December 17, 2010

InsideCounsel.com

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TECHNOLOGY

Outsourcing Transactions – Strategies, Tactics and Gotchas – Part 2

Employee, tax and exchange rate issues can be significant, and should be addressed early.

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Outsourcing transactions are different from the other complex transactions, such as acquisitions or divestitures, faced by in-house counsel. They are not zero-sum, win-lose negotiations, but are instead the beginning of a long-term relationship. The playing field may not be level since the vendor is an expert and the customer frequently is not. Also, unlike other negotiations handled by in-house counsel, the key business terms, such as price and scope, often fluctuate during the negotiation of the contract. For these reasons (and more), an attorney knowledgeable about outsourcing transactions has the opportunity to add significant value, both as a project manager and as a substantive expert. This article will address some of the areas that need to be "managed" by counsel to avoid what can be significant problems.

Employee Issues

One of the very first questions to ask your client is: Are employees being transferred to the vendor (sometimes called "rebadging") or terminated as part of the transaction? If the answer is yes, it is critical to start addressing the possible issues early. To perhaps state the obvious, you must be thoughtful regarding when and what you communicate to your employees. On this topic, outsourcing transactions are in fact similar to divestitures – there is a significant risk that morale and productivity can plummet once employees find out about the pending transaction. Inside counsel should make sure that your HR and communications professionals are fully engaged and focused on these issues. In general, the approach should be (1) maintain confidentiality (if you can) for as long as is reasonable, and then (2) communicate clearly, and often, to your employees as inoculation against the rumors that will otherwise arise.

Of particular concern is the transfer of employees in facilities outside the United States. In most non-U.S. jurisdictions, due to the general absence of at-will employment, any act of termination, even if followed immediately by employment with the vendor, likely triggers notice and/or severance pay obligations. Note that only some of these obligations can be waived by the consent of the affected employees.

Even worse for the employer are employee transfers in "automatic transfer" jurisdictions, such as the European Union with its Acquired Rights Directive. In these countries, the employees (and their rights as employees) are deemed automatically transferred to the acquirer in the sale of a business or, in some cases, the transfer of a business function. While at first glance this might appear to be a desirable result if the vendor wishes to use the customer's workforce, in many outsourcing transactions economies of scale and pricing are based on the understanding that a significant portion of the customer's workforce will be made redundant and the work will be sent to lower-cost employees in lower-cost jurisdictions. The automatic-transfer principles can therefore turn into a human resources nightmare. A detailed analysis of the Acquired Rights Directive and its brethren is beyond the scope of this article, and in certain countries their applicability to outsourcing transactions is unclear, so I will just leave you with this warning: Get expert advice early, including local country employment counsel. These issues can have a significant effect on the economics of the transaction and it seems likely that failing to address these "legal" issues early will not reflect well on the in-house counsel that is supposed to be handling the transaction.

Tax Issues

Ideally, both the customer and the vendor will knowingly take into account the tax benefits and tax detriments in structuring the outsourcing transaction, pricing the services, and negotiating the terms of an outsourcing agreement. In addition, the structure of a cross-border outsourcing transaction can have a significant effect on the total taxes payable, and the failure to be tax-efficient is therefore a painful (and avoidable) mistake. In particular, the structure of the transaction and geographical locations of the applicable customer and vendor entities can have a significant effect on the recovery of value-added taxes, the applicability of certain sales taxes, and the tax withholding requirements that may apply.

Because the tax costs can be significant, they should be addressed early in a transaction, preferably pre-RFP and certainly before commencing negotiations with the vendor. A significant tax surprise during negotiations will, at a minimum, consume unnecessary resources and can sometimes completely derail the project due to the changed economics. As far as staffing, I recommend first getting your internal tax resources fully engaged and then hiring outside experts for the international tax and/or local country applications as needed.

Currency Exchange Rate Issues

An outsourcing customer's failure to analyze the currency trends and review the exchange rate risks can be a significant mistake. Put simply, foreign exchange risk arises whenever a vendor incurs performance costs in one country but is paid in the currency of a different country. For example, in a typical offshore outsourcing arrangement in India, the vendor leases space, hires personnel and pays for other resources in Indian rupees but typically receives payment in U.S. dollars.

In many cases, the customer is more concerned about avoiding a fee increase when the U.S. dollar declines than it is in preventing the vendor from reaping a windfall when the U.S. dollar strengthens. This is because the customer is usually more concerned about locking in its cost reductions and obtaining budgetary certainty than it is about participating in every gain that the vendor may realize from its declining relative costs. Likewise, the vendor is usually more concerned about a declining U.S. dollar because it will find its profits eroding when the U.S. dollar declines.

As with tax matters, a key to handling currency matters is to ensure that your internal finance resources are fully engaged. I have found a significant variation among companies in their approach to currency fluctuations and the corresponding allocations of risks with suppliers, and to some extent these are more financial than legal issues. However, depending on how these risks are allocated, the parties may need to negotiate automatic price adjustment provisions (perhaps going into effect only after the exchange rate moves beyond a certain percentage "band") or the parties may choose to incorporate various renegotiation and/or termination rights upon a significant change in exchange rates.

In part three of this series, I will be addressing some of the other key, and most negotiated, provisions in outsourcing agreements.

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