

**Key Business Agreements**  
**The Basics of Outsourcing**

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## **1. INTRODUCTION TO OUTSOURCING**

### **1.1 What is Outsourcing?**

Outsourcing is the use of a third-party service provider to perform a business function, activity, or process that could be performed by the customer. Outsourcing can involve a simple service such as payroll processing or maintenance of a copy machine. Alternatively, it can include a major project, such as outsourcing the work of a whole division or department of an enterprise. Two major types of outsourcing are “back office” and “front office”. Back office outsourcing provides internal business functions, such as billing or purchasing, while front office outsourcing comprises customer-related services, such as marketing or tech support.

### **1.2 Why Outsource?**

Organizations may choose to outsource a business function for a variety of reasons. Common reasons that an organization may choose to outsource some of its activities include the following: (i) a desire to reduce operating costs, particularly in the case of information technology (“IT”) systems that have essentially become commodities; (ii) improved focus on the organization’s core areas of competence; (iii) access to specialized expertise in areas outside of the organization’s core areas of competence (or access to expertise in areas where the organization has none); (iv) relief of internal resource restrictions – i.e., additional help in situations where the expansion of internal resources are “frozen”; (v) increased revenue/profit; (vi) increased delivery speed; (vii) access to new technologies; (viii) making capital funds available for other projects; (ix) elimination of problem areas/functions; and (x) distribution of risk.

### **1.3 Risks of Outsourcing**

There are various risks associated with outsourcing. The transfer of important responsibilities to third-parties (e.g. risk management and compliance functions), potential

quality concerns, loss of control, and hidden/uncertain costs are risk factors. Occasionally, customers and service providers have differing motivations, which leads to opposing interests. There may also be a lack of flexibility in adapting to market change. A further risk factor is the loss of expertise that arises with the potential inability to bring outsourced functions back in-house. *The Supply Chain Handbook*<sup>1</sup> by James A. Tompkins, Ph.D., and Dale Marmelink contains an excellent discussion of outsourcing risks. Schedule “A” provides the authors’ descriptions of the various risks associated with outsourcing.

## **2. TRENDS IN OUTSOURCING**

### **2.1 Offshore Outsourcing**

Offshore outsourcing, or “offshoring”, has become an increasingly popular practice. Offshoring is the practice of outsourcing a function to an overseas service provider, primarily due to lower wages and operational costs in the overseas jurisdiction (e.g. the labour costs for an IT engineer in India or China can be 15-20% lower than an equivalent American engineer). This traditional offshore model has now evolved to mean “restructuring a company’s workforce to find the optimum mix of jobs performed locally and jobs moved to foreign countries.”<sup>2</sup> The consulting firm Capgemini has even obtained a trade-mark registration in Canada and the U.S. for the word “Rightshore”<sup>3</sup> pertaining to these types of services.

While the potential for significant financial savings through offshoring certainly exists, it is important to weigh the risks as well. The following are typical offshoring risks to consider:

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<sup>1</sup> James A. Tompkins, Ph.D., and Dale Marmelink, eds., *The Supply Chain Handbook* (North Carolina: Tompkins Press, 2004).

<sup>2</sup> Word Spy, “Rightshoring”, online: < <http://www.wordspy.com/words/rightshoring.asp>>.

<sup>3</sup> Capgemini, (2005). Canadian Trademark No. TMA646670. Gatineau, QC: Canadian Intellectual Property Office; Capgemini, (2003). U.S. Patent No. 2945851. Washington, DC: US Patent and Trademark Office.

- **Cost savings:** Executives have expectations regarding the cost saving implications of offshoring: “Many executives assume that labour arbitrage will yield savings comparable to person-to-person comparison (e.g. a full-time equivalent in India will cost 40% less) without regard for the hidden costs and differences in operating models. In reality, most IT organizations save 15%-25% during the first year; by the third year, cost savings often reach 35%-40% as companies "go up the learning curve" for offshore outsourcing and modify operations to align to an offshore model.”<sup>4</sup> Potential cost savings are undermined by companies lacking an internal process model maturity (e.g. Capability Maturity Model).
- **Security:** Customers must be assured as to the security of the offshore service provider’s systems, data security, physical security measures, and the political stability of the relevant country. Further, the long-term financial viability of the service provider, particularly with a small private company, should be considered.
- **Quality of Service:** While this is a commonly raised concern regarding offshoring, many leading offshore service provider countries provide high quality service levels (in particular, India’s British heritage has provided its workers with a high level of familiarity with Western culture, and the lower cost of living has allowed Indian service providers to retain highly qualified employees at competitive rates).
- **Differences in Relevant Legal Systems:** With regard to the relevant legal system, a company considering offshoring should examine whether the offshore service provider’s jurisdiction has adequate protections for intellectual property rights.
- **Cultural:** The implications of the local culture may also have an impact, especially if the offshoring involves front office services.
- **Government Oversight:** Another risk factor is whether the offshore provider is capable of providing the level of transparency that is required by North American regulatory statutes.

## 2.2 Common Methods of Offshoring

A common method of offshoring involves outsourcing directly to a third-party service provider in the offshore jurisdiction. The potential financial savings are significant under this method; however, there is a possibility of higher transaction costs and increased risk due to direct responsibility for all aspects of the multi-jurisdictional outsourcing arrangement.

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<sup>4</sup> Dean Davison, “Top 10 Risks of Offshore Outsourcing” *Meta Group*, (16 February 2004) online: <[http://searchcio.techtarget.com/news/article/0,289142,sid182\\_gci950602,00.html#>](http://searchcio.techtarget.com/news/article/0,289142,sid182_gci950602,00.html#>).

A second method is to outsource to the domestic office of a global service provider, which then outsources to an offshore subsidiary. There is significantly less risk associated with this process since the global provider handles many of the relevant issues, but there is less potential for financial savings as some functions will be handled domestically.

The third method of outsourcing is to create an overseas subsidiary. Although control over the outsourced services should lead to lower labour costs and risk reduction, there are significant costs associated with establishing a subsidiary, which may outweigh the labour savings. Another disadvantage of the overseas subsidiary model is the magnification of problems associated with managing the service in-house.

### **3. SERVICE PROVIDER SELECTION**

#### **3.1 Methods of Service Provider Selection**

A single source method is often based on a pre-existing relationship between the customer and the service provider i.e. the belief that the business will be even-handed and the service provider will perhaps offer lower prices. This belief is often unfounded due to lack of competition and common use of the service provider's standard form agreement.

An alternate method is to select several service providers, to produce more favourable terms and conditions than would be the case in sole sourcing. Selecting a group of providers maintains pressure on service providers to perform because otherwise service can be cancelled and switched to other service providers. A problem with this method is that it often leaves critical details to be negotiated later. This method also requires services to be transportable, which is often more expensive – but may be better for short term contracts.

The third method of selection is to hold negotiations with several service providers. Negotiations are likely to result in the best deal due to the ongoing competitive pressure. A disadvantage of this method is that it is often longer and much more costly to implement.

### 3.2 The RFP Process

Outsourcing service providers are often selected through a formal request for proposal (“RFP”) process, especially where the customer truly is seeking proposals about how to implement and deliver particular service. The goal in selecting a service provider in this manner is to keep the RFP process as competitive as possible, in order to ensure the best value service for the money. RFPs may include a definitive agreement as part of the RFP documentation. Bidders must agree to the use of this form of agreement, but can provide any necessary comments in their proposals, and usually this agreement is the subject of substantial negotiation.

### 3.3 Law of Tendering

Any sourcing discussion needs to consider the law of tendering. A tender is an irrevocable offer or bid put forward for acceptance, in a response to a call for tenders and is usually accompanied by a form of security deposit. The Supreme Court of Canada significantly altered the law of tendering in Canada in its decision in *The Queen (Ontario) v. Ron Engineering*<sup>5</sup>. In *Ron Engineering*, a multi-contract or Contract “A”/Contract “B” analysis was introduced into the traditional tendering model. Under Contract A, the call for tenders is the offer and the submission of a compliant tender is acceptance, thus creating an enforceable initial Contract “A”.<sup>6</sup> This contract “A” is governed by principles of fairness and the terms of the tender call.

The successful bidder wins the right to enter into Contract “B”, which is the substantive contract for the supply of goods and services. However, it should be remembered that this model was developed in the context of construction contracts; situations in which the supply of goods

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<sup>5</sup> [1981] 1 S.C.R. 111 [*Ron Engineering*].

<sup>6</sup> *Supra* note 4 at 4.

and services is often on a commodity-type basis, using industry-standard contracts. RFPs often represent a different scenario.

### 3.4 RFPs vs. Tenders

RFPs may or may not fall into the official tendering model. Courts will look to the substance, rather than the form of the request and may consider several factors including<sup>7</sup>: the parties' intentions to enter into a contract vs. a non-binding invitation to enter into negotiations; the level of detail in the request (a tender typically contains specific requirements and an RFP may be seeking information); whether there is a provision for further negotiations regarding the terms of the ultimate contract as opposed to a prescribed form as found in a tender call; the subjective components of each request (tenders tend to be cost comparisons of identical work and RFPs can look different from one another); the revocability of the proposal (a tender is usually irrevocable but an RFP may be as well); and the provision of established timelines and deposit requirements, which can both be present in the tendering or RFP process.<sup>8</sup>

The tendering process can result in the creation of a binding contract whereas the RFP process involves the submission of a proposal based on the terms and conditions of the non-binding RFP. The submission and acceptance of a non-binding proposal in response to an RFP may not create the contractual obligations of Contract "A" that results from the tendering process.<sup>9</sup> Notwithstanding the differences between the RFP process and the tendering process, the lines are often blurred and courts do not always clearly address the issue.<sup>10</sup>

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<sup>7</sup> *Ibid.* at 2.

<sup>8</sup> *Ibid.* at 3.

<sup>9</sup> *Ibid.* at 5.

<sup>10</sup> *Ibid.* at 5.

## **4. DRAFTING THE OUTSOURCING AGREEMENT**

### **4.1 General Considerations**

When drafting an agreement, a standard form service provider agreement should be avoided as it may not include provisions that are key to the customer's business and may not represent the customer's interests appropriately. Unlike other forms of commercial contracts, the outsourcing agreement forms the basis of an important ongoing relationship – if the customer is too adversarial or demanding, the service provider may not live up to the customer's expectations.

Internal reviews should be conducted to determine the exact nature and scope of the function to be outsourced. Due diligence will also require ensuring that the service provider fully understands these details and that they are specifically related in the agreement. Flexibility should be built into the agreement to allow for changes over the course of the relationship.

A comprehensive outsourcing agreement will address all elements of the relationship, including the following: base assumptions; scope; approval of changes; pricing; representations and warranties; intellectual property ownership; subcontracting; length of the agreement; auditing; contingency plans; defaults and termination; dispute resolution mechanisms; and transition planning following termination.

### **4.2 Scope of the Contract**

The Office of the Superintendent of Financial Institutions Canada (“OSFI”) has issued “Guideline B-10: Outsourcing of Business Activities, Functions and Processes”<sup>11</sup> (“*OSFI Guideline*”), which describes the necessary due diligence by a financial institution required in an outsourcing and sets out a number of provisions that must be included in financial institution

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<sup>11</sup> Office of the Superintendent of Financial Institutions Canada, *Guideline B-10: Outsourcing of Business Activities, Functions and Processes* (Ottawa: OSFI, 2003), online: <[http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/sound/guidelines/b10\\_e.pdf](http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/guidelines/sound/guidelines/b10_e.pdf)>.

outsourcing agreements. While it only applies to financial institutions, the *OSFI Guideline* is an excellent overview of the provisions that all outsourcing agreements should contain. According to the *OSFI Guideline*, an outsourcing agreement should address the following issues:

1. **Nature and Scope of Service:** Details should include the frequency, content, format, and location of the provided service;
2. **Performance Measures:** These should be included in order to accurately determine whether the obligations under the agreement are being performed. They are often contained in a separate service level agreement;
3. **Price:** The method of calculation and any potential adjustments should be specified in the agreement;
4. **Ownership and Access to Assets:** Both intellectual and physical property should be included;
5. **Subcontracting:** Any restrictions or rules with regard to subcontracting;
6. **Reporting Requirements:** The type and frequency of reports to be provided to the customer;
7. **Contingency Planning:** The service provider's procedures when unexpected disruptions occur;
8. **Auditing:** The respective audit rights and obligations of the customer and the service provider;
9. **Dispute Resolution:** Details of the process to be followed if disagreements occur;
10. **Termination and Events of Default:** Definitions of when termination or an event of default occurs, notice requirements, and transitioning.

#### 4.3 Employment Issues

At the minimum, the outsourcing agreement should clearly distinguish between employees of the customer and those of the service providers, as well as specify the minimum proficiency, training levels, and level of supervision of all employees. If employees are to be transferred, due diligence should be conducted to identify at least one of the following issues:

1. Employees to be transferred;

2. Details of employment contracts (including “golden parachute” contracts as well as non-disclosure agreements and agreements regarding intellectual property) and collective agreements, including benefit plans;
3. Existing employer debts (e.g. vacation and overtime pay);
4. Pension fund obligations – and whether pension fund is over-funded or under-funded;
5. Existing employee debts (e.g. payroll advances, travel advances, and prepaid educational expenses); and
6. Any potential outstanding claims (e.g. union grievances, human rights complaints, and workers’ compensation claims).

Since the “transfer” will actually involve the termination of employees by the customer, issues involving severance pay, constructive dismissal, and claims for breach of contract may also arise.

#### **4.4 Drafting Representations, Warranties, and Covenants**

Representations are statements regarding existing or past facts. Warranties are contractual assurances or guarantees that, if untrue, could lead to an action for damages or to a repudiation of the agreement if the breach is critical. Covenants are promises contained in the agreement.

Common service provider assurances in an outsourcing agreement include:

- Services will be performed in accordance with professional standards;
- Services will be cost effective;
- Service levels will be achieved;
- Qualified and properly trained individuals will be used; and
- Current technologies will be utilized.

Common customer assurances in an outsourcing agreement include:

- Services being taken over are compliant with applicable laws as of the date of the agreement;
- All transferred assets are free of all encumbrances;
- No intellectual property rights are being violated; and
- Current technologies will be utilized.

Since outsourcing service providers often engage subcontractors to perform at least part of the services, the customer may wish to ensure that provisions allowing the customer to

directly enforce any such representations, warranties, or covenants are included in any subcontracts. Additionally, representation, warranties, and covenants should only be finalized when the agreement is near completion in order to ensure that all relevant obligations are included.

## **5. DRAFTING INDEMNIFICATION CLAUSES**

### **5.1 What Are Indemnities?**

Indemnities are common contractual devices to expand the scope of relief available to the parties for various types of claims. Indemnities can provide for a wider group of entities to receive protection in the event of a claim; they can expand the group of entities for whom a party is responsible under the agreement, and they can provide a contractual promise to reimburse the other party for costs over and above that which the party might be able to recover in a breach of contract action. They also continue throughout the life of the contract whereas breach of contract claims may become statute-barred through the passage of time.

However, there are several relationship risks associated with indemnities. The demands for broad indemnities can increase conflict during negotiations. Negotiations of indemnities often take a great deal of time and significantly raise legal costs to the client. With regard to the price of the services to be performed under the agreement, the other party may demand greater compensation in response to the perceived additional liability imposed by the expanded indemnifications.

### **5.2 When are indemnities Useful?**

Indemnities are helpful to establish a process for parties to deal with third party claims. Since third party claims involve entities that are not parties to the contract, the standard

contractual dispute resolution process for claims between the parties would not apply.<sup>12</sup> Under an indemnity, the indemnified party will have greater flexibility to expeditiously settle the third party claim and recover losses (as opposed to relying on its rights under the *Negligence Act*<sup>13</sup>), so long as the losses can be shown to be covered under the indemnity provision.<sup>14</sup> It may also be possible to recover solicitor-client costs under an indemnity.

Although there is recourse for an indemnified party to exercise their rights under the *Negligence Act*, Kyer and Beardwood<sup>15</sup> summarize a number of practical advantages for the indemnified party under a contractual indemnity provision:

- i. A contractual indemnity clause does not depend upon the indemnifying party being amenable to the suit, whereas contribution and indemnity under the *Negligence Act* requires that both parties be at fault, and if they are sued by the injured party, for each to be held liable;
- ii. The indemnified party can deal with the third party claim in a more expeditious manner under an express contractual indemnity provision, allowing greater freedom to settle the third party claim and recover the amount from the indemnifying party;
- iii. The indemnified party is entitled to be fully indemnified under the indemnity provision, as long as the loss can be shown to be within the terms of the provision (even if the third party claim raises doubt or defences or counterclaims are raised against the third party claimant);
- iv. Having the indemnification obligation as a term of the contract allows it to be open to the parties to select an alternative procedural mechanism for enforcing the obligation;
- v. A party is generally entitled to recover the entirety of any damages, claims, costs, and expenses under an indemnity provision. The indemnified party is also entitled to the entirety of costs incurred in defending the claim and collecting from the

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<sup>12</sup> C. Ian Kyer & John Beardwood, *Outsourcing Transactions: A Practical Guide*, looseleaf (Aurora: Canada Law Book, A Division of The Cartwright Group Ltd., 2007) at 5-13.

<sup>13</sup> R.S.O. 1990, c. N.1.

<sup>14</sup> *Ibid.* at 5-14.

<sup>15</sup> *Ibid.*

indemnified party. The recovery of these amounts will generally exceed the partial indemnity costs provided under the *Negligence Act*;

- vi. Contractual indemnity provisions usually contain the expressions “hold harmless” or “save harmless”, which may obligate the indemnifying party to directly pay the third party claimant, without any prior payment by the indemnified party. Without this indemnity provision, the indemnified party may have to discharge its obligation to the claimant before having any right to pursue reimbursement; and
- vii. A contractual indemnity provision is express, providing a degree of certainty and predictability, which may make it possible for the parties to arrange for insurance coverage at an overall lower cost.<sup>16</sup>

### **5.3 Drafting Indemnification Clauses**

Restricting indemnification to third-party claims is an alternative to insisting upon broad indemnity clauses between the customer and the service provider. If the parties restrict indemnities in this manner, they rely on breach of contract rights at common law to settle issues between the parties. With regard to timing of negotiation, indemnity clauses should only be finalized towards the end of negotiations to ensure that all potential third-party claims have been identified and addressed. Procedures regarding enforcement of indemnities should be specified in the agreement to place limits on the expense to the indemnifying party.

## **6. LIMITATIONS OF LIABILITY**

### **6.1 Why Limitations of Liability are an Important Issue**

Limitations of liability are an important issue for the service provider, especially in IT outsourcing. The consequences of a mistake in an IT environment can have catastrophic effects – a service provider probably does not bargain for taking on the quantum of risk for the amount of fees charged. Investors in the service provider’s business want to see limited exposure to

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<sup>16</sup> *Ibid.* at 5-14 – 5-15.

catastrophic losses. Damages may be awarded as a consequence of liability. The classic case of *Hadley v. Baxendale*<sup>17</sup> stands for the following rule:

“Where two parties have made a contract which one of them has broken, *the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.* Now, if the special circumstances under which the contract was actually made where communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated. But, on the other hand, if these special circumstances were wholly unknown to the party breaking the contract, he, at the most, could only be supposed to have had in his contemplation the amount of injury which would arise generally, and in the great multitude of cases not affected by any special circumstances, from such a breach of contract. For such loss would neither have flowed naturally from the breach of this contract in the great multitude of such cases occurring under ordinary circumstances, nor were the special circumstances, which, perhaps, would have made it a reasonable and natural consequence of such breach of contract, communicated to or known by the defendants.”

Many service providers are only prepared to return all or a portion of the fees paid (i.e. return of money to avoid unjust enrichment of service provider). Customers usually want to also recover lost profits to put them back in the position they would have been had the problem not occurred (i.e. expectation or “benefit of the bargain”/reliance damages). Commercial reality is somewhere between these two extremes.

## 6.2 Limiting Exposure Through Time

Often the limitation of liability clause will contain time limits on bringing claims that are shorter than the statutory limitation period, which, in Ontario, is two years from the date of discovery or deemed discovery.<sup>18</sup> The limitation periods provided under the *Limitations Act*

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<sup>17</sup> (1954) 9 Exch. 341, 156 E.R. 145.

<sup>18</sup> *Limitations Act*, S.O. 2002, c. 24, Sch. B., s.4 [*Limitations Act*].

apply regardless of any agreement to vary or exclude them,<sup>19</sup> however, there are a few exceptions to this general rule under the *Limitations Act*.<sup>20</sup> For contracts where the variation of the limitation period is not prescribed by statute, companies should consider what types of problems could occur and when they might be discovered before agreeing to the clause. In particular, the Ontario *Limitations Act* prohibits the variation of the limitation period.

### **6.3 Relationship to Insurance Coverage**

One technique in negotiating a limitation of liability clause is to tie it to the amount of liability insurance that the service provider carries. While this might be helpful in setting a financial limit that the service provider can accept (because it will accept the risk if it knows that it can insure for the risk), the limitation should not be tied to the existence of the policy itself, since coverage can be denied, depending upon the circumstances. If addressed in an outsourcing agreement, the requirement to maintain a certain level of insurance coverage is just comfort to the customer that funds should be available in the event that certain types of claims are made.

### **6.4 Requesting Mutuality**

The customer may also want to limit its liability even though it is not providing services. Possible exposures that the customer might want to limit are: IP claims, ramp up/investment by service provider to take on customer's business, or employee issues. In the end there is no "right" answer – it depends on each party's appetite/resources for bearing risk.

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<sup>19</sup> Bruce McNeely, "Limitations Law in Ontario," (27 February 2008) *Cassels Brock* online: CasselsBrock.com <<http://casselsbrock.com/publicationdetail.asp?aid=1464>>.

<sup>20</sup>*Supra* note 15 at s.22(2)-(5).

## **7. PERFORMANCE MEASURES AND SERVICE LEVELS**

### **7.1 Service Level Agreements**

Service Level Agreements (“SLA”) are commitments to maintain or exceed certain agreed quantifiable levels of performance with financial consequences for non-performance. The SLA differs from the outsourcing agreement itself. A simple SLA provides a percentage refund of fees based on the failure to achieve certain measurable standards. A more complex SLA could provide a refund of fees based on weighted measures, subject to a cap with escalating service level credits. Potential metrics include availability of service, number of times a service is used, and speed of performance.

### **7.2 Appropriate Service Levels**

It is important to determine the appropriate service level. A useful first step is to determine the level of service the customer has been receiving internally prior to the decision to outsource, in order to determine a minimum standard. In addition, the customer should assess the appropriate service levels required by its business interests in order to determine which elements of the business will need to be monitored. Measurement periods will also need to be determined (e.g. monthly, quarterly, or yearly). Further, a well negotiated SLA would include a service provider commitment to attempt to improve performance throughout the term of the agreement.

### **7.3 Weighting the SLA**

The monitored elements should be ranked and weighted according to their respective importance. The relative differences between weights are important. The company could consider an escalating range of service level credits based on repeated failure to meet required service levels. An SLA matrix can be created – credits can be determined by the severity level of issue by service level achieved.

## 7.4 Other Potential SLA Provisions

Other potential SLA provisions include the following:

- **Gain sharing:** allowing service providers to share the benefits of “super-performance”;
- **Reporting Requirements:** including status of all current problems, chronic problems and action plans, trend analysis, and capacity planning;
- **Increasing Credits over the Course of the Agreement:** due to the competence level of the service provider improving over time; and
- **Excused Performance Failures:** for example, due to actions of the customer, assets supplied by the customer, or a *force majeure*.

## 8. CONSEQUENCES OF FAILURE

### 8.1 Determine the Consequences of Failure

The consequences of failure need to be determined. The purpose is to motivate the service provider to provide better service. Since default and termination of the agreement is an extreme remedy, it can be advantageous to have more limited remedies available for minor service level failures – for example, the customer receives credits against future fees. Another possible incentive is to provide the opportunity for service providers to earn back lost revenue through rewards for improved service. However, while the service provider will often try to categorize these credits as exclusive remedies, the customer needs to be very wary of this approach. Often the credits are fairly nominal financial penalties that in no way could compensate for serious problems. In those cases, the customer needs all remedies available to it under the contract and at law.

## 9. BENCHMARKING

### 9.1 Benchmarking

“Benchmarking” refers to the requirement for periodic reassessments in order to remain competitive with industry standards. Benchmarking is a solution whereby an independent third

party (“Benchmarker”) reports back to the service provider and customer on current service levels and industry trends. Benchmarking should be used sparingly as it is expensive and time consuming.<sup>21</sup> Service providers tend to dislike Benchmarking since it can result in higher service levels down the road. A potential alternative is to reassess both service levels and pricing periodically.

Adam D. Vereshack<sup>22</sup> identifies certain basic elements that should be addressed when negotiating the terms and conditions of Benchmarking. According to Vereshack, the parties must initially address the selection of the Benchmarker, who will cover the cost of the Benchmarking, and how often Benchmarking may be requested.<sup>23</sup> In selecting a Benchmarker, both parties should ensure that the Benchmarker is “an independent, unbiased collector of reliable, current, comparable data. It is crucial that the Benchmarker be an independent, trustworthy party experienced with benchmarking in the relevant industry sector and with access to the comparable data.”<sup>24</sup> The parties must also agree on the scope and execution of the Benchmarking process, ensuring that certain specifics are finalized in the Benchmarking agreement, such as the geographic area the outsourcing agreements and services will be selected and what factors will be used in comparing between the customer’s agreement and services and the agreements and services of other customers of the service provider.<sup>25</sup>

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<sup>21</sup> *Supra* note 1 at 10-5.

<sup>22</sup> Adam D. Vereshack, *A Practical Guide to Outsourcing Agreements* (Markham: LexisNexis Butterworths, 2005).

<sup>23</sup> *Ibid.* at 109.

<sup>24</sup> *Supra* note 1 at 10-6.

<sup>25</sup> *Ibid.* at 110.

## **10. GOVERNANCE AND RISK MANAGEMENT**

### **10.1 Board of Directors**

Given that the customer's board of directors retains responsibility and potential liability for their outsourcing policy and outsourced activities, any potential outsourcing activity must be carefully evaluated. With respect to the financial services industry, the *Basel Guidelines*<sup>26</sup>, produced by the Basel Committee on Banking Supervision, include a number of principles to help regulated entities outsource safely, but they are also useful to help manage outsourcing risk in general. The *OSFI Guidelines* mirror the *Basel Guidelines*, particularly with respect to recommendations on risk management. Further, both Guidelines provide useful principles to guide a successful outsourcing arrangement, and serve as a "best practices" benchmark for companies considering outsourcing.<sup>27</sup> Schedule "B" provides an overview of the principles of the *Basel Guidelines* and the *OSFI Guideline* with respect to outsourcing arrangements.

### **10.2. Business Continuity Plan**

A business continuity plan should be implemented by the service provider. A business continuity plan contemplates situations where the service provider's services are interrupted, either temporarily or permanently. The plan should ensure that the customer has access to all necessary records and information to continue business operations and meet its statutory obligations if service is interrupted.

## **11. AUDITING**

### **11.1 Audit Rights**

Audit Rights provide an opportunity to observe, request documents, examine, and confirm the accuracy of reporting by the service provider. Sometimes the service provider will

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<sup>26</sup> Basel Committee on Banking Supervision, "The Joint Forum: Outsourcing in Financial Services (2005 February) online: Bank for International Settlements < <http://www.bis.org/publ/joint12.pdf?noframes=1>>.

<sup>27</sup> *Supra* note 6 at 3-13.

only allow more of an inspection rather than an audit. Audit rights should be outlined in the outsourcing agreement and give the customer the right to evaluate all aspects of the service provided or have it evaluated by a third party. Schedule “C” provides an overview of the types of audits that are available and the elements of audit language.

## **12. INTELLECTUAL PROPERTY: OWNERSHIP AND LICENSING**

### **12.1 Who is the Owner of Work Product?**

This can be a contentious issue between the customer and the service provider. The customer will want to acquire ownership of any work product developed either solely by the service provider or in conjunction with the customer, whereas the service provider will likely wish to use some of the work product for future customers. These conflicting interests can often be accommodated by giving ownership to the customer in conjunction with a licensing scheme.

### **12.2 Customer Ownership**

From the customer’s perspective, ownership of the work product should vest in the customer automatically as a result of the general payment for services, as opposed to requiring specific payment for the work product. The service provider should also provide any requested assignments to customer. The outsourcing agreement should provide for the waiver of any potential moral rights to the work product to prevent any “authors” (i.e. employees or subcontractors of the service provider) from objecting to any modifications. The agreement should clearly specify any work product that the service provider will retain ownership of and that work product would be licensed back to the customer for use with the work product that is owned by the customer.

### **12.3 Licensing**

The service provider’s interests can often be accommodated by granting a license to the service provider to use, modify, and create derivative works from certain elements of the work

product. It is also important to ensure that the agreement provides for the licensing of customer-owned or licensed software to the service provider in order to provide the services, and that the service provider grants the customer a licence to use any relevant intellectual property both during and after termination of the agreement.

The customer has to ensure that any intellectual property that it licenses from third parties may be used by the service provider to provide the contracted services. This may require additional fees if there is no negotiation up front. The customer also has to be prepared to indemnify against third party infringement claims in respect of the intellectual property that it owns and allows/requires the service provider to use.

Similarly, the service provider has to ensure that any third party tools that it uses may be used to provide services for others in an outsourced setting. The service provider would have to be prepared to indemnify against third party infringement claims in respect of the intellectual property that it supplies and allows/requires the customer to use in order to take advantage of the services.

## **13. CHANGE MANAGEMENT**

### **13.1 Change Order Process**

Outsourcing contracts often run for 7 to 10 years, but many aspects of the customer's requirements can change during this period. For example, a number of changes could occur that would affect the appropriate pricing level, such as: cost increases; changes in demands for services; changes in the scope of services; changes in regulatory frameworks; and extraordinary events. A change order process should be included in the agreement to specify how changes are to be managed. The change order process can apply to all changes, or specific changes can be enumerated in the agreement. Changes which are not to be managed by the change order process should also be specifically stated. A change order process will normally provide for the issuance

of change requests, timelines for acceptance or rejection, and the effect of acceptance or rejection.

## **14. PRIVACY AND DATA PROTECTION**

### **14.1 Applicable Statutes**

Outsourcing of services generally involves the collection, use and disclosure of personal information. When personal information originates in Canada, the outsourcing organization must comply with Canadian legislative requirements, most significantly, privacy requirements under the *Personal Information Protection and Electronic Documents Act*<sup>28</sup> (“*PIPEDA*”). The Privacy Commissioner of Canada (“Privacy Commissioner”) makes findings on complaints made under *PIPEDA*. Findings made by the Privacy Commissioner do not have force of law. However, in a set of findings concerning complaints against the potential use of personal information by U.S. authorities under the *USA PATRIOT Act*<sup>29</sup>, the Privacy Commissioner appears to have taken the position that a “transfer” of personal information under *PIPEDA* is something other than a “disclosure” for which the individual data subject’s consent is required.<sup>30</sup> In the case of an outsourcing “transfer”, the service provider is required to use the information for the same purposes as its customer (who entrusted the information to it); the service provider must be required to provide a comparable level of protection for the information (to that which the customer was obligated to provide); and the customer should notify the data subjects.

This issue is particularly heightened in cross-border outsourcing to U.S. service providers because in the U.S., the *USA PATRIOT Act* significantly extends the search and seizure

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<sup>28</sup> S.C. 2000, c. 5.

<sup>29</sup> *Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot Act) Act of 2001*, Pub. L. No. 107-56, 115 Stat. 272 [*USA Patriot Act*].

<sup>30</sup> *Bank's notification to customers triggers PATRIOT Act concerns* (19 October 2005), *PIPEDA Case Summary* 313, online: Office of the Privacy Commissioner of Canada < [http://www.privcom.gc.ca/cf-dc/2005/313\\_20051019\\_e.asp](http://www.privcom.gc.ca/cf-dc/2005/313_20051019_e.asp)>.

powers of U.S. law enforcement officials, including the ability to seize information held by U.S. organizations or on servers located in the U.S. Consequently, personal information could be subject to disclosure under the *USA PATRIOT Act* even if outsourced to a non-U.S. service provider, if the data is being stored on servers located in the U.S.

If a third party does not qualify as a mere processor of information, then it would not be covered by this “transfer” treatment under *PIPEDA*. Given the potential liability of the organization outsourcing the processing of the information, the organization will want covenants from the service provider that it will comply with all relevant privacy legislation. Schedule “D” provides examples of techniques for dealing with personal information and confidential business information.

## 15. ENDING THE OUTSOURCING RELATIONSHIP

### 15.1 Common Circumstances of Termination

- **Expiration:** the agreement will generally expire after a fixed term subject to renewal.
- **Customer Events of Default:** this should be restricted to the following scenarios: failure to pay undisputed amounts, and failure to pay disputed amounts greater than the dispute limit.
- **Service Provider Events of Default:** in addition to any material breaches, a number of specific breaches (including any cure periods) should be included in the agreement to clarify the customer’s termination rights.
- **Termination for Convenience:** the right of the customer to terminate the agreement at will after a certain period, subject to an early termination fee.
- **Termination due to *Force Majeure*:** the agreement should generally include a disaster recovery plan to deal with such scenarios, and an option for the customer to terminate the agreement without any fees if the service provider fails to implement the plan effectively.

### 15.2 Transitioning

A description of the problem should be provided following termination of the outsourcing relationship. The outsourced services will likely need to be brought back in-house or transferred

to another service provider. Outsourcing agreements differ from many other service contracts in that they must address the post-termination transition period.

### **15.3 Typical provisions to consider**

The agreement should include a transition plan, which will specify the services to be provided during this period. Issues to be addressed include: changes to the fee structure, assignment of agreements/subcontracts, acquisition of assets, hiring of employees, and whether any consents or approvals will be necessary. Transitioning and service level agreements provide relief during transition in and out.

## **16. CONCLUSION**

This paper has provided a cursory examination of the various aspects and components involved in an outsourcing arrangement. Outsourcing can reduce operating costs and make economical use of firm resources, resulting in efficient management mechanisms. Firms can reap additional advantages in an outsourcing relationship by taking note of industry regulations and the Guidelines, which address outsourcing arrangements. In the same regard, though outsourcing a business function often yields many significant benefits to the firm, there is a need to balance the benefits with the associated risks. An outsourcing relationship will vary by industry, signalling an exercise of balancing risk with the service provider. Accordingly, a comprehensive outsourcing contractual agreement must account for these factors.

## SCHEDULE "A"

### **OUTSOURCING RISKS**

#### **Outsourcing Strategy Risks\***

- Outsourcing undesirable functions versus ones that provide greatest competitive advantage;
- Not clearly defining goals and objectives before stating the outsourcing process;
- Not establishing an effective internal baseline to measure providers against, including costs, service and value adds;
- Outsourcing in the international market without international operations experience;
- Inadequate business case development for the outsourcing decision;
- Making the decision to outsource without complete information on internal costs and processes;
- Not considering the impact of outsourcing on other functions and areas of risk, such as environmental and regulatory factors;
- Lack of understanding the human relation and employment law requirements for an outsourcing initiative; and
- Announcing outsourcing before sufficient details have been finalized, creating morale issues.

#### **Outsourcing Implementation Risks\***

- Not establishing an outsource relationship that has sufficient flexibility to deal with business fluctuations;
- Initiating an agreement with a service provider that limits flexibility in the future;
- Having an unrealistic timeline for any of the steps of the outsource process including start up;
- Poor implementation planning with respect to timing of transition to service provider and demands on the organization;
- Underestimating the time required to negotiate a service agreement;
- Not fully defining an employee transition plan;
- Not getting the operational issues resolved in the service agreement before moving into the legal aspects of the agreement;
- Inadequate planning concerning information systems and interfacing with the service provider;
- Insufficient technology development before implementation.; and
- Not training the provider on critical elements of the company product line or service expectations.

### **Outsourcing Selection Risks\***

- Not including enough resources to effectively manage the vendor selection process;
- Not having the proper internal skill set to effectively manage the selection process;
- Not understanding or leveraging the benefits a Request for Information (RFI) can have in narrowing the potential provider field before entering the Request for Proposal (RFP) process;
- Not casting one's net widely enough for potential providers of the service, and thus missing good candidates;
- Not involving a variety of perspectives in the selection process;
- Poorly developed and documented service or product specifications;
- Inaccurate costing of assets that will be transferred to the service or product provider;
- Not doing business and financial due diligence on potential providers;
- Insufficient knowledge of service provider capacity limitations; and
- Making the selection process a personal rather than a commercial decision.

### **Outsourcing Management Risks\***

- Not considering the full impact of an outsourcing agreement on a company's financial condition;
- Lack of internal communication;
- Lack of incentives for provider continuous improvement;
- Not establishing multiple touch points between the company and the provider;
- Lack of a contingency plan for major disruptions at the service provider;
- Not putting a full communication plan into effect including escalation processes, regularly scheduled meetings, review periods and employee communication;
- Doing a poor job managing expectations around the go-live;
- Expecting too much from a provider in the early months after go-live;
- Neglecting to "flex" the outsource relationship as outsource requirements evolve; and
- Lack of a formal "lessons learned" roundtable on outsourcing in general and, specifically, established outsource relationship.

\* James A. Tompkins, Ph.D., and Dale Marmelink, eds., *The Supply Chain Handbook* (North Carolina: Tompkins Press, 2004).

SCHEDULE “B”  
**BASEL GUIDELINES**

Under the *Basel Guidelines*<sup>31</sup>, the Basel Committee on Banking Supervision provides high-level guiding principles a regulated entity should follow, including the following:

1. A comprehensive policy to assess whether and how a proposed activity can be properly outsourced;
2. A comprehensive outsourcing risk management program to assess the service provider and proposed activities;
3. Ensuring obligations to third parties can still be fulfilled;
4. Conducting appropriate due diligence regarding service providers;
5. Taking appropriate steps to require that confidential information is adequately protected by the service provider; and
6. Establishing and maintaining contingency arrangements.

**OSFI B-10 GUIDELINE**

Section 7 of the *OSFI B-10 Guideline*<sup>32</sup>, states that the FRE is expected to have a comprehensive risk management program for material outsourcing arrangements. According to OSFI, the FREs risk management policy should include the following:

1. An internal due diligence process to determine the nature and the scope of the business activity to be outsourced;
2. A comprehensive due diligence review to assess risks associated with the outsourcing arrangement;
3. Policies and procedures to manage risks including contracts for services, outsourcing in foreign jurisdictions, and a business continuity plan; and

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<sup>31</sup> *Supra* note 9 at 14.

<sup>32</sup> *Supra* note 5 at 11.

4. Procedures should be developed and implemented to oversee and monitor material outsourcing arrangements.

## SCHEDULE "C"

**AUDITS****Types of Audits**

1. **Internal Audits:** the service provider is usually required to engage in periodic internal audits to assess internal controls regarding performance of the outsourcing agreement;
2. **External Audits:** the service provider is usually required to undergo independent third party audits of control procedures; and
3. **Customer Audits:** the customer also usually has the right to conduct its own audits of the service provider.

**Elements of Audit Language**

The following issues should be addressed:

- frequency;
- notice requirements;
- access to service provider's internal audit results;
- minimal disruption to service provider;
- allocation of costs;
- compliance with service provider's security requirements;
- respect for service provider's other confidentiality obligations;
- sharing of results;
- corrective measures; and
- where the customer is a federally regulated entity, the outsourcing agreement should give OSFI or its representative the right to participate in or exercise the customer's audit rights with respect to the service provider.

## SCHEDULE "D"

**CONFIDENTIAL BUSINESS INFORMATION****Dealing with Confidential Business Information**

Since confidential business information is most often necessarily disclosed in an outsourcing relationship, it is important for the customer to take measures to prevent disclosing more information than is required. This is especially important when the disclosure occurs in the context of negotiating the outsourcing agreement.

**Useful Precautions Include:**

- Signing a confidentiality agreement;
- Restricting disclosure to necessary individuals only;
- Disclosing information in a multi-stage process; and
- Commissioning a third party who is subject to a confidentiality agreement to prepare a report on the confidential information as opposed to direct access.

**Important Confidentiality Agreement Provisions:**

- A statement as to the purpose of the agreement;
- A definition of "confidential information", including any potential exclusions;
- Guidelines with respect to how the confidential information is to be handled by each party;
- Warranties outlining security arrangements, including the use of appropriate encryption, measures to ensure electronic document integrity, and compliance with relevant document retention standards;
- A statement as to the ownership of any disclosed confidential information;
- Whether there are any permitted disclosures and any respective notice requirements;
- The process by which the confidential information will be returned or destroyed upon completion of the agreement; and
- Remedies available to the parties.

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