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Legal issues in technology outsourcing arrangements

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Technology outsourcing arrangements are becoming more and more widespread. Commercially, they can allow businesses to save money while at the same time improving the quality of IT services.

But these arrangements also raise a number of legal issues for both vendors and customers. Depending on the specifics of the outsourcing, the contracts may involve agreements for consulting, software development, licensing, implementation and maintenance among others. The following are some of the issues that may be of concern when negotiating technology outsourcing agreements.

When the outsourcing involves a licensing component, attention must be paid to precisely what is being licensed and the rights and obligations of the licensor and licensee. For example, regarding a software licence, the customer should consider whether the terms of the licence are sufficient to allow him actually to use the licensed software for the intended purpose.

If the customer will need to make improvements or other modifications to the licensed software, he should ensure the licence terms allow for that. On the other side, the vendor will want to make certain the agreement includes provisions that sufficiently protect the intellectual property being licensed.

In situations where the vendor is to provide maintenance or other support, service-level agreements are important. Among other standards, these stipulate the times within which the vendor is contractually obligated to respond to requests to fix bugs or deal with other problems that may arise. Often, the specified response time frames differ, depending on the severity of each problem.

Service-level agreements are helpful to both parties in that they function to achieve a mutual understanding on response times and what actions the vendor will take when problems are reported. The agreement may also specify liquidated damages to be payable when the vendor is late or otherwise fails to meet these obligations.

Another issue involves modifications and enhancements a customer may request that go beyond the scope originally agreed. While there are a number of commercial arrangements that can deal with these, it is generally important to agree, from the beginning, that such modifications and enhancements shall be made only pursuant to a written change order signed by both parties.

The change order should clearly describe the scope of the modification or enhancement to be made and should clearly set out the price to be paid for the change. This helps to ensure both parties have a common understanding regarding deliverables and costs.

When contracting with a vendor's local subsidiary, some customers are concerned about the ability of the subsidiary to fulfil its contractual obligations. Some of these concerns can be addressed by a letter of guarantee from the parent company of the local subsidiary.

The wording typically provides that the parent company will perform, or cause to be performed, the obligations of the local subsidiary in the event the local subsidiary fails to do so.

Following a failure to perform, the customer will give notice to the local subsidiary to perform, and if the local subsidiary still fails to perform, the customer will then make a demand on the parent company, under the letter of guarantee.

In some outsourcing arrangements, there are major barriers to switching vendors. When significant development and customisation is required to put a new system in place or significant time or expense is otherwise involved in switching to a new vendor, the incumbent vendor is in a good position to demand price increases in future years.

For this reason, it is important to agree in advance how pricing adjustments in future years will be handled. Some contracts are written to include a numeric percentage increase to be applied on a particular schedule _ perhaps at the beginning of each calendar year or the start of every three contract years, for example. Others are written to be adjusted in alignment with a particular consumer price index.

On a related issue, careful consideration should be given to termination clauses. While the parties may easily agree that either party should have the right to terminate the agreement following a party's failure to cure a material breach, there may be concerns about a party's ability to terminate for convenience.

Whether it is appropriate to allow termination for convenience depends largely on the nature of what is being outsourced. In mission-critical installations, presumably the customer will not want the vendor to be able to terminate so easily. On the other hand, the customer will likely want some ability to terminate for reasons other than breach _ for example, in the event of selection of a replacement vendor.

A related issue is the amount of notice to be required in the event of termination. At the very least, the agreement should be written to provide notice that gives sufficient time to arrange for a new vendor to put in place a replacement system.

Thought should also be given to what will happen if the vendor goes out of business or otherwise stop supporting the technology. In installations that are critical to the customer's ability to operate, a lack of support could be quite problematic. For this reason, many customers opt for source code escrow agreements. In arranging these, particular attention should be given to the terms of release and the identity of the selected escrow agent.

These are but a few of the important issues that may need to be addressed in contracts that provide for technology outsourcing. Of course, the specific issues of concern will vary, depending on the nature of what is being outsourced. For this reason, both customers and vendors should take the necessary steps to ensure they have a full understanding of the legal issues and their options for structuring the transaction.

This article was prepared by David Duncan, a consultant in the Corporate and Commercial Department at Tilleke & Gibbins. Please send comments to Andrew Stoutley at andrew.s@tilleke.com