

# 10 Critical Considerations for Your BPO Contract

## ***1. What Services are to be performed?***

Although it may seem obvious, the parties to a BPO contract need to perform thorough due diligence on each other and describe in extensive detail the services to be performed by the service provider, together with the customer's role and responsibilities. Many BPO projects involve the management of financial documentation or the delegation of responsibility over processes that could affect the customer's financial reporting. Under Section 404 of the Sarbanes-Oxley Act (the "Act"), public companies must annually assess and report to the Securities and Exchange Commission (SEC) on the effectiveness of their internal controls *over* financial reporting, including their *service providers'* applicable controls. Outsourcing customers subject to the Act must not only understand and document what services will be performed, but also what controls the service provider has in place and whether those controls are effective in properly authorizing, recording and reporting transactions that affect the customer's financial reports.

Regardless of whether the Act applies, Customer employees responsible for the functions to be outsourced should take an active role in developing the scope of services. Beware this process may prove difficult and frustrating. Customer employees will need to think about and document their daily activities and responsibilities associated with the outsourced function. However, the parties' efforts at this stage will prove *very* beneficial as the contract is prepared and the outsourcing arrangement is implemented.

## ***2. What happens if a Change in Services is required?***

The BPO contract should be a flexible agreement - one able to withstand the test of time and changing circumstances. Consider the following events that could affect the scope of services:

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- A change in applicable laws, rules or regulations or industry best practices that affects the nature or quantity of the outsourced services. For example, consider a situation where a mutual fund company outsources its fund accounting and administration services. Today, as a general rule, the net asset value of a mutual fund is required to be computed once each trading day at the close of trading. What if the regulations change to require multiple net asset value computations per trading day? Imagine the impact on the provider's cost structure.
- A significant change in services requested by the customer's end-users. How will the proposed change be analyzed? Will the provider be required to implement the change? Will there be an impact on fees, service levels and other performance criteria?
- Changes in the customer's underlying business, such as product additions or withdrawals, acquisitions or dispositions of business lines, and other effects on the nature or quantity of services required.

Although it is impossible to accurately predict all changes that may impact the outsourcing contract, the well-drafted contract will include a framework under which the parties can address changed circumstances in a fair and even-handed way, using appropriate procedures and relationship governance protocols.

### 3. Service Levels

Service levels are specific measurable performance standards for the outsourced services that detail exactly what is expected of the service provider in the performance of such services. In developing service levels for a BPO agreement, it is imperative to set a realistic baseline for performance, which should ideally be derived from the existing performance metrics associated with the business.

The service levels should require continuous performance improvements over the term of the contract to motivate the provider to enhance service quality and take advantage of improvements in technology and capabilities. The form,

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frequency and nature of reports, scorecards and other measurement tools should be stated clearly in the contract, as should the procedures for resolving service level failures; so should the timing and format of meetings between the parties to discuss performance and other relationship issues.

### **4. Service Level Credits and Bonuses**

Service-level credits are specific amounts that will serve as credits against fees payable by the customer upon the provider's failure to meet one or more service levels. The credits should be set high enough to encourage the provider, and should escalate based upon the frequency or severity of the failures.

A critical consideration not to be overlooked here is whether or not the credits constitute the customer's exclusive monetary remedy for the provider's failure to meet the service levels. If the service-level credits are an exclusive monetary remedy, the customer should ensure that the credits roughly approximate the anticipated damages associated with the service-level failure. In addition, the customer would be well-advised to include a right to terminate the contract if the service provider "consistently fails" to meet stipulated service levels. For their part, providers sometimes seek reciprocal treatment on service-level performance, arguing that if the provider exceeds expectations, the provider should be eligible for a service-level bonus.

### **5. Pricing Issues; Audit Rights**

The parties should fully understand the pricing structure in the BPO contract. What portion of the fees is fixed and what portion is variable? If variable, what factors will be used to determine fees payable, and when will adjustments apply? How will out-of-pocket expenses be addressed, especially if the expenses benefit the service provider's other customers? Finally, the fee section should be flexible enough to handle the service changes described *above* to compensate the provider when appropriate.

The customer should have the right to inspect and audit the books and records of the provider to verify the provider's compliance with the contract in regard to fees, expenses and other matters. For customers subject to the Act,

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consider whether the contract should require the service provider to undergo an SAS 70 (which covers service agreements for third parties) Type II examination at least annually. Moreover, the customer should seek the right to review the provider's SAS 70 Type II reports and otherwise assess the effectiveness of the service provider's internal controls over financial reporting in relation to the outsourced services.

### **6. Subcontracting by Service Provider**

The service provider will often request the right to subcontract to third parties, which is generally acceptable as long as the provider remains liable for the subcontractor's performance or non-performance. For many reasons - including, with respect to public companies, concerns over compliance with their obligations under Section 404 of the Act customers may be reluctant to allow large-scale delegation of services by the provider. That is especially true if the outsourced functions relate to critical aspects of the customer's business, including financial reporting obligations, or the customer has concerns about maintaining the confidentiality of its or its customers' data or personal information.

### **7. Standard of Care**

What should be the standard of care for measuring the provider's performance? Should there be an overlay of liability beyond service-level credits for negligence (the failure to use such care as a reasonably prudent and careful person would use under similar circumstances) or gross negligence (the intentional failure to perform a duty in reckless disregard of the consequences)? Providers often resist a negligence standard, saying it imposes too great a burden.

### **8. Limitations on Liability and Exclusions**

Contract discussions with regard to limitations on liability generally focus on two areas: qualitative limitations and a quantitative cap on liability. A qualitative limitation refers to an exclusion of claims under the BPO contract for consequential, indirect, special, incidental and punitive damages. A quantitative

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cap on liability refers to an absolute aggregate amount of liability that a party will be required to bear under the contract. The cap usually resets annually.

Exclusions to these limitations are often heavily negotiated. Common exclusions are:

- Amounts that are paid by an indemnitee in respect of an indemnifiable third-party claim (such as, consequential damages paid by an indemnitee to a third party should be recoverable against the indemnifying party, even though recovery of consequential damages is otherwise prohibited).
- Indemnification associated with fraud, willful misconduct or infringement of another's intellectual property by the indemnifying party.
- Breach of the confidentiality or record retention provisions in the BPO contract by the other party.

### 9. *Dispute Resolution*

If the parties to the BPO contract have a dispute, the contract should clearly stipulate the dispute-resolution procedure. Will the parties be required to escalate the dispute within their organizations before triggering the formal dispute-resolution procedure? Are mediation and/or arbitration more appropriate for what is likely to be a technical and fact-intensive dispute? Or does the court system offer the best method for dispute resolution, and, if so, what is the appropriate venue?

### 10. *Exits and Transition*

The BPO contract should specify the term of the contract and termination right trigger events. Typical termination events include those listed in the Table below.

<b><i>Events That Should Trigger Termination</i></b>
<ul style="list-style-type: none"><li>• Insolvency and related events affecting the other party;</li></ul>

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<ul style="list-style-type: none"><li>• A material breach of the contract by a party which remains uncured after a stipulated cure period;</li></ul>
<ul style="list-style-type: none"><li>• Provider's "consistent failure" to meet the service levels;</li></ul>
<ul style="list-style-type: none"><li>• A force majeure that has a material impact on the performance of the service for a minimum period (usually this is a termination right for the customer only, and force majeure event should not relieve the provider for activating a disaster recovery or business continuity plan if otherwise part of the agreed-upon services); and</li></ul>
<ul style="list-style-type: none"><li>• Customer's right to terminate for convenience (although this right, if exercised, is often accompanied by a large payment to the provider to compensate it for the capital outlays associated with the project and a reasonable amount of lost profit over the full contract term).</li></ul>

If the contract renews for successive terms automatically, either party should have the right to provide a notice of non-renewal. Upon the contract's expiration or termination, the customer should be eligible to receive transition services and cooperation from the provider to enable the customer to smoothly and efficiently transfer the services to another provider or to internalize the outsourced function. A maximum period for the transition should be set to encourage the parties' separation, and the provider may seek an escalation of fees over the course of the transition period to create a strong incentive for the customer completing the transition. Consider what rights or assets will be critical to a successful transition, such as rights to intellectual property, leased space or equipment; the customer should address these matters as a part of the transition services to be performed by the provider.

You don't have to be a BPO novice to run afoul of these issues. It behooves all new or long-time BPO customers to examine their contracts and make sure that these issues have been properly addressed.

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**Reference:** Howard T. Spilko and Kevin Colangelo. (April, 2005). Financial Executive.

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