



A Primer on IT Outsourcing

What to Look for *Before* You Leap

By Dwayne D. Stresman and William C. Lentine

Information technology outsourcing (ITO) is a global industry worth nearly \$60 billion annually that shows no signs of slowing down.¹ Rather, with the introduction and maturation of “cloud computing,” outsourcing is now available to a host of smaller-scale entities for whom ITO was previously impossible. In light of this situation, any business entity considering outsourcing possibilities would be well advised to take a careful, considered look at all of its ITO options. Such a review should contemplate the potential challenges and hidden drawbacks as well as the possible benefits.

Information Technology Outsourcing Explained

While the definitions applied to outsourcing are many and somewhat varied, at its core, outsourcing is the contracting of services to a third-party provider, often referred to as a vendor. Information technology, meanwhile, can be even more difficult to pin down but may generally be defined as “the development, installation, and implementation of computer systems and applications.”² With respect to ITO, an ITO contract is an “agreement between a business and a service provider in which the service provider promises to provide necessary services.”³ Such services often include “data processing and information management” and are commonly performed by the vendor “using its own staff and equipment, and usually at its own facilities.”⁴

Like all outsourcing, ITO can either be performed by an entity within the same country as the client or by a vendor in a different nation. When the vendor is on foreign soil, this type of outsourcing is referred to as offshoring. Two of the leading destinations for American offshoring of IT services are India and China, mainly because of the presence of high levels of “people skills and availability” in those nations.⁵

Established and Emerging Types of ITO

The most common type of ITO involves the practice of business process outsourcing (BPO). BPO is the assignment to a vendor of a well-established specific process or task. BPO itself can then be broken down into two main types: “back office” and “front office” outsourcing. Invoking a traditional storefront analogy, back-office outsourcing relates to those aspects of a business that the customer generally does not see or have access to, such as billing, cataloging of inventory, and accounts receivable and payable. Front-office outsourcing, on the other hand, relates to those business aspects that involve customer interaction or visibility, such as marketing, customer service, and product and technical support.

In contrast to standard BPO, a more recent and less developed area of ITO involves the outsourcing of tasks that require a relatively high level of knowledge, skill, and independent judgment. This type of ITO, referred to as knowledge process outsourcing

Fast Facts:

Information technology outsourcing (ITO) is a multibillion-dollar worldwide industry that continues to expand in step with the growth of the information economy.

One of the fastest growing types of ITO is cloud computing, in which a client connects to a vendor's services directly through the Internet.

While the benefits of ITO, including those offered by cloud computing, can be readily apparent and extremely attractive, entering into an ITO agreement without careful consideration could easily lead to unintended ramifications.

(KPO), is quickly gaining traction in the marketplace. Common types of KPO include research and development, data mining and analysis, and valuation or fairness opinions. Indeed, a leading business sector for KPO is the legal profession, with legal process outsourcing (LPO) “‘growing very, very quickly.’”⁶ For example, while formerly handling more routine legal tasks like document review, LPO operations are increasingly taking on more complex assignments such as legal research and memo writing in addition to the drafting of contracts or litigation documents.⁷

Cloud Computing

Cloud computing is the latest form of ITO, formally defined by “convenient, on-demand network access to a shared pool of configurable computing resources (e.g., networks, servers, storage, applications, and services) that can be rapidly provisioned and released with minimal management effort or service provider interaction.”⁸ Most often what this complicated definition entails, however, is consumer-friendly ITO services provided by a vendor over the Internet with little or no face-to-face interaction between vendor and client. Most individuals are likely familiar with consumer-based ITO services provided by the cloud, such as remote e-mail (Gmail, Hotmail, and the like) and social networking (Facebook, etc.). This, however, is but a single subset of the cloud, which also offers a variety of high-end, industry-specific commercial applications. In the legal-services realm, for instance, a familiar high-end cloud computing example would be web-based research engines such as Lexis and Westlaw.

Essentially, cloud computing has brought ITO accessibility down to the medium- and even small-business level because of its relatively inexpensive nature. It is so attractive because even at that lower cost, cloud computing still offers the desirable features of outsourcing such as ease of use, lack of up-front cost, and limited maintenance requirements. For many entities, the potential to gain valuable IT services simply by connecting their own hardware to the Internet is simply too good to pass up. As a result, ITO interest in the form of cloud computing continues to skyrocket.⁹

Why Entities Consider Outsourcing Their IT

There may be myriad reasons why a business would consider ITO, but among the more common are:

- **Lack of internal skills**—An entity lacking IT skills can quickly increase its IT knowledge base by employing a technically savvy vendor, enabling it to provide an overall level of sophistication in line with its core competencies.
- **Cost reduction**—Offshoring is commonly used to achieve savings by contracting with countries having lower overall price levels, often as a result of lower labor costs. Common offshoring destinations have included India and China; however, as price levels in those countries rise, new and lesser-known options such as Ghana, Indonesia, and Vietnam have become more attractive.
- **Focus on core business practices**—Dealing with IT issues may be a nuisance or a financially unattractive area of an entity's business model. Outsourcing provides a way to minimize that inconvenience.
- **To limit investment in infrastructure**—The entity may lack the ability, especially in economically difficult times, to secure necessary funds for the major capital investment needed to properly manage its IT. Outsourcing provides a lower-cost alternative.

For many entities, the potential to gain valuable IT services simply by connecting their own hardware to the Internet is simply too good to pass up.

Essential Considerations in Any Outsourcing Agreement

Like any contract, the terms of an ITO agreement will vary depending on the circumstances. There are, however, certain subject areas that any entity considering an ITO agreement should squarely address.

Scope of Services

ITO agreements may range from those involving the transition of all aspects of an entity's IT to a vendor to those merely dealing with the outsourcing of a single task such as data storage or disaster recovery. Perhaps it's axiomatic, but keeping the scope of your ITO simple increases the chance of a successful outcome. According to past research, ITO agreements involving "discrete processes" with "well defined business rules" are successful approximately 90 percent of the time.¹⁰ Meanwhile, those relationships involving joint project management between client and vendor are successful only 63 percent of the time, with the success rate dropping to a mere 50 percent when an outsourcing vendor takes on a host of IT services.¹¹

Against this success rate backdrop, an entity considering outsourcing multiple aspects of its IT must also weigh the cost of potentially having to supervise more than one vendor. While outsourcing discrete tasks to leading vendors in their areas of expertise may increase the chances of a successful outcome in each instance, it can also increase oversight costs as the entity is forced to keep tabs on multiple vendors. Further, each ITO agreement will likely involve materially different contracts, requiring the entity to ensure that it honors the various obligations of each agreement.

Sample clause: Client and Vendor agree that Vendor shall retain and manage all of Client's Proprietary Customer Information including data mining operations. Client shall be responsible for providing all Proprietary Customer Information to Vendor in the agreed upon format as required under Client's Obligations in paragraph X.

Pricing

ITO agreements may be priced in several different manners. Pricing schemes run the gamut from completely fixed pricing systems in which the price remains constant for the duration of the contract to risk/reward sharing options in which both the client and the vendor are incentivized to perform efficiently. One of the foremost concerns with regard to pricing of an ITO agreement, however, is that the agreement does not potentially cripple the client with an unfavorable pricing scheme in the future. Thus, one of the most popular pricing models is that of performance-based pricing, in which the pricing scheme is designed to reward a vendor for optimal performance. Should a business decide to adopt a performance-based plan, service-level tracking and measurement then become extremely important.

Sample clause: Client shall make estimated monthly payments to Vendor, as payment for Services rendered, based upon the greater of either: X% of Client's Gross Sales or Y% of Client's Net Income subject to Adjustments and Performance Awards or Penalties.

Service-Level Tracking and Measurement

Once an entity's IT has been outsourced, the entity no longer has the unilateral right to change that particular aspect of its business. Rather, the ITO contract now governs. Because of this, any agreement must adequately ensure that customers' needs are being met and complaints are being addressed. To ensure such efficiencies, many ITO clients insist on inclusion of tracking provisions in what are commonly termed "benchmarking" clauses. Such clauses allow for a third-party evaluator to assess the current competitiveness of the vendor and, depending on the result, either reward or punish the vendor for its level of performance.

Sample clause: Client's estimated monthly payments to Vendor shall be based on Vendor's maintenance of a Customer Satisfaction level of X%, as measured quarterly by Independent Auditor. Deviations either above or below X% will subject Vendor to those bonuses/sanctions laid out under Performance Rewards & Penalties.

Maintenance of Privacy and Security

Data security is fundamental in the information age. Not only must an entity ensure that its IT remains safe from nefarious attacks, but now more than ever, it must also ensure compliance with relevant data privacy and security laws. As the vendor is an

ITO agreements are not the kind you can simply walk away from when they terminate.

extension of the client, any ITO agreement must absolutely ensure that the vendor also complies with all laws directly applicable to the client. Legal compliance is doubly difficult in the case of offshoring, where the client must not only ensure that the agreement complies with its own domestic law, but also complies with the laws of the vendor's locale.

Intellectual Property Rights

The moment information passes to a vendor, intellectual property (IP) rights immediately become an issue. Depending on the nature of the ITO agreement, the type of IP rights implicated could range from trade secrets (such as client lists, contact information, or proprietary formulas or recipes) to copyrights (such as software code) to trademarks or other IP areas. Further, not only should an ITO client ensure protection of its existing rights in this field, it should also clearly define who owns any rights created by the ITO itself (for example, copyrights arising from KPO agreements in which the vendor's staff drafts original documents).

Jurisdiction, Choice of Law, and Enforcement of Contractual Rights

Long a staple element of many business contracts, jurisdiction and choice-of-law clauses may be particularly poignant in an ITO agreement, as the very nature of the agreement contemplates the possibility that the vendor will be remote from the client. This concern is particularly heightened in the case of offshoring, where the agreement may be adjudicated, or enforced, in a foreign nation. It would be particularly disastrous to arrive at a dispute with a foreign IT vendor having failed to negotiate any meaningful mechanism for dispute resolution or enforcement of the agreement in that foreign jurisdiction. Quite obviously, the quality and stability of any foreign judicial system is also of paramount concern in any offshoring agreement.

Provisions for Termination/Breach

ITO agreements are not the kind you can simply walk away from when they terminate. With regard to any termination, the chief concern for the client is continued access to the IT itself with assurances that the vendor cannot simply abandon, erase, or deny the client access to its data. Even assuming a natural or otherwise amicable termination, first and foremost is the fact that the vendor very likely has a significant amount of valuable client IT stored on its servers located at the vendor's facilities. Any agreement, therefore, must explicitly provide for an orderly mechanism for transition of data and services upon termination, especially in the case of a contractual breach, when tension is likely to be high.

Conclusion

Any entity contemplating information technology outsourcing, including the rapidly emerging area of cloud computing, should make an informed decision. This requires that the business care-

fully consider not just the pros, but also the potentially hidden cons of any outsourcing strategy. ITO is a major area of commercial activity that has every indication of continued growth. It will also become ever more complex as data in the information age becomes increasingly regulated. Without an informed and coherent entrance and, if necessary, exit strategy, an entity could well end up with unforeseen consequences from what it thought would be a quick business solution. ■



Dwayne D. Stresman is an associate with Kerr, Russell and Weber, PLC, and a member of the State Bar of Michigan Information Technology Law Section. His practice encompasses both litigation and transactional matters related to information technology and intellectual property. Mr. Stresman is a graduate of McMaster University (BSc, chemistry), the University of Western Ontario (BA, economics), and the University of Michigan Law School.



William C. Lentine is an associate with Kerr, Russell and Weber, PLC, and a member of the State Bar of Michigan and ABA sections on business and tax law. His practice encompasses transactional matters related to business planning, taxation, and information technology. Mr. Lentine is a graduate of Michigan State University (accounting) and Michigan State University College of Law and is a licensed CPA in Illinois.

FOOTNOTES

1. See Technology Partners International, Inc., *The TPI Index: An Informed View of the State of the Global Commercial Outsourcing Market Fourth Quarter and Full Year 2010*, at 10 (January 20, 2011), available at <<http://www.tpi.net/pdf/index/4Q10-TPI-Index.pdf>>. All websites cited in this article were accessed June 15, 2011.
2. Answers.com, *Information Technology* <<http://www.answers.com/topic/information-technology>>.
3. *Outsourcing Agreement*, Black's Law Dictionary 1136 (Deluxe 8th ed 2008).
4. *Id.*
5. A.T. Kearney Inc., *The Shifting Geography of Offshoring: The 2009 A.T. Kearney Global Services Location Index*, at 2 (2009), available at <http://www.atkearney.com/images/global/pdf/Global_Services_Location_Index_2009.pdf>.
6. Leinwand, *More Legal legwork Gets Outsourced to India*, USA Today (October 14, 2008), available at <http://www.usatoday.com/money/economy/employment/2008-10-14-outsourced_N.htm>, quoting Saikat Chaudhuri, an assistant professor in the business school at the University of Pennsylvania.
7. See Weiss, *Indian lawyers handling outsourced work do more than document review*, ABA Journal (May 12, 2008), available at <http://www.abajournal.com/news/article/indian_lawyers_handling_outsourced_work_do_more_than_document_review>.
8. Mell and Grace, *NIST Definition of Cloud Computing* (2009), available at <<http://www.nist.gov/itl/cloud/upload/cloud-defv15.pdf>>.
9. See Avanade, *Global Study: Recession Has Little Impact on Cloud Computing Adoption*, available at <<http://www.avanade.com/Documents/Research%20and%20Insights/fy10cloudcomputingexecutivesummaryfinal314006.pdf>>.
10. CIO.com, *Outsourcing Definitions and Solutions* (compiled by Stephanie Overby) (March 9, 2007) <http://www.cio.com/article/40380/Outsourcing_Definition_and_Solutions>.
11. *Id.* The study at issue was jointly operated by CIO magazine and MIT's Center for Information Systems Research.