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**IT OUTSOURCING AND GLOBAL SOURCING:
A COMPARATIVE APPROACH FROM
THE INDIAN, U.K. AND GERMAN
LEGAL PERSPECTIVES**

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ABSTRACT

Businesses today have been able to take advantage of technology in order to use models such as offshoring in order to reduce their costs without a corresponding decline in quality. However, concerns such as data confidentiality and security issues have emphasised the need for businesses to take considerable care when dealing with cross-border transactions, especially since some knowledge of the needs of different jurisdictions is necessary. This article examines the outsourcing model in the context of the information technology industry and looks at the most important clauses and legal issues in such contracts in the light of Indian, English and German law.

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I. BASIC SUMMARY OF OFFSHORING AND GLOBAL SOURCING

A. Introduction

Businesses are constantly being driven to reduce costs and enhance productivity in order to increase shareholder value. Many business models have

been adopted to achieve these goals, and for many years outsourcing has been seen as one of the proven solutions. Businesses have also been taking advantage of global sourcing opportunities, and nowadays going offshore is hardly novel. Venturing offshore can offer the opportunity of cost arbitrage by using equally qualified, but cheaper, employees and lower-cost resources and services from offshore locations. Originally a trend led by manufacturing, offshoring is now also a concept readily deployed for providing services via call centres and back-office service centres.

However, offshoring is not necessarily the same as outsourcing, as any of a wide range of business models may be adopted. One option is to set up and manage the business's own offshore operations as a 'captive' organisation. Companies such as SAP, Hewlett-Packard, Accenture, Siemens and Microsoft are following this model. Another model is third-party outsourcing, in which the customer utilises the services of an external service provider. Yet another option used frequently in India is the BOT (Build-Operate-Transfer) model, a hybrid model in which the customer initially uses an external service provider but reserves the right to operate the service later on (e.g. a joint venture with a call option).

Outsourcing comprises the following services and models:

1. *Outtasking*: sourcing certain tasks, such as payroll services, to an external service provider
2. *Selective Outsourcing*: sourcing a selected part of a larger business unit (e.g. sourcing of maintenance services)
3. *Transitional Outsourcing*: sourcing in the context of a technology upgrade
4. *Complete Outsourcing*: sourcing an entire business unit
5. *Business Transformation Outsourcing (BTO)*: a combination of business consulting and outsourcing (e.g. the reorganisation of a business unit, followed by the sourcing of the reorganised business unit)
6. *Business Process Outsourcing (BPO)*: sourcing an individual business process (e.g. sales, accounting, human resources) to a third party

7. *Out-servicing*: sourcing business processes that are organised pursuant to the Service-Oriented Architecture (SOA)
8. *Managed Services*: offering services in the areas of information/communication that can be sourced by the client on a case-by-case basis (similar to Application Service Providing, or ASP)

Sourcing offshore is not without its risks and disadvantages. For an offshoring project to be successful, it is important for a business to understand its reasons for offshoring as well as why it has selected and how it can manage a certain offshoring model. Offshoring is about more than just saving costs. Issues such as control, core competency, provider capability and reputation are also highly relevant.

As with any business solution, there are always advantages and disadvantages to the eventual model that is adopted by the business user. The following table sets out some of the pros and cons in the context of the three typical offshoring models (captive, third-party and hybrid).

| MODEL | THIRD-PARTY | CAPTIVE | HYBRID |
|---------|--|--|--|
| CONCEPT | Subcontracting work to a third party to provide services or products | Establishing and running an offshore operation to carry out business functions | Any combination of onshore, offshore, captive or third party operations |
| PROS | <p>Time to solution can be shorter than other models</p> <p>Customer can rely on contractual rights to ensure satisfactory performance</p> <p>Service flexibility</p> <p>Access to expertise</p> | <p>Customer has direct control</p> <p>Can reduce costs by avoiding third-party profit margins and ongoing savings</p> <p>IPR vests within the group and can easily be monitored and controlled</p> | <p>Each function can be sourced to the operation best suited to perform it</p> <p>Better risk management through diversification</p> <p>Flexibility to transfer functions between operations when needed</p> |

The Table continues

| MODEL | THIRD-PARTY | CAPTIVE | HYBRID |
|-------|--|--|--|
| | Value for money | Captive's employees can be part of the customer's corporate culture | |
| CONS | <p>Loss of control</p> <p>Harder to incentivise provider's personnel</p> <p>Potential IPR issues, such as contamination and security</p> <p>Business risk because function taken outside the corporate boundary</p> <p>Enforcement issues where provider is offshore</p> | <p>Time to solution often slower than third-party model</p> <p>Higher setup costs</p> <p>Potential difficulties with bureaucracy</p> <p>Direct exposure to local risks</p> <p>Customer responsible for ongoing compliance with local laws and regulation</p> | <p>Requires increased resources to manage each relationship and delineate responsibilities</p> <p>Can be more costly</p> |
| USE | <p>Growing trend towards partnership models such as Build-Operate-Transfer and Build-Operate-Manage</p> | <p>A joint venture can be established to exploit shared resources and experience (compulsory in some countries and circumstances)</p> <p>Increasingly popular with multinational corporations</p> | <p>Certain services can be provided globally from a single location on an Application Service Provider basis</p> |

B. Sourcing Models and Analysis of the Utilisation of the Various Models

The usage of the various service delivery models outlined above varies around the globe, as does the degree to which outsourcing and offshoring has been adopted successfully. India has dominated the world market as the supplier to the global outsourcing market since the trend to seek offshore services first emerged in the late 1990s. This is principally thanks to the size of its skilled English-speaking workforce, low-cost bases and understanding of the need for flexibility and culture of learning.

India's pre-eminence may now be working against it, however, as cost inflation fuels growing competition from China, Eastern Europe and South America (particularly Brazil), amongst others. China has already established itself as the number two outsourcing destination and, with its phenomenal economic growth, massive workforce, and strong government backing, there is a good chance that it will overtake India in coming years. The outsourcing industries of Eastern Europe and South America are still in the early stages of development but look set to benefit from their proximity to Western Europe and the U.S. respectively.

C. India

There has been a resurgence of interest in the Indian IT sector in the recent past, along with an increased focus on the movement of work to India. In the late 1990s, many U.S. and British companies turned to Indian IT professionals for help in dealing with the threat of the Y2K bug. It was at this time that Indian IT professionals became a sought-after resource, and many Indian IT professionals shifted to the U.S. and U.K. as a result. However, the subsequent bursting of the dotcom bubble forced many Indian IT professionals to head back to India, and IT companies in the U.S. also started looking at means to cut costs without having to compromise on the quality of the services they offered. Many looked at India as a viable option, since they found an abundance of IT professionals who had worked in the U.S. and were acquainted with the American work ethic and culture. The movement of work to India thus began for a number of reasons, including the following:

1. *Language*: English became an official language in India as a result of the country having been a British colony until 1947. There is thus no dearth of talented and educated people who are highly fluent in English. This attracted most nations to India for outsourcing, putting India ahead of China in tapping the IT outsourcing market.
2. *Culture*: Another advantage is the perceived adaptability of Indian workers. Their fluency in English also enables them to meet cross-cultural requirements when delivering to international clients.
3. *Market domination*: Global companies have realised that outsourcing to India can offer numerous potential benefits focused on the economic, strategic and IT expertise of the Indian vendors. IT revenues in the Indian market by the foreign companies have been growing at quite a rapid pace.¹

D. The United Kingdom

In the U.K., outsourcing has been a popular business solution for many years. The industry has evolved from the early bureau service models to a diverse and rapidly growing market sector. The outsourcing market has become a mature market supported by specialist providers (from all over the world), consultants, lawyers and other specialists.

Today, U.K. business uses all the models of outsourcing detailed above. However, according to the predictions of IT services exporter Luxoft, no single model is likely to gain supremacy over the others in the near future.² It is believed that each company will assess its available global resource and skills pool and choose a combination of in-house teams and outsourced services in order to attempt to reach its desired business and technical goals. The U.K. seems to be following the U.S. in this trend towards smaller multi-sourcing deals. As Phil Morris, Morgan Chambers' CEO, put it: "The [U.K.] outsourcing market has matured and clients are becoming smarter in the way they contract. Businesses are beginning to drop the 'offshore' or 'nearshore' labels, moving instead to

¹ NASSCOM, *Indian IT Software and Services Revenues to Reach U.S. \$50bn mark in FY 07-08*, at <http://www.nasscom.in/Nasscom/templates/NormalPage.aspx?id=51734>.

² Dmitry Loschinin, *Luxoft: Outsourcing Predictions 2007*, at http://www.noa.co.uk/index.php?option=com_content&task=view&id=274&Itemid=85.

‘global sourcing’, with no geographical boundaries. This opens up the market to a new wave of providers and contracting models.”³

1. Language

With English as the international business language of choice, the U.K. has found it very easy to leverage world resources and various low-cost countries as the outsourcing offshoring market has matured. The British population and workforce are far less advanced in other languages than their European counterparts. This makes it an easy market to serve, but a difficult supply hub for international service provision. India has been a particular and dominant beneficiary, having been a British colony and thus sharing colonial, linguistic and legal ties with the United Kingdom. China’s current shortage of sufficient English-speaking workers is one of the major challenges in the growth of international service provision in China (though this is rapidly changing).

2. Culture

Despite the trend for U.K. businesses to outsource offshore, the culture in the U.K. still has a lot to offer. The English workforce has extensive exposure to global sourcing compared to continental Europe and its ability to combine knowledge of IT domains with the realities and imperatives of real-world business challenges is a real advantage. For this and other reasons, the British have freely adopted the outsourcing model across many industries (and in recent years, the public sector outsourcing market’s growth has been particularly strong). In a now mature market, it can certainly be said that there is a British outsourcing culture. The savings, efficiencies and business successes to be gained from outsourcing and offshoring frequently speak volumes to those tasked with the sourcing decision, and the change and effort required is usually justified at the Board level, though there is sometimes debate further down the line about whether all the benefits promised by a discrete project are ever fully realised.

From time to time, there is substantial hype when a business advocates and implements an ‘insourcing’ program, bringing solutions back in-house or back

³ Press Release, Morgan Chambers, UK Faces ‘Outsourcing Turmoil’ (Dec. 12, 2006), http://www.morganchambers.com/press_office/41.

onshore. In other instances, outsourcing is resisted from the outset as some maintain their philosophical objections. At times, in some industries, there can be significant union objection and resistance to offshoring plans, and from time to time such pressure has influenced the nature of the solution eventually delivered.

3. Market Domination

The forecast for the U.K. software and IT service market is one of slow growth. A June 2006 study by Ovum for the Department of Trade and Industry stated that the market is looking to increase by a modest 5.5% in 2007 and 4.9% in 2008.⁴ The U.K. IT industry is becoming more heavily reliant on global sourcing, with many companies expecting to increase offshore capabilities. The business processing market is stronger.

According to outsourcing advisory service TPI, the average value of outsourcing contracts was at its lowest in five years in the last quarter of 2006, with a decrease of 8% in the value of new outsourcing deals compared to 2005 levels.⁵ This may be due to client companies in large continental agreements being less satisfied with what they are getting than those in smaller contracts.⁶ This means that IT managers are no longer flocking to the six largest outsourcing companies (Accenture, ACS, CSC, EDS, HP and IBM) and the U.K. market for outsourcing deals is being opened up to the smaller players.

Outsourcing, for many, has been an unnecessary risk from the perspective to data security. In particular, financial services companies have historically preferred to manage their own data centres internally. This fear has been heightened by a number of stories of data security breaches in India.⁷ However,

⁴ David Bradshaw et al., *The Impact of Global Sourcing on the UK Software and IT Services Sector* 10, at <http://www.berr.gov.uk/files/file32496.pdf>.

⁵ Press Release, TPI, Tighter Times for Outsourcing Providers (Jan. 11, 2007), <http://www.tpi.net/newsevents/news/releases/070111-UK.html>.

⁶ See Morgan Chambers, *Outsourcing Service Provider Performance Study 2007: A Morgan Chambers Management Summary*, at http://www.morganchambers.com/downloads/MorganChambers_Outsourcing_Study_BeLux_2007_ManagementSummary.pdf.

⁷ See, e.g., Ed Frauenheim, *Insecurities over Indian Outsourcing*, at http://www.news.com/Insecurities-over-Indian-outsourcing/2100-7355_3-5685170.html.

it is fast approaching the situation where such companies will start to outsource due to the increasing need for power, cooling and storage of these systems that they simply cannot meet internally. Global publicity for these breaches can only assist institutions when deciding whether to send contracts offshore, and security is set to be an important factor, rivalling costs and deliverability.

Overall, it seems that the market will continue to grow in the U.K., if only modestly, but that large single-provider contracts will fragment into multi-source, increasingly specialised deals.

E. Germany

In Germany, the outsourcing models described above are all used in practice. The German market is a difficult one to crack for outsourcing service providers. This is due to many reasons, especially the following:

1. *Language*: Although English is the international business language of choice, and global companies such as Siemens have already adopted English as their first language, many German companies still prefer to operate in German. Service providers have to cater to this and prepare all documents, contracts, and services in German. Also, some outsourcing services, such as BPOs and BTOs, require consulting services, which must be provided in German. Therefore, it is easier for international service providers in India to cater to American or British customers.
2. *Market domination*: The German market for outsourcing services has historically been dominated by the four top providers, T-Systems, IBM, Siemens Business Services and EDS, although the recent spate of captive takeovers offers a threat to that dominance. It is a challenge for Asian service providers to break this market dominance and the 'old boys' network' of the established market players, and this is a contributing factor to the lead that nations such as the U.K. and U.S. have over Germany. Nevertheless, the market is likely to grow dramatically in coming years, and the value of outsourcing in Germany is expected to hit 60 billion euros by 2010.⁸

⁸ Ulrich Bäumer, Jame Mullock & Mark Webber, *Offshoring and Global Sourcing* 16, <http://www.osborneclarke.de/publikationen/Offshoring%20and%20global%20sourcing.pdf>.

II. A CLOSER LOOK AT THE OUTSOURCING MODEL

As discussed above, outsourcing can offer real benefits; but the impact and potential consequences for the business undertaking outsourcing must be properly evaluated. Among the advantages of outsourcing are cost savings (through factors such as economies of scale and reduced overseas costs and overheads); access to cutting-edge technology, processes and skills; the ability to focus internally on core competencies and objectives, access to flexible; adaptable and scalable solutions; more efficient management of workloads; and decreased product development cycle/speed to solution. However, there are also the risks of loss of control (including loss of quality control), adverse public opinion (especially where there is a loss of domestic jobs or a negative impact on the local economy), scope creep leading to cost increases, problems with security/confidentiality, retransition issues and cultural and communication difficulties.

One way to understand outsourcing is to think of it in terms of a cycle going through four initial stages preceding operation (and subsequently retransition): self-assessment, choosing a provider, negotiation and implementation.

A. Self-Assessment

Before a company embarks on any outsourcing project, it needs to make a full and frank assessment of its current business and any anticipated impact on the way the sourcing is structured. This will typically involve a statement of requirements or service/solution specifications based on its own internal due diligence and the knowledge it has of its existing solution, often using the assistance of specialist advisers. In the case of second-generation outsourcing this can be a harder task, and a well-advised user will build in certain contractual rights to elucidate the information and any support that it may require in these circumstances from the incumbent supplier.

This self assessment should include technical, commercial, and legal analyses. For example, questions would have to be raised as to the severability of the processes, whether the processes require proximity, whether they can be standardised, whether they are of sufficient scale, and whether there are any legal or regulatory impediments. Aside from this, questions will also be raised as

to what the management and shareholders would want from the strategic sourcing programme, what the impact on existing personnel would be, whether the union (if one exists) should be consulted, and also as to what the market's perception of these changes would be.

This statement of requirements is then often used to approach potential suppliers to market-test and sometimes to commence a selective procurement process. Such a selective process is frequently driven by an all-encompassing invitation to tender (ITT) which outlines the potential outsourcing in hand and invites prospective suppliers to bid for the project at the same time as providing further information about their specific recommended solution. It is essential to communicate the rationale for the sourcing and then identify the objectives and instill them in the project team. It is often prudent for a customer embarking on offshoring for the first time to first outsource a small-scale non-critical project before exporting any business critical operation. Providers offering the most attractive solutions may be short-listed by the user, and a specific solution and provider then chosen. At times, a 'preferred supplier' and reserve may be selected and a competitive negotiation created by the user allowing him to extract maximum gain from each of the providers in a competitive situation. However, such a process is time-consuming, only justified in some situations, and can be a significant cost of bid for the suppliers in question (costs which can eventually be passed on to the unwitting user).

In other circumstances, the user may simply select a certain provider without recourse to an ITT or competitive tender. Selection can be made based upon alternative reasoning or because the provider (or a third party consulting provider) has consulted with that user and recommended or sold certain services. In certain public sectors or in the case of specifically regulated industries such as water supply, the project may be subject to the national public procurement rules applicable to that business depending on the nature and value of the project in hand. This can significantly affect the way potential providers are sought as well as the timing and manner in which a potential contract with a provider is offered.

The impact of offshoring on external sources should not be underestimated. There are many current examples of businesses trying to distinguish themselves

in the marketplace by emphasising the fact they do not offshore.⁹ It is increasingly common for 'thou shalt not offshore' clauses to be negotiated into agreements with the chosen provider. In trying to reach into the service delivery methods of their contractors and prohibit them from utilising offshore services in the delivery or subcontracting of services, the customer can frustrate real savings. While one might consider this approach prudent, a blanket dismissal of the opportunity is perhaps a little naïve.

B. Choosing a Provider

A customer can maximise its options and benefit from competition among providers in tendering for its work. The ITT should clearly specify the customer's requirements in order to increase its prospects of attracting suitable providers and accurate proposals. It is also important to examine the size and capability of the provider, whether the provider uses its own employees or subcontractors, what processes and operational procedures are deployed to protect confidentiality and intellectual property rights, and what other customers the provider is supplying (in case of a conflict of interest).

If a decision has been made to go offshore, the location of the offshoring service also needs to be considered. Naturally, there are many factors to consider: time zones, languages, product localisation needs and synergies with exiting or potential markets or users all need to be considered when making a decision on location. This may be compounded if multiple locations are to be used. The choice of country ought to be influenced by factors such as the expected role of the country in the global economy in the long-term, the talent pool and experience available (including language ability), the legal controls and export

⁹ See, e.g., LetsTalk, *Why Buy from LetsTalk*, at <http://www.letstalk.com/promo/whybuy/whybuy2.htm> ("Buy from fellow Americans. We're proud of our Dallas, Texas-based customer sales representatives, and we do not offshore customer care outside our country to save money at the expense of good service. Your business is handled here in the U.S.A. from start to finish."); Travel Sciences, Inc., *About Us*, at <http://www.travelsciences.com/AboutUs.asp> ("Our solutions are designed and built in the United States of America. We do not offshore to third world countries for cheap engineering labor and profit on their labor without telling you like other companies do. Your technology and proprietary information is safe with us, and any proprietary innovations that you want us to custom develop for your company will not show up with your competitors through some unknown company operating in a country where you are not protected."); ActionMedia.net, *ActionMedia.Net*, <http://www.actionmedia.net/> ("All of our technicians are ranked as TIER 3 engineers, and are located in the USA. You will never have to rely on India for support, NEVER.").

controls applicable, the scalability of operations and potential speed to operations, the availability of governmental incentives (such as the software technology parks in India), the country's infrastructure and potential risks; and the overall effect on cost (including domestic management costs).

C. Negotiation

An outsourcing contract should be a 'living' document that can evolve and be actively managed by the parties, helping to sustain and build the relationship by providing practical solutions to identify and resolve issues at an early stage. The contract should incorporate a clear definition of each party's responsibilities, along with service level agreements, as well as contract management procedure with co-operation, monitoring and reporting procedures, and procedures to identify and deal with changes to the agreement. It should also incorporate an escalation and business continuity procedure, and a clear retransition/exit strategy.

D. Implementation

This stage of the life cycle — when the project goes live — is the one that most commonly causes problems. Success often depends on good preparation, and it is therefore important to have a well-developed implementation plan that includes project managers with clearly defined roles and responsibilities, a defined and clear timetable, a milestone process, and acceptance testing procedures for deliverables.

E. Summary and Recommendations

Outsourcing, and especially offshore outsourcing, has its advantages and disadvantages. The risks are inherent and obvious when one considers that every project involves many parties from all corners of the world, working in various languages and time zones. However, the advantages can far outweigh the risks if the project has been prepared thoroughly, and if the customer outsources certain business operations to the right service provider for the right reasons.

One particularly important aspect is the organisational and legal framework of such IT projects. Typically, outsourcing and offshoring projects are long term

commitments for the customer, and the service provider and the duties and rights of the partners need to be defined. Therefore the outsourcing contract (framework or master services contract and statement of works) needs to address all relevant aspects of the project. The contract also needs to include exit scenarios and exit clauses that assist the parties from the beginning with the retransition of the application. The application must then be backsource to the customer or transferred to another service provider, and the parties must know their rights and duties during that phase of the contractual relationship as well.

Therefore, it is imperative for both parties to think about and negotiate a contractual framework for the outsourcing project that takes into consideration all material aspects of such a long-term business relationship. This article goes on to describe important legal clauses under Indian, British and German law in a comparative analysis. Please take note that the following list is not exhaustive, and that there are many more legal and commercial issues (such as tax, human resources and real property) that need to be addressed in a framework agreement.

III. A COMPARATIVE LEGAL ANALYSIS OF THE MOST IMPORTANT CLAUSES AND LEGAL ISSUES

Every offshoring project by definition deals with partners from different jurisdictions, and needs a solid contractual framework, especially since such projects are often intended for longer periods of time. A comparison of the legal systems in India, the U.K. (specifically with reference to English law) and Germany with respect to IT outsourcing, as well as the contractual frameworks available in each jurisdiction, would thus be helpful at this juncture.

A. Overview of the Different Legal Systems with Respect to IT Outsourcing

1. India

India has a detailed and well-defined legal system in place. The Indian legal system is based on English common law, and is thus governed by statutes, rules and case law. The Indian judicial system has a unified structure, with the Supreme Court, the High Courts and the lower Courts constituting a single

judiciary, the independence of which is guaranteed by the Indian Constitution. Generally, the contract is considered supreme among its parties.

2. The United Kingdom

Under English law there are no laws specific to outsourcing and, save for any contractual restrictions, in general, businesses have complete freedom to outsource on whatever terms they wish. Every outsourcing arrangement will involve a wide spectrum of contractual issues, some of which are discussed in more detail below. In addition to these, the parties to an outsourcing agreement governed by English law must consider the implication of legislations such as the Data Protection Act, 1998 (DPA) and the Transfer of Undertaking (Protection of Employment) Regulations, 2006 (TUPE). The DPA protects the rights of individuals in relation to the use of their personal data. A customer that outsources the processing of personal data remains responsible for any breaches of the DPA by the provider.¹⁰ TUPE protects the rights of the employees of a business being transferred. Where TUPE applies in an outsourcing situation, any of the customer's employees who are engaged in the function being outsourced may, in certain circumstances, automatically transfer to the supplier (along with all related rights, liabilities, and obligations). There are a range of associated rights and obligations. For example, there must be consultation with representatives of the affected employees and such employees are protected from dismissal in connection with a transfer.¹¹ The customer must take all proper measures to avoid breaches of TUPE and minimise cost and disruption to its business. If the customer is regulated by the Financial Services Authority by virtue of being a financial services firm, bank, insurance company or any other regulated financial service provider regulated by the Financial Services and Markets Act 2000, then it must comply with FSA outsourcing regulations, which include taking "reasonable steps to avoid undue operational risk."¹² There

¹⁰ The DPA fixes responsibility on the 'data controller', who is defined in section 1 as "a person who (either alone or jointly or in common with other persons) determines the purposes for which and the manner in which any personal data are, or are to be, processed". Data Protection Act, 1998, § 1.

¹¹ See Transfer of Undertaking (Protection of Employment) Regulations, 2006, § 4-7.

¹² Council Directive 2004/39/EC, art. 13(5), <http://eur-lex.europa.eu/LexUriServ/site/en/consleg/2004/L/02004L0039-20060428-en.pdf> (the Markets in Financial Instruments Directive, which came into force on November 1, 2007, replacing the existing Investment Services Directive); Financial Services

are also widely accepted best practices within the industry, such as exit strategy provisions, which will usually be followed by any party choosing to enter into outsourcing transactions in the U.K.

3. Germany

Pursuant to German law and IT outsourcing, the first and most important distinction that one has to make is between sales contracts (*Kaufvertrag*, governed by § 433–453 of the German Civil Code, known as the *Bürgerliches Gesetzbuch* or BGB), contracts to assist (*Dienstvertrag*, governed by § 611–630) and contracts to perform (*Werkvertrag*, governed by § 631–651). The German courts apply a ‘centre of interest’ analysis to establish which type of contract (and therefore which set of statutory provisions) governs a certain transaction.

If the main duty of the service provider is to grant a licence for a standard software of the service provider, and the customer customizes and installs the standard software himself, then this will be construed as a sales contract, and the German courts will apply the rules for sales contracts laid down in §§ 433–453 of the BGB. If the service provider writes a code for the customer, provides additional services, and is relatively free to decide how he will create and deliver his products/services, then the courts in Germany will most likely decide that it is a contract to perform, and they will apply § 631. In this case, the German Supreme Court, or *Bundesgerichtshof* (BGH), has held that the service provider is responsible for the end result.¹³ This leads to a higher degree of responsibility for the service provider.¹⁴

In most, if not all cases, a complex IT outsourcing relationship will include various duties to be performed by the service provider, and will be construed as a contract to perform services. Ultimately, the service provider must deliver his

Authority, *SYSC Senior Management Arrangements, Systems and Controls* 13.9, http://www.ukregulation.co.uk/topics/FSAH_SYSC_13_9_Outourcing/48714.

¹³ BGH NJW 83, 1489; BGH NJW 02, 749.

¹⁴ The service provider is, for example, responsible for warranty claims of the customer in such a scenario. The customer also has to formally accept the deliverables to trigger the right of the service provider for his remuneration. This is not the case in a ‘services to assist’ scenario, where the only remedy of the customer in such a case is to terminate the contract and where the customer does not have to formally accept the deliverable.

products and services according to the specifications of his client, but he will decide how to best create and deliver these services.

The next legal test under German law is whether the contract is individually negotiated between the parties (*Individualvertrag*), or whether this is a 'terms and conditions' scenario (*Allgemeine Geschäftsbedingungen*¹⁵). Pursuant to § 305(1) of the BGB, a 'terms and conditions' scenario exists where the rules were drafted in advance for a (theoretically) repeated use, and where the party proposing the terms was not willing to negotiate such terms (where the terms were accepted by the other party without negotiations).¹⁶ This distinction is very important under German law, and triggers a different legal review of the contractual clauses by the German courts. If the clauses are terms and conditions in the sense of § 305 of the BGB, then these clauses must withstand a more rigid test by the German courts. §§ 305-310 of the BGB were written to safeguard consumers against unfair contract clauses by large businesses, which are perceived to be in a stronger position to negotiate a contract vis-à-vis consumers. However, the German courts apply some of the same restrictions in a B2B context, and therefore IT outsourcing contracts in a 'terms and conditions' scenario are subject to much more rigid review by German courts.¹⁷ It is therefore imperative for the service provider to discuss its own draft of the outsourcing contract with the German customer, and to keep a record of such discussions. The most common legal structure for complex IT outsourcing agreements is the contract to perform (*Werkvertrag*), on an individually negotiated basis (rather than a 'terms and conditions' basis).

B. Liability

1. India

In India, the issue of damages is covered under §§ 73 and 74 of the Indian Contract Act, 1872. The concept of extra-contractual damages (including

¹⁵ § 305–310 BGB.

¹⁶ BGH NJW 77, 624.

¹⁷ Some of the restrictions are enumerated in § 308-309 BGB. However, any breach of a material provision of the German Civil Code can be annulled by a German court pursuant to § 307(1)-(2) BGB as well. This has far-reaching implications for the parties. Once a part of a liability clause, e.g. the limitation of liability for consequential damages, is found to be in breach of German law, the German

punitive and exemplary damages) is not well established in Indian jurisprudence. Compensation is payable for loss which (a) naturally arose as a result of the breach, or (b) the party knew would arise as a result of the breach.¹⁸ Here, the principle of restitution is applied and the party suffering the loss is compensated so as to put it in the same position as if the contract had been completed. In other words, the measure of compensation is directly related to the measure of loss actually suffered. § 73 itself provides that no compensation will be given for any remote and indirect loss resulting from the breach. This is, however, set to change if a recent ruling by the Delhi High Court is anything to go by. In *Microsoft Corporation v. Deepak Raval*,¹⁹ Justice Sikri not only awarded compensatory and punitive damages, he went on to state:²⁰

In the present case, the claim of punitive damages is of INR 500,000, which can be safely awarded. Had it been higher even, this Court would not have hesitated in awarding the same. This Court is of the view that punitive damages should be really punitive and not flea bite and quantum thereof should depend upon the flagrancy of infringement.

Parties may agree beforehand to a fixed sum payable by the party committing the breach to the other party ('liquidated damages'). In such a case, § 74 of the Indian Contract Act would apply. If the sum agreed to is a reasonable pre-estimation of the expected loss, the court may award the entire sum without insisting that the innocent party prove that the loss actually suffered by it was commensurate. If the predetermined amount has the nature of a penalty, and if the party committing the breach is able to prove that the other party has not suffered any loss despite the breach, the innocent party may not be entitled to be the said predetermined sum.²¹ Even if the party in default is not able to prove this, the innocent party is entitled only to reasonable compensation not exceeding the amount mentioned in the Contract Act. Finally, India also follows

court will set aside the entire clause and apply the statutory German law. For the above example (limitation of liability for consequential damages is invalid), this means that the court will apply the statutory German law, i.e. unlimited liability for the service provider for intent and negligence and for direct and indirect damages. There are many such restrictions under German statutory law.

¹⁸ Indian Contract Act, 1872, § 73.

¹⁹ 2006 (33) PTC 122 (Del).

²⁰ *Id.* at 3174.

²¹ See Indian Contract Act, 1872, § 74.

the principle of mitigation of loss/damages. Therefore, the innocent party is obligated to try and mitigate its losses in the face of the said breach.²²

2. The United Kingdom

The principles governing damages for breach of contract are fundamentally the same in the U.K. as they are in India. The claimant is entitled to be put into the position he would have been in if the contract had been performed.²³ However, the claimant may only recover direct losses, which are those (a) arising naturally from the breach, or (b) as may reasonably be supposed to have been in the contemplation of the parties at the time they made the contract, as a probable result of the breach.²⁴ Furthermore, there is a principle which has developed through English case law over time that the claimant has a duty to mitigate his losses, so he cannot recover damages for any part of his loss which he could have avoided by taking reasonable steps.²⁵

Both user and supplier are usually keen to avoid the uncertainty of legal technicalities, and so limitation and exclusion of liability clauses are the norm. Parties are generally free to do this, except that liability for fraud, death, or personal injury caused by negligence can never be excluded. In most circumstances any restriction on liability for misrepresentation must be reasonable, pursuant to the Unfair Contract Terms Act, 1977 (UCTA), and implied terms as to title to assets cannot be excluded or restricted.²⁶ Certain provisions of the UCTA are excluded in relation to international supply contracts.²⁷ It is common for parties to impose a financial cap on liability. The cap is, of course, a matter for negotiation, and a variety of commercial factors will apply in reaching the applicable cap (not least the bargaining strength of

²² See Indian Contract Act, 1872, § 73, Explanation; *Murlidhar Chiranjilal v. Harishchandra Dwarkadas*, A.I.R. 1962 S.C. 366.

²³ See, e.g., *Surrey County Council v. Bredero Homes Ltd.*, [1992] 1 W.L.R. 1361, applying *Robinson v. Harman*, [1843-60] All E.R. Rep. 383.

²⁴ *Hadley v. Baxendale* (1854) 9 Ex. 341, 355.

²⁵ *British Westinghouse Electric Co. Ltd. v. Underground Electric Railways Co. of London Ltd.*, [1912] A.C. 673, 689.

²⁶ Unfair Contract Terms Act, 1977, § 2(1), 6(1).

²⁷ Unfair Contract Terms Act, 1977, § 26.

the parties). It is also common to exclude liability for certain types of loss, in particular economic loss (e.g., loss of profits, contracts, business, anticipated savings, goodwill and revenues). In the landmark *British Sugar* case,²⁸ it was held that the term 'consequential loss' only refers to foreseeable loss (such loss as may reasonably be supposed to have been in the contemplation of the parties at the time they made the contract, as a probable result of the breach) and does not include direct loss (losses arising naturally, according to the normal course of things, from the breach of contract itself). Therefore, a clause excluding only consequential or special loss would not preclude the recovery of pure economic losses that flow directly from the breach. However, where a service is business-critical, and particularly where it is intrinsic to the customer's ability to generate money, it may be perfectly appropriate to seek to recover lost profit where a service failure impedes that money generation. In addition, under the UCTA a party seeking to rely on a provision purporting to exclude or restrict liability for any other damage or for misrepresentation, where the agreement is made on that party's standard written terms of business, must show that the provision passes a test of 'reasonableness', a factor in which is the relative bargaining strength of the parties. However, the vast majority of outsourcing contracts are individually negotiated, and, where this is the case, any exemption clauses contained therein will not be subject to this test.

In practice, of course, it is unlikely that a customer would wish to sue an incumbent supplier for breach of contract, and therefore the recovery of damages by way of court action is generally unpalatable as an option unless the contract is terminated. It is therefore necessary to have other remedies within the contract, as otherwise the customer risks having no effective control over the performance of the supplier, making his position vulnerable (the supplier, of course, being aware that termination would be a risky and extreme option). Such contractually agreed remedies invariably include an escalation procedure and service credits in the form of liquidated damages. However, there is a wide range of other options, such as re-performance of failed services, services in kind (e.g. free consultancy), specific costs or losses (e.g. costs of wasted advertising or third party substitute services) and partial termination.

²⁸ *British Sugar plc v. NEI Power Projects Ltd.*, [1997] C.L.C. 622 (Q.B.D.).

3. Germany

Pursuant to the statutory provisions in §§ 631, 633 and 634 of the BGB regarding contracts to perform (*Werkvertrag*), the service provider of customised, or individual, software is obliged to deliver software/services that are “free of defects”. In case he does not rectify the defects within a reasonable period of time (set by the ordering party), the vendor may be held liable for damages pursuant to §§ 280 and 281 of the BGB. Furthermore, in regard to the delivery of software, German courts have imposed additional pre-contractual and contractual duties upon the developer of individual software. In the event that the service provider’s knowledge in regard to the requirements, complexity and expenses of the software is superior to that of the ordering party and the service provider is able to identify any shortcomings in the ordering party’s ideas, the service provider has a duty to provide expert advice to the ordering party.²⁹ This is often referred to as ‘expert liability’. The service provider thus has to ask all relevant questions in order to determine the actual requirements of the ordering party. He then has to advise the ordering party regarding the identified specifications of the software. The Cologne Federal State Court (*Oberlandesgericht*, or OLG) has held that this duty also applies in case of ambiguity in the specifications.³⁰ Moreover, the service provider should try to establish a high degree of IT knowledge on the part of the customer in the framework agreement.

The industry standard in Germany is that the service provider is liable without limitation for intentional acts,³¹ or for gross negligence, but also that he can limit his liability for simple negligence. The actual limitation of liability for simple negligence is subject to the bargaining powers of the parties and, at the end of the day, is also subject to a fairness test applied by a German court on a case-by-case basis. That said, the most important issue concerning liability under German law is to establish the difference between simple (limited liability) and gross (unlimited liability) negligence (assuming, of course, that no service provider would intentionally harm a customer).

²⁹ BGH NJW 1985, 1769, 1771; BGH NJW 1984, 2289, 2290; BGH NJW 1983, 2493, 2494.

³⁰ OLG Koeln NJW-RR 1993, 1528.

³¹ See § 309 BGB.

While there are no statutory provisions defining gross negligence, the German courts, in a string of decisions, have developed a detailed concept of gross negligence.³² Gross negligence means “a failure to act or a conduct that is so reckless that it demonstrates a substantial lack of concern for whether damage will result or not.”³³ Gross negligence has to be distinguished from simple negligence. Simple negligence is generally considered as “a failure to exercise the degree of care considered reasonable under the circumstances, resulting in an unintended damage to another party.”³⁴ In short, the distinction between simple and gross negligence is that while simple negligence is a standard of “may happen”, gross negligence is a standard of “must not happen”. German courts have defined the meaning of gross negligence as meaning, *inter alia*, a violation of a duty of care that exceeds simple negligence significantly and is individually inexcusable, a severe disregard for obvious and easily applicable security measures and for the necessary duties of care, the absence of the slightest precaution or alertness, and the disregard of obvious deliberations and of what would have been clear to everyone in the relevant situation.³⁵

There is no precedent of gross negligence in the area of IT or outsourcing projects in Germany. The reason for this is probably that the majority of software contracts and outsourcing projects that were the subject of a legal dispute are high-profile transactions with established market players. Therefore they are mostly resolved through an out-of-court settlement between the contracting parties. Additionally, service providers in Germany usually do not want to be publicly exposed in the courts as having acted in a grossly negligent manner.³⁶ Importantly, the burden of proof to establish gross negligence is on the customer. It is therefore up to the customer to try to establish gross negligence on the part of the service provider by showing that the service provider mismanaged the project or that it used inexperienced developers.

³² OLG Frankfurt VersR 1981, 27, 30; BGH VersR 1970, 568, 569; BAG NJW 1982, 1013.

³³ BGHZ 10, 16; BGH NJW 92, 3236.

³⁴ BGHZ 39, 283.

³⁵ BGH NJW 1984, 789, 790.

³⁶ See § 169 GVG (*Gerichtsverfassungsgesetz*, or the German Court Organisational Act).

C. Warranties

1. India

Indian law implies a number of terms into any contract for goods or services. The Sale of Goods Act, 1930, implies a term that goods shall be of satisfactory quality and fit for their purpose.³⁷ A warranty is a stipulation collateral to the main purpose of the contract, the breach of which gives rise to a claim for damages, but not a right to reject the goods and treat the contract as repudiated. Where a contract of sale is subject to any condition to be fulfilled by the seller, the buyer may waive the condition or elect to treat the breach of the condition as a breach of warranty and not as a ground for treating the contract as repudiated. Thus, in a contract of sale, unless the circumstances of the contract are such as to show a different intention, there is:

- (a) an implied condition on the part of the seller that, in the case of a sale, he has a right to sell the goods and that, in the case of an agreement to sell, he will have a right to sell the goods at the time when the property is to pass;
- (b) an implied warranty that the buyer shall have and enjoy quiet possession of the goods; and
- (c) an implied warranty that the goods shall be free from any charge or encumbrance in favour of any third party not declared or known to the buyer before or at the time when the contract is made. Where there is a contract for the sale of goods by description, there is an implied condition that the goods shall correspond with the description; and, if the sale is by sample as well as by description, it is not sufficient that the bulk of the goods corresponds with the sample if the goods do not also correspond with the description.

2. The United Kingdom

There are no standard warranties in an outsourcing contract, but English law does imply a number of terms into any contract for goods or services. The

³⁷ Sale of Goods Act, 1930, § 16.

Sale of Goods Act, 1979, implies a term that goods shall be of satisfactory quality and fit for their purpose³⁸ and the Supply of Goods and Services Act implies a term that services shall be performed with reasonable care and skill.³⁹ These terms are implied as conditions, which give the innocent party the right to terminate and claim damages, as opposed to warranties, which only give a right to sue for damages. However it is common for all implied terms to be excluded. Where the agreement is on the supplier's standard terms, such an exclusion clause is likely to be held unreasonable and therefore unenforceable under the UCTA, but as mentioned above, this will not be relevant where the contract has been individually negotiated.

There are some areas in relation to which express warranties will often be agreed, such as the standard to which the supplier will perform the services, confirmation of entitlement to enter into the agreement and perform the obligations, confirmation as to the accuracy of information exchanged prior to contract, compliance with the DPA and FSA regulations and the Euro currency compliance of the services or products being supplied. Clearly, however, the parties will seek to tailor warranties to the circumstances of each particular deal.

3. Germany

In the absence of a contractual provision in the framework agreement or statement of work, the warranty issue under German law is governed by §§ 633-639 of the BGB. The service provider is thus required to deliver the product/service free of errors and legal claims of third parties, with a statutory warranty period of twenty-four months. However, the parties are free to contractually agree to a lesser duration of warranty. In a 'terms and conditions' scenario, they can limit the warranty period to twelve months, and in an individually negotiated contract, they can limit the warranty period even further. A typical warranty clause should also address the following issues:

1. What happens if an error occurs: does the warranty period extend automatically, or does it start anew after the error was fixed?

³⁸ Sale of Goods Act, 1979, § 14.

³⁹ Supply of Goods and Services Act, 1982, § 13.

2. What constitutes an error? What are the error classes and how do the parties categorise the errors?
3. When does the warranty period begin?
4. What are the rights of the customer? Can he demand the delivery of a new deliverable? Who can choose the right?
5. What are the limitations? Is the service provider still liable if the customer amends the services or uses the service against the recommendations of the service provider?
6. What are the overall liabilities under warranty?

Generally speaking, the service provider needs to accept responsibility for his deliverables, and the customer needs to understand that there must be a balance between the risk of the service provider and the potential profits. The definition of the obligations and the status of the service provider is an important aspect of a warranty. The service provider therefore has to make sure that the duties are well defined (and that the scope also expressly states what is beyond the scope!) In this respect, it is important to note that the German Supreme Court for Civil Matters has repeatedly held that the service provider has a special obligation as an expert and therefore has to point out if there are insufficiencies in the requirement specifications of the customer.⁴⁰ The parties therefore need to work diligently on defining the scope of the services.

Since missing or insufficient documentation and program descriptions are tantamount to an error in developing the software, the clearer the definition of the scope and the mutual responsibilities, the easier it is for the parties to define an error and to deal with a warranty situation. The service provider has to provide warranty free of charge. This includes all packaging and travel costs and all other costs associated with bug-fixing. Needless to say, there can be a conflict between maintenance and warranty, and the parties also have to describe an error clearly in order to agree if this is an error (e.g., under warranty and therefore free of charge for the customer) or an issue for maintenance.

⁴⁰ BGHZ 102, 135 (the service provider has to assist the customer in defining the requirements and describing the solutions).

D. Intellectual Property Rights

1. India

There are several intellectual property rights principles and statutes that may be relevant in an outsourcing arrangement. Copyright can be transferred from the author to third parties, provided such transfer is recorded in writing.⁴¹ As a general rule, computer programs and methods for doing business are not patentable in India, although computer-related inventions can be patented in some cases.⁴²

2. The United Kingdom

There are several intellectual property rights principles that may be relevant in an outsourcing arrangement. For instance, IPR created by an employee acting in the course of his employment automatically vests in the employer unless otherwise agreed – there is no principle of work-for-hire under U.K. law (as there might be in the U.S.).

As in Indian law, copyright can be transferred from the author to third parties, provided such transfer is recorded in writing.⁴³ However there is also a distinct concept of an author's moral rights, which cannot be transferred. Moral rights include the right to be identified as the author of the work, but it should be noted that these do not apply to computer programs.⁴⁴ As a general rule, computer programs and methods for doing business are not patentable in the U.K., although computer-related inventions can be patented in certain narrowly-defined circumstances.⁴⁵

3. Germany

Unlike most of the common law statutes, German civil law does not allow for a transfer of the copyright itself as stipulated in § 29 of the German Copyright

⁴¹ Copyright Act, 1957, §§ 18-19.

⁴² Patents Act, 1970, § 3(k)-(ka).

⁴³ Copyright, Designs and Patents Act, 1988, § 90(3).

⁴⁴ See Copyright, Designs and Patents Act, 1988, §§ 77-89.

⁴⁵ See *Aerotel Ltd. v. Telco Holdings Ltd.*, [2006] EWCA Civ 1371.

Act (*Urheberrechtsgesetz*), which permits transfer only by inheritance. The reason for this is the civil law concept of *droit moral* (*Urheberpersönlichkeitsrecht*), which is not as common in some of the common law countries.⁴⁶ This principle stipulates that the creator of a copyrighted work has some personal, 'moral' rights, and that these cannot be taken away from him. A clause in an outsourcing contract whereby the service provider transfers the copyright in a certain deliverable is, therefore, void under German law.⁴⁷ Thus, the correct legal mechanism under German law is a licence. The customer will demand a simple or exclusive license to use and exploit the deliverable for a certain period, and in a certain geographical area. Normally, the licence clause will include the following parameters:

- a) Simple or exclusive licence (depending on the software itself; standard versus customised software);
- b) Irrevocable or revocable licence;
- c) Unlimited or limited licence (by time);
- d) Unlimited or limited licence (by geographical reach);
- e) Right to sublicense (or the absence thereof); and
- f) Limited or unlimited rights of the licensee.

One additional question that needs to be addressed in the intellectual property and license clause is the point in time until which the license right is valid. This could be upon the conclusion of the contract, upon the formal acceptance of the deliverable, or upon the payment of remuneration in full. Another issue in this respect is the ownership of the documentation and program descriptions. These rights should also be addressed in an IT outsourcing

⁴⁶ The U.S., for example, expressly stipulates the concept of *droit moral* only in the Visual Artists Rights Act, 1990, and recognises the general principle of *droit moral* to a far lesser extent; in the U.K., such rights are recognised in § 77 of the Copyright, Designs and Patents Act, 1988.

⁴⁷ As in many other countries, software is generally protected by copyright law under § 69 of the German Copyright Act. There are, of course, patents available for some deliverables but the requirement for a 'software patent' is generally speaking much higher than, say, in the U.S.. Databases are also protected under the German Copyright Act in § 87.

agreement, and they should correspond with the IPR clause, in which the service provider should include a provision that he is allowed to use and exploit the deliverable, and that he is free to use all 'pre-existing rights' for other customers and projects. Generally speaking, the customer will try to limit the ability of the service provider to execute similar projects for his competitors, and the service provider has an interest to advance his industry expertise by providing similar projects for numerous market players. This conflict of interest needs to be addressed up front, preferably in the master services agreement itself.

E. Indemnifications

1. India

Indemnity under the Indian Contract Act is a contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself, or by the conduct of any other person.⁴⁸ Damages under Indian law can generally only be recovered for breach of contract if the claimant can prove that the breach caused loss, and to the extent that those losses are direct and have been mitigated. However, these rules do not apply where the claimant relies on an indemnity. In most IT outsourcing contracts, the service provider is expected to indemnify the buyer of services for non-compliance with the specifications given by the buyer to create the software, for any intellectual property infringement of any third party, for any employee-related claims, for any personal injury or property damages, etc.

2. The United Kingdom

As in India, the rule that a claimant can only recover damages for breach of contract if he can prove that the breach caused loss (and to the extent that those losses are direct and have been mitigated) does not apply where the claimant relies on an indemnity, because the claim is for a debt rather than for a breach of contract. As such, indemnities are often heavily negotiated, and often avoided at all costs, in any outsourcing deal where there are likely to be significant potential losses which are too remote to fall within a claim for contractual damages.

⁴⁸ Indian Contract Act, § 124.

In many outsourcing deals, intellectual property rights are either licensed or transferred, and it is standard for the recipient of the rights to be indemnified against any claims or losses resulting from the infringement of any third-party rights by the rights licensed or transferred. Indemnities are commonly tied to the agreed warranties, and so will often cover losses resulting from non-compliance with the DPA, security breaches, and for infringement of third party IPR. Where employees are transferred under TUPE as part of the outsourcing, the customer will generally agree to indemnify the supplier against historic liability in respect of those employees, and, likewise, the supplier will indemnify the customer against any future liability.

3. Germany

In most IT outsourcing projects, the service provider will create individual software for the customer. He will therefore be responsible for the result (error-free software). Since 2002, German law does not differentiate between errors in the deliverable because of factual deficiencies (*Sachmangel*) or legal deficiencies (*Rechtsmangel*). Both have the same consequences: the German customer can first demand rectification, reduce the price, or not pay the price at all. The customer can also correct the error (either himself or through a third party), and also claim damages.⁴⁹

The industry standard in Germany is that the service provider only has to indemnify the customer if the customer (i) informs the service provider about a third-party claim, (ii) assists the service provider against such a claim and (iii) lets the service provider have the final word on how he wants to settle the dispute. Also, the amount of damages payable under the indemnity is usually limited to the same extent as the general limitation of liability.

F. Delay and Penalties

This is always a key area of negotiation. The customer will usually seek multiple penalties for delay, and the service provider will try and limit this. In both India and the U.K., the service provider may want to rely on statutory law requiring the customer to prove actual loss. Since it will often be difficult to

⁴⁹ §§ 434, 435, 437, 633 BGB.

predict the amount recoverable as contractual damages in an outsourcing deal, the parties may try to introduce some certainty by providing for liquidated damages, but, as mentioned earlier, unless the sum specified in such a clause represents a genuine pre-estimate of loss, it will be deemed to be an invalid penalty clause.⁵⁰

The position in German law, however, is rather different. Generally speaking, the parties must agree on the delivery schedule in the contract in order to create a binding obligation for the service provider to keep a certain deadline. Unless stipulated in the contract, dates are generally not binding. However, most German customers will demand a fixed timetable, and these times are then binding for the service provider. Under German law, there is no delay unless (i) the time is fixed (contractually or by law), (ii) the service provider has received a final warning (unless an exception applies, e.g., if the service provider expressly or impliedly states that he will not perform his services), (iii) the service provider is late with the performance of his services, and (iv) he is at fault.⁵¹

The last point is especially important for the service provider. If, for example, the customer committed contributory negligence by not fulfilling one of his own duties under the contract, the service provider can argue that the delay is not attributable to his own fault. The industry standard in Germany on penalties for delay is that the service provider has to accept penalties to a defined amount. German customers are likely to expect that the service provider will accept responsibility for the timeliness of the execution and therefore would focus on the penalty amount rather than on the question of whether penalties will create an incentive for more timely deliveries. As a rule of thumb, a cap for all penalties is negotiable. Additionally, the service provider can try to direct the attention of the German customer to different performance-measuring tools, such as bonuses or other incentives that should safeguard the timely performance of services.

G. Acceptance

Outsourcing agreements generally provide for detailed acceptance provisions to set out the various duties that each party has to fulfil prior to, during, and

⁵⁰ *Dunlop Pneumatic Tyre Co. v. New Garage & Motor Co.*, [1915] A.C. 79.

⁵¹ § 286 BGB.

after acceptance. This is mostly also dealt with in the service-level agreement. Detailed provisions relating to how the services are to be implemented, rolled-out and/or deployed should be included for the sake of prudence. Any outsourcing arrangement should include agreed-upon acceptance criteria and a related acceptance process in order to gauge a successful service roll-out, as there are no particular laws in the U.K. or India relation to such procedures. The user may also want to build in other checks and mechanisms to monitor and influence service quality. These may include rights to survey and investigate service provision on regular occasions, to test service delivery, and to anticipate general satisfaction amongst the user base that relies on or uses the services.

In relation to delay, missing a contractual deadline entitles the innocent party to claim damages for loss, but does not confer a right to terminate, unless non-performance by a certain date is held to be a fundamental breach of the contract. If a party deems the performance of certain obligations to be time-critical, then it should seek an express provision that time is of the essence in relation to those obligations. This would enable the innocent party to terminate (as well as claim damages) for failure by the defaulting party to meet the deadline specified.

As mentioned earlier, German law differentiates between 'services to assist' and 'services to perform'. Acceptance is relevant only in 'service to perform' contracts, where the service provider is responsible for the end result. In such contracts, the customer must formally accept the deliverable. Acceptance is defined as the physical handing over of the deliverable together with a declaration by the customer that the deliverable essentially corresponds with the agreed scope. The service provider should direct all his attention to this point, and should try to make the customer accept the deliverable at the earliest time, as the legal consequences of the formal acceptance are very important for the service provider. The warranty period only begins after formal acceptance, and if there is no such acceptance, the customer does not have to pay for the services.⁵² That said, it is of no advantage to the customer to sign the formal acceptance protocol. A possible solution is to include a deemed acceptance provision, stating that the deliverable is deemed to have been accepted if the

⁵² § 641 BGB.

customer uses the deliverable for a certain time or does not sign the formal acceptance protocol although there are no major errors in the deliverable. However, it is still imperative for the service provider to define various error classes and to make sure that this mechanism can be used to ensure an early acceptance.

H. Duration

Generally speaking, all outsourcing contracts stipulate a certain duration, and are then either renewable or expire upon that date. There are no rules in respect of the term of outsourcing contracts in India or the U.K. The term is simply a matter for negotiation and depends on the nature of the work outsourced, although longer terms (five to ten years) can be common, given the amount of business disruption involved, the protracted supplier involvement, and management requirements as the deal is implemented. Although a contract can usually be terminated immediately in India and the U.K. in certain statutorily specified cases, it is usual for the parties to set out specific events that give rise to a termination right. These will generally include material breach (with a period during which the breaching party is first given the opportunity to cure the breach), minor but persistent breaches, change of control (i.e., effective ownership) of the supplier and insolvency (where a definition of insolvency is agreed upon). It is also common for the customer to negotiate a right to terminate for convenience, or 'without cause'. This will inevitably involve the customer having to pay a termination payment to compensate the supplier for wasted costs and loss of expected profits. It is important to remember that, unlike in India, contractual claims can be brought up to six years after breach in the U.K.⁵³

In Germany, while, the parties are generally free to agree upon any term they wish, the customer will usually ask for an initial period and a right to extend this period perpetually, thus (hopefully) influencing the quality of the service provider. This also makes sense for the service provider, as he will not be in a position to legally force the customer to stay with him forever. In most instances, the parties will agree that the master services agreement will be for

⁵³ Limitation Act, 1980, § 5.

an indefinite period of time, or that it will be for a definite period extendable at the option of the customer. (The parties should also include provisions in the contract that deal with the question of what happens to an existing statement of work in case the master services agreement is validly terminated and vice versa.) German law differentiates between a normal termination right (*Einfache Kuendigung*, which always requires a notification period for the termination to be effective) and a termination for important reasons.⁵⁴ In most cases, the parties agree to a reasonable notification period for the normal termination (e.g., three months from the termination notice). German law also stipulates that the customer can terminate the agreement at any time prior to the completion of the deliverable, but in these cases the customer still has to pay the full contractual remuneration to the service provider, minus any saved costs.⁵⁵

Naturally, the parties will disagree on the saved costs to the service provider, and this will often lead to a long negotiation about the right amount of payment for the customer's premature exit. To be able to terminate the contract without waiting for the end of such a notification period, the customer needs to show an 'important reason'. An 'important reason' is defined by the German courts as a reason so imperative that the party affected cannot be expected to wait until the end of the normal notification period.⁵⁶ However, this depends entirely on the individual facts of the case at hand,⁵⁷ and therefore it is almost always impossible to predict whether or not the breach of the other party can justify a termination for an important reason.

I. Retransition

Outsourcing relationships are very complex and personal arrangements, in the sense that the customer is looking very hard to find the right partner, and is trying to make sure that it will be a long-lasting relationship. The investments on both sides are thus quite significant (negotiating the framework agreement, transition of the system, transfer of know-how and employees). Therefore, most

⁵⁴ § 626 BGB.

⁵⁵ § 649 BGB.

⁵⁶ BGH NJW 1993, 463; BAG NZA 94, 74 (German Supreme Court for Employment Matters).

⁵⁷ BAG NJW 85, 1853; BAG NZA 06, 491 (German Supreme Court for Employment Matters).

good outsourcing agreements also deal with the issue of retransition, and stipulate rules regarding how the parties will deal with each other once the contractual relationship ends and the system is transferred back to the customer or a third service provider, especially since parties usually do not want to involve the court in retransitioning the service and/or dissolving the contractual relationship.

Closing an outsourcing relationship is complex and time-consuming. Staff, contracts and assets may have to be reallocated, and in the U.K. staff may transfer under TUPE, regardless of any agreement between the parties. As well as being time-consuming, the exit procedure can be expensive, and it is prudent to set out how these costs are to be shared while the parties remain on good terms. It is common to see the agreement contain an exit plan, or a contractual obligation to agree and update an exit strategy throughout the life of the agreement. The retransition clause will expressly state what the mutual rights and obligations shall be upon the termination of the contract, and how long the service provider will be available for the customer or the new service provider to effect the transition. Generally, the retransition clause stipulates that the service provider will be available for one or two more releases of the software, and that during that period the responsibility for the system gradually shifts back to the customer or the new service provider. It also addresses issues such as availability of the project team during transition and the costs for such a transition. The user will usually argue that cost should follow fault, and that the supplier should be liable for exit costs when it is in breach of contract. Where there is no fault, costs are usually shared.

J. Summary

From the above legal analysis it is obvious that the three legal systems examined have substantial similarities as well as differences. Unsurprisingly, the Indian and English legal systems are very similar. On the other hand, the German civil law system deals with these issues differently, and has a different starting point; the German statutes and the concepts of *Werkvertrag* and *Dienstvertrag*. Above all the national legal systems, there are also international agreements and legal theories that can also play a role in finding the right answer to a specific legal issue.⁵⁸

⁵⁸ See, e.g., United Convention on Contracts for the International Sale of Goods, *opened for signature* Apr. 11, 1980, 19 I.L.M. 671 (entered into force Jan. 1, 1988).

IV. CONCLUSION

Although very mature in some markets (especially the U.S. and, to a lesser degree, the U.K.), outsourcing and global sourcing are still in their infancy. There are quite a few central European and other markets that are virtually untapped by the outsourcing phenomenon. Outsourcing transactions and global sourcing initiatives are also becoming larger and more complex, as evidenced by the rise of the BPO market. Transactions are more global in nature, and more aspects of businesses are being outsourced. Multinational companies are not just outsourcing an aspect of their business in one jurisdiction, but are more likely to look at this from a global perspective. In terms of the outsourcing transaction, this means bigger rewards – and ultimately, bigger risks. Therefore, contracts have to be precise enough to deal with the various legal, technical, and operational issues, and at the same time flexible enough to leave room for development. Outsourcing relationships are by nature long-term relationships where trust and co-operation between the partners are required attributes and also necessities for success. Furthermore, various legal systems are involved in transactions such as offshoring and thus must be taken into consideration. The differences between the various legal systems need to be taken seriously, and the parties should make sure that the contractual relationships will withstand the test of all jurisdictions involved and comply with all legal requirements from the various supervisory institutions in those jurisdictions.

However, this does not mean that parties cannot structure their transactions in a way that safeguards them against risks associated with multi-party and multi-jurisdictional transactions and satisfies the compliance officers in both organisations. The parties are ultimately working on a common project, and a security or compliance problem will always affect both parties. This should motivate them to start the transaction on a solid legal basis and manage it closely. If the industry is not hit by any more security or compliance scandals, the market for outsourcing and global sourcing will continue to grow substantially over the next few years, benefiting both customers and service providers.