE AND VENDOR SELECTION**

The criticality of vendor selection to whether an offshore BPO transaction is successful simply cannot be overstated. While this fundamental point may be obvious, potential customers surprisingly still need prodding to be extremely careful and discriminating during the vendor selection process. To maximize its odds of selecting the “pick of the litter” of competing vendors, it is imperative that a customer develop comprehensive and precise vendor selection criteria up-front that are to be used in a rigorous and competitive RFP process. The customer should develop a clear set of financial, operational, and qualitative expectations that every competing vendor should be readily able to meet. The customer’s vendor selection process should also involve substantial vendor due diligence, including a substantial and verifiable understanding of the vendor’s technical expertise in the to-be-outsourced functionalities, the vendor’s performance history in the market, including customer references, and
certainly a careful vetting of the vendor’s financial position.

A customer must also identify the risks particular to the specific offshore location and perform detailed due diligence regarding, among other things, the offshore country’s local economic, political and legal environment, data privacy and security laws, export control laws, intellectual property laws, tax laws, currency fluctuations, qualified labor pool and infrastructure, such as business continuity capability, electric power and telecommunications, to name several. Careful, in-depth location due diligence will enable customers to select offshore destinations that offer lower risks than others in terms of political unrest, religious strife, natural contingencies, national laws and government policies (such as taxes, duties, regulatory hurdles, and so on). If possible, potential BPO customers should include offshore site visits as part of the due diligence process to evaluate an offshore vendor’s expertise and performance capabilities and to assess the viability of the offshore location.

OFFSHORE SERVICE DELIVERY MODEL

In any offshore BPO transaction, the customer must diligently analyze and structure the appropriate service delivery model. To a large extent, the structure will be driven by, among other things, the process(es) to be outsourced, the customer’s risk tolerance, and its outsourcing strategy, including tax implications. U.S. companies employ various service delivery models in establishing offshore operations. Examples include:

(i) pilot projects to outsource selective functions,

(ii) contracting with multiple offshore vendors with geographical dispersion,

(iii) contracting with U.S. vendors with offshore capability,

(iv) establishing wholly-owned subsidiaries in the countries from where the outsourced processes will be performed, and

(v) entering into joint ventures, and “build, operate, transfer” type arrangements with local business partners.

Each approach has its own advantages and risks, and should be evalu-
ated carefully so as to identify the relative pros and cons for a particular BPO strategy. For example, a third-party vendor structure can be more quickly implemented and often can offer greater flexibility in scalability and cost structure. But it also yields to the third party more control over day-to-day operations and the handling of sensitive data and intellectual property. In comparison, the use of a local subsidiary structure usually requires more time to implement and provides less flexibility to ramp up or down quickly, but it ensures substantially more control over the management of the offshore operations and the company’s sensitive data and intellectual property.

INTELLECTUAL PROPERTY

The protection of a customer’s proprietary information and intellectual property (IP) should always be a critical consideration in any offshore BPO transaction. Proprietary information and technology often necessarily must be made available to the offshore vendor so that the vendor can perform effectively. But depending on how the service delivery model is structured, the vendor may not be subject to U.S. laws and the local jurisdiction’s laws might be weak, confusing, or unenforceable in practice, or even non-existent, and its court system may be slow, unreliable or commercially unsophisticated, or extremely culturally idiosyncratic. A customer must carefully consider that IP protection and enforcement vary considerably on a country by country basis. This can affect a customer’s expectations in the outsourcing relationship and, in the absence of appropriate contractual safeguards, can potentially jeopardize a customer’s rights to its own IP or critical vendor technology. For example, the “work made for hire” doctrine is an important protection in the U.S. governing ownership in deliverables, but it is not universally recognized around the world and thus may not be a reliable safeguard in an offshore structure. In such a circumstance, contractual protections, such as assignment provisions, become critical to assure that ownership in the deliverables vests with the customer. Similarly, laws in some countries attach “moral rights” to authors of copyright works, which, unless contractually waived, can severely interfere with a customer’s ability to use the deliverables it has paid for. Also, because many countries do not provide statutory protection
against the theft of trade secrets, this gap in protection must be countered through alternative contractual mechanisms to protect customer data and confidential information.

Further complicating the issue, local jurisdictions may yet apply local IP laws notwithstanding the operative contract’s provisions, which can limit the intended benefit of those provisions. A customer should therefore carefully consider in the early stages of the transaction the enforceability of contractual choice of law and forum provisions (discussed below) and all other possible impacts local laws might have on negotiated terms and structure measures that will, in that jurisdiction, adequately protect against the risk of losing control of IP during the course of the offshore transaction.

Another often overlooked, but important, issue which should be addressed upfront is whether any technology licensed by the customer from third parties will need to be transferred to the vendor overseas and, if so, whether the licenses already permit such transfer or will require third party consents to permit it, which can add additional complexity and costs to the transaction. The contract should also clearly address, among other things,

(i) the specific allocation of relative ownership and access rights in deliverables and other IP between the customer and the vendor and what happens to those rights after the relationship is terminated,

(ii) the vendor’s non-compete obligations restricting use of competitive technology or personnel for customer competitors,

(iii) the vendor’s non-disclosure obligations, including the customer’s right to enforce such obligations directly against vendor personnel having access to customer IP, and

(iv) other appropriate protections such as IP warranties and indemnities and requirements that transaction-critical code or data be delivered in regular installments during the contract term to minimize the risk of the customer being denied access in the event of a dispute or vendor insolvency.
SECURITY AND DATA PRIVACY

Security and data privacy are also among the top concerns for customers considering offshore BPO. Offshore vendors typically derive their economies of scale by providing similar services from shared facilities to multiple customers, thereby creating concern about whether valuable and sensitive customer information is being adequately protected. Furthermore, connectivity networks between offshore service delivery centers and customer systems can create potential vulnerabilities for unauthorized access, viruses, and intrusions by hackers, for instance. A customer must assess whether the offshore vendor has sufficiently robust security practices and if it is capable of meeting the customer’s security requirements. Security measures sought from the offshore vendor should be commensurate with the risk. For example, when outsourcing a critical business function the customer should consider strict, and unambiguous, financial penalties for security violations and other measures such as dedicated servers, server firewall, anti-virus applications, data encryption, background checks on employees working on the customer’s account, physical facilities security, password controls, and hacking detection and prevention measures.

The customer should also require the offshore vendor to ensure data privacy through measures that are consistent with internal policies, customer expectations and applicable laws, and include contractual protections that provide the customer the right to conduct comprehensive security reviews and audits to measure vendor compliance. Depending on the offshore location in which the services are performed, careful consideration should also be given to any local data protection laws that could have an impact on the legal transfer of a customer’s personally identifiable data.

KNOWLEDGE TRANSFER

An offshore BPO transaction involves the transfer of technical and business knowledge concerning the outsourced business process to an offshore vendor. This transfer can be complex and involve added costs not initially baked into the financial model. Business processes are typically
unique to customers, but few customer employees (if any) transfer to the offshore vendor, so there is an inherent risk of discontinuity and loss of institutional knowledge. The offshore vendor is tasked with knowledge transfer without any previous knowledge of the customer’s systems, business processes or corporate culture, and the fact that much of the work is performed from a distant offshore location presents a unique contract and quality management challenge. The relationship is particularly vulnerable during the transition phase. To facilitate knowledge transfer and minimize associated risk, the customer should:

- Require a detailed transition plan that sets out the transition activities and associated milestones and monetary penalties if the offshore vendor fails to meet the defined milestones. Such a plan will not only create an incentive for the vendor timely to complete the transition but also provide the customer with the requisite visibility into the transition process.

- Define the appropriate mix of onsite, onshore, near-shore, and offshore vendor personnel and the required staffing levels. Flexibility to allocate onshore and offshore resources might have an adverse marginal impact on cost, but it mitigates risk for mission critical functions.

- Require the vendor to take defined efforts to manage key employee turnover risk, including, for example, implementing retention strategies. Rapid growth among offshore vendors has created a dynamic labor market causing excessive employee turnover, which indirectly burdens knowledge transfer and associated costs.

- Retain the right to hire vendor employees and obligate the vendor to provide termination assistance services upon termination to transition the services back in-house or to a third party. Certain jurisdictions may impose stringent hiring and termination requirements on employers, requiring government approvals for layoffs, downsizing, and closure. The customer should assess labor issues and how local laws might impact the customer’s right to hire. Termination assistance services can be particularly critical in
offshore transactions because of the diminished likelihood of the customer hiring vendor employees in offshore locations.

QUALITY CONTROL

Quality control is a critical factor in offshore BPO transactions. To ensure service quality, the customer should:

- Define (a) stringent quality assurance and change control requirements that the offshore vendor must comply with in performing the services and require regular assessments of vendor compliance and (b) recognized industry standards and certifications to be maintained by the vendor, which include, for example, CMM, Six-Sigma, and ISO certifications and SAS 70 audits.

- Maintain the right to interview, remove, or replace key vendor personnel assigned to the customer’s account and require transparency with respect to any subcontractors to be engaged by the offshore vendor to perform the services.

- Establish (a) meaningful service levels for every measurable component of the outsourced function, including the ability to add, delete or modify service levels, (b) a mechanism for regularly measuring and evaluating the offshore vendor’s performance and (c) strict and readily determined monetary penalties for any failure to meet the established service levels. The customer should also require the offshore vendor to perform root cause analysis of problem areas and retain the right to terminate if the service quality is consistently lacking.

REGULATORY COMPLIANCE

BPO functional areas can often be subject to stringent legal, regulatory, and accounting requirements, such as GAAP, the Health Insurance Portability and Accountability Act (HIPAA) governing health and medical information, the Gramm-Leach-Bliley Act governing personal financial information, and the Right to Financial Privacy Act governing confi-
dentiality of bank examinations and other records, to name a few. Other U.S. legal requirements, such as U.S. export control laws, the Foreign Corrupt Practices Act,\(^9\) and Sarbanes-Oxley\(^10\) compliance may also be implicated in offshore BPO transactions. Under these laws and regulations, the customer bears the responsibility for compliance on behalf of itself and the vendor at the risk of severe civil and criminal penalties. The customer therefore should:

- Ensure that the offshore vendor is sensitive to the customer’s industry-specific requirements and clearly address the responsibility of the vendor to comply with, and facilitate the customer’s compliance with, the federal, state, and local laws in the U.S. to which the customer continues to be subject. A vendor’s failure to comply with these applicable laws should not only permit the customer to immediately terminate the contract but also result in uncapped financial consequences to the vendor.

- Retain the right to conduct comprehensive financial and operational audits of the offshore vendor.

- Address how the cost of adjusting to changes in applicable laws will be borne by the parties. This is particularly important to account for developing laws and regulations as the BPO industry matures.

- Hold the offshore vendor responsible for complying with local laws of the jurisdiction from where the services are provided and seek indemnities for vendor violation of such laws.

**EFFECTIVE EXIT PLAN**

Broad termination rights are important in any outsourcing contract. But they are particularly critical in an offshore contract because of unknown variables inherent in the fact that services are being provided from offshore locations. Depending on the contract’s term, a customer should have a well-defined exit plan in place that allows for flexible adjustments in the scope of services and the ability to address independently particular areas of customer dissatisfaction. Failure to so plan can
leave the customer over-exposed to the offshore vendor. In addition to customary provisions permitting a customer to terminate the BPO contract for a vendor’s breach, the customer should:

- Require termination rights that are tied to changes in circumstances that may materially affect the economics of the contract relative to the customer or adversely impact the delivery of the services. In return for such extended termination rights, however, vendors may seek to have termination charges associated with them.

- Include contractual protections designed to facilitate the orderly transition of the services back to the customer or another third party at the end of the contract, including the customer’s right to hire vendor employees or assume any vendor-provided equipment, software or third party contracts used by the vendor to perform the services.

DISASTER RECOVERY

A disaster recovery and business continuity plan to address sudden interruption of services due to events beyond the control of the offshore vendor are essential to any offshore BPO transaction, particularly if mission critical business processes are outsourced. Depending on those processes’ criticality, the customer should:

- Define clearly each party’s rights and responsibilities in the event of a force majeure event.

- Explore risk mitigation strategies, such as establishing disaster recovery sites in geographically disparate locations (e.g., mirrored operations, hot sites), network redundancy, and data backup off-site storage. The benefit of these strategies should be balanced against the added cost they frequently entail, however.

FINANCIAL CONSIDERATIONS

Reliable BPO pricing models and methodologies continue to evolve
as the BPO industry matures, which makes pricing a challenging aspect of a BPO transaction. This issue is further complicated in an offshore transaction which can present additional financial factors that impact pricing and drive cost savings. A customer should therefore build pricing flexibility into the contract that will allow for pricing adjustment and even renegotiation from time to time and be aware of these factors and consider them carefully. A complete list is beyond this article’s scope, but below are several important factors that are unique to offshore outsourcing:

- Taxes – The customer should ensure that anticipated cost savings are not eroded or eliminated by unintended adverse tax consequences, including through permanent establishment exposure or imposition of taxes such as goods and services taxes or value added taxes, for example. Local and international tax counsel should be consulted as well to understand potential tax implications to minimize tax liabilities. Although certain offshore jurisdictions provide tax holidays to promote IT-enabled exports, outsourced activities can subject the parties to additional taxes under local jurisdiction laws. Such taxes should be identified upfront and allocated between the parties. The contract should also permit flexibility to address changes in applicable foreign tax regimes and associated compliance costs.

- Inflation – Inflation is a staple cost component in a long term outsourcing contract, with cost of living adjustments for labor inevitable. The question thus becomes one of allocation of inflation risk between the parties. Vendors often seek local inflation benchmarks because wage inflation in offshore destinations can be substantially higher than in the U.S. The customer, however, should resist these demands and instead insist on limiting cost of living adjustments to domestic indices, such as the U.S. consumer price index.11

- Currency Fluctuations – An offshore BPO customer should consider whether and how local currency fluctuations might influence the transaction’s economics. Most offshore outsourcing contracts are priced in the local currency of the customer so as to shift cur-
currency risk to the vendor. The customer should be mindful that a vendor therefore may propose pricing already based on assumed currency risk or seek higher prices or frequent price adjustments, particularly in a long term contract, in an effort to mitigate currency risk.

ENFORCEMENT OF CUSTOMER RIGHTS AND REMEDIES

The enforcement of the customer's rights and remedies is always a vital concern of course, and those concerns can be exacerbated when dealing with an offshore vendor, particularly one that has few or no meaningful assets against which any obtained judgment could be executed. Choice of law and forum clauses tied to U.S. courts and laws (for U.S. customers) should be demanded, but these clauses in themselves provide no protection against a vendor that is in this practical way effectively immune from liability in the event of default in its performance. This gap in protection not only can adversely affect or destroy the customer's ability to recover damages against the vendor, but can render ineffectual indemnity rights a customer may have against the vendor with respect to third party liability claims. To assess its likely ability to enforce rights and remedies with respect to an offshore vendor, the customer should:

- Obtain advice from local counsel regarding the enforceability of judgments and awards obtained in foreign jurisdictions under local laws or applicable international treaties.

- Perform due diligence to identify the physical location of an offshore vendor's assets. This exercise should include determining the extent to which the vendor has a domestic presence and, correspondingly, local assets which would be available for the satisfaction of judgments.

- Explore the availability of relevant insurances, performance bonding, letters of credit, or guarantees from financially responsible affiliates of the vendor, as appropriate, and insist on flexible termination rights for the customer, as discussed above.
DISPUTE RESOLUTION

In any BPO transaction, the customer does not want to become embroiled in litigation in a foreign court in connection with any dispute with the offshore vendor. In many of the preferred offshore destinations, local process can be slow, unfamiliar, and unpredictable. To address a customer’s risk of exposure to unfamiliar jurisdictions and their laws, the BPO contract must:

- Address clearly how all disputes between the parties will be handled, including having a clear set of escalation procedures and a clear statement of the parties’ respective rights and obligations pending dispute resolution to ensure continuity of services. Also, the right to withhold disputed amounts pending resolution of the underlying dispute can be a critical protection for the customer.

- Include unambiguous choice of law and jurisdiction provisions that expressly exclude the application of conflicts of law principles of any jurisdiction. The U.S. customer should demand that the parties adjudicate or arbitrate any dispute arising from the offshore BPO transaction in a U.S. jurisdiction and that the governing law be U.S. law or a particular state’s law, as applicable. An opinion from local counsel in the offshore location that such provisions are enforceable against the offshore vendor in a court, and under the laws, in that location should also be obtained. Furthermore, a number of jurisdictions may apply their own laws in some fields such as IP, labor issues, insolvency, and data privacy regardless of the contract, thereby limiting the practical realization of the contract’s intended protections, should a vendor seek protection in a court situated in the offshore location. Therefore, a customer must be cognizant of the affect local laws might have on the contract terms agreed between the parties.

- To best mitigate this latter risk of a vendor seeking refuge in a court in an offshore jurisdiction, arbitration is the preferred means of dispute resolution in cross-border BPO transactions. Most popular offshore jurisdictions are signatories to the New York Convention^{12} on foreign arbitral awards, which makes an arbitral
award easier to enforce abroad than comparable court judgments. In addition, a single arbitral award can be enforced in multiple jurisdictions and arbitration clauses often empower local judges to stay a legal action where the parties have agreed to resolve their disputes through arbitration. The BPO contract should therefore provide that all disputes, consistent with applicable laws, be arbitrated and identify the applicable rules and procedures applicable to the arbitration. The contract should also set forth a venue for arbitration outside the offshore vendor’s local jurisdiction, and preferably in the customer’s principal location.

GOVERNANCE

Effective governance is a critical success factor for any outsourcing arrangement, but it takes on an added complexity in offshore BPO. BPO requires intense collaboration between the customer and vendor as it rests on meshing the customer’s processes, technology base and skills with the vendor’s offerings, which can be a challenge given the distance between the parties. The contract must, therefore, provide an effective means to govern the critical and often complex relationship between the parties. The governance processes must provide an effective means to review and manage vendor performance, manage the operational touch points and interdependencies of outsourced and retained functions, escalate issues and disagreements, and resolve the inevitable disputes in the operational context.

CONCLUSION

In summary, offshore BPO can be a powerful means of streamlining business functions that can yield enormous cost savings, increased efficiencies and improved service quality. The potential BPO customer must also be aware, however, that offshore BPO presents a host of risks that must be properly considered and addressed. These risks can be managed, however, with thorough due diligence, objective vendor selection, and the careful assessment and treatment of the issues discussed above in a
contract that memorializes all underlying business terms and provides real and practical protections and enforcement mechanisms.

NOTES

1 Under this concept, an author of a work has a right to the integrity of his or her work ("integrity right") and to be associated with his or her work by name ("attribution right"), including the right to object to distortion or alteration of the work which would be prejudicial to the author's reputation. In most jurisdictions, moral rights cannot be assigned to another person but they can be waived in whole or in part.

2 SEI Capability Maturity Model certification; http://www.sei.cmu.edu/cmmi

3 International Standards Organization; http://www.iso.org

4 Statement on Auditing Standards (SAS) No. 70 is an internationally recognized auditing standard developed by the American Institute of Certified Public Accountants.

5 Generally accepted accounting principles.

6 Public Law 104-191.

7 Public Law 106-102.

8 Public Law 95-630.

9 Public Law 105-366.

10 Public Law 107-204.

11 http://www.bls.gov/