Outsourcing
Global

Offshoring:
Managing Risk in Global Sourcing

Michael S. Mensik

2009

Baker & McKenzie

Baker & McKenzie has been global since our inception. It is part of our DNA.

Our difference is the way we think, work and behave – we combine an instinctively global perspective with a genuinely multicultural approach, enabled by collaborative relationships and yielding practical, innovative advice. With 3,900 lawyers in 39 countries, we have deep understanding of the culture of business the world over and are able to bring the talent and experience needed to navigate complexity across practices and borders with ease.

Table of Contents

Executive Summary

Offshoring is an inherent feature of today's extended enterprise that manifests itself at increasingly deeper layers of the organization. The growth of offshoring may have slowed in recent times, but it has not stopped and will re-accelerate on the back of enterprise imperatives to reduce costs and improve efficiency. In this environment, it becomes even more critical to manage risk. Risk management is an ongoing process that recognizes key risks change over time and control activities must continually adapt to such changes. This article discusses some of the most pressing current risks: potential insolvency or other business interruption in the supply chain; bribery, fraud or other corruption committed by agents of the enterprise in the conduct of its business; increasingly aggressive challenges by tax authorities of how global profits are allocated among members of an extended enterprise; and possible new restrictions on global workforce mobility. It also explores the importance of implementing appropriate control activities in the context of legal process outsourcing, one of the latest extensions of the offshoring phenomenon whose impact remains to be seen.

Offshoring:
Managing Risk in Global Sourcing

> *"Organizations are leveraging capabilities around the world to improve their operations and the products and services they deliver to their customers. Offshoring began with manufacturing, but over the past few years it has quickly spread to information-based work. The result is that most of the work of the modern organization is now 'place-less.' Just as offshore manufacturing increased the amount and quality of products we enjoy while simultaneously reducing prices, the same is happening as these new areas go offshore."*[1]

Michael Corbett, author of a forward-looking book about outsourcing, *The Outsourcing Revolution – Why It Makes Sense and How To Do It Right*, wrote these words sometime back in 2004 – five years ago now. "[N]ew areas go[ing] offshore." What were they then? What are they now? How have these offshored activities grown and changed in the last five years? Some answers lie in the opening paragraphs of Sajai Singh's companion article, *Offshoring to India: A View in the Economic Downturn*.[2] Even in a period of economic downturn, Sajai observes, Indian service providers are focusing on various new areas, such as R&D, product development and legal outsourcing. Did Michael Corbett foresee back in 2004 that these areas too would ultimately be offshored? And if we place ourselves five years hence – in 2014 – what other areas will have been "offshored" by then?

Offshoring is nothing new, but its scope continues to expand and morph as the world becomes ever more "flat." It does not appear to be going into reverse gear, despite recent economic turmoil and shifting political tides. Its growth may have temporarily slowed. Yet it is still growing, and this growth will inevitably re-accelerate. Enterprises (and governments) around the world are seeking to trim costs; the work force in most of the developed world is aging; countries like India offer a growing supply of well-educated labor at reasonable prices; and communication technologies only become faster, cheaper and more ubiquitous with each passing day. For these and other reasons, managers are likely to drive their enterprises to offshore more business activities over time, not less, despite political pressures to "keep jobs in America."

Offshoring is likely to continue growing for a variety of reasons. In the coming years, more activities of more types will be performed in an increasing number of countries, whether by so-called "captives" or third party service providers. However, the essential nature of offshoring has also been changing in important ways that must be recognized in order to place this phenomenon in proper historical perspective: offshoring no longer necessarily just means re-locating an entire business function (e.g., manufacturing product X) from the United States to another country; instead, it increasingly involves disaggregating business processes ever more finely and shifting discrete process steps (even a customer-facing step) to offshore locations. The offshore captive or service provider then performs these steps as part of a globally integrated effort that involves multiple inter-dependent players operating in close collaboration from various locations around the world. Here, the lines between external providers and internal shared service centers begin to blur.

There are various examples of this more collaborative form of offshoring ("co-shoring"). Insurance companies have reportedly hired service providers in India to monitor elderly clients in the United

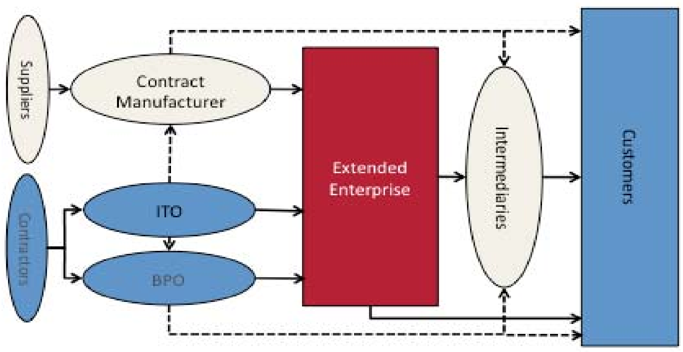
[1] Michael F. Corbett, *The Outsourcing Revolution – Why It Makes Sense and How To Do It Right*, Dearborn Trade Publishing (2004), p. 55.

[2] Sajai Singh, *Offshoring to India: A View in the Economic Downturn,* Outsourcing and Offshoring 2009: Meeting New Challenges, Practicing Law Institute, Chicago – September 21-22, 2009, San Francisco, October 22-23, 2009, New York City, November 2-3, 2009.

States. According to The New York Times, "[e]ast of New Delhi, on a corporate campus that was once farmland, dozens of Indian doctors, nurses and pharmacists are scheduling checkups for patients in the United States and monitoring clinical trial data for some of the world's biggest pharmaceutical companies."[3] Or, consider what is occurring in our industry: legal process outsourcing ("LPO"). My law firm, for instance, recently hired an Indian LPO provider to help review millions of email and other documents under tight deadlines in connection with a global FCPA investigation that lasted for many months. Although situated halfway around the world, this offshore diligence team was no less integral to the investigatory process – or closely supervised – than our onshore in-house team.

The modern enterprise, therefore, is becoming increasingly "extended" – not only does it operate globally; it is increasingly dependent on third party players to perform everything from entire business functions to discrete process steps. These players may include suppliers, contract manufacturers and assemblers; service providers across the ITO/BPO/KPO spectrum; and agents, brokers, distributors, resellers and other intermediaries of various kinds. These players, in turn, may depend on yet other players to fulfill their obligations to the extended enterprise. Managing this web of inter-dependent relationships resembles leading an orchestra, where some significant portion of the music invariably is being played offshore.

Inter-dependencies of an Extended Enterprise



The extended enterprise faces certain imperatives in today's economic climate. Perhaps the most urgent are reducing costs, improving efficiency, and managing risk. How do these imperatives impact offshoring within the extended enterprise? How might its offshoring activities and initiatives change in the future under the weight of these imperatives?

A. Reducing Costs

Reducing costs is commonly cited as the key driver for offshoring. In his recent article, *Getting Serious About Offshoring in a Struggling Economy*, Professor Arie Y. Lewin of Duke University's business school writes: "a renewed and increased emphasis on 'taking out costs' continues to be the most essential strategic driver for continuing with plans to expand existing outsourcing projects offshore as well as initiating new projects."[4] A survey conducted by the business school found that "labor cost savings have become even more important."[5] As will be revealed below, offshoring involves many other obvious and some "hidden" costs that need to be considered in determining

[3] *India Feels Less Vulnerable as Outsourcing Presses On*, The New York Times, June 3, 2009.

[4] Arie Y. Lewin, *Getting Serious About Offshoring in a Struggling Economy,* Shared Service News, February 2009, p. 19.

[5] *Id.* at p. 20.

actual savings.[6] In addition, labor costs are not static – recall the frequent reference to Indian wage inflation prior to the recent economic downturn? In any case, as a general proposition, Professor Lewin's conclusion – that reducing costs will continue the offshoring drive despite current political tides – is difficult to dispute.

B. Improving Efficiency

Eliminating inefficiency perhaps lies just below reducing costs as the most common imperative in today's economic climate. According to Professor Lewin, enterprises that have outsourced offshore will seek to increase efficiency by "improving coordination and integration of their offshoring processes."[7] Business processes will be scrutinized, streamlined and optimized; service levels will be reconsidered, reshaped and perhaps eased to allow for some additional cost savings; governance structures will be rethought and reinvigorated to better manage offshore captives and service providers and more effectively monitor performance; some functions may be in-sourced, re-sourced or otherwise consolidated; etc. These types of efforts are clearly now underway at many enterprises. In some instances, reduced consumption levels have triggered contractual obligations to renegotiate (or "equitably adjust") existing contracts. In other cases, this dialogue has been commenced as a matter of urgent economic necessity on the part of the customer, service provider or sometimes both, regardless of whether or not the contract contains a trigger or provides any relevant guidance.

C. Managing Risk

The third critical enterprise imperative is to manage risk. Risk is difficult enough to manage in a largely self-contained enterprise, where most critical business functions are performed within the four corners of the organization. The challenges are greater in an extended enterprise that relies on multiple parties around the world to conduct its business. According to some commentators, moreover, the risks associated with offshoring have risen dramatically in recent times. In a recent study, *2009 The Year of Outsourcing Dangerously*, Black Book Research observed that until recently "[g]lobalization aggressively chased the cheapest offshore delivery location"; however, "[t]he events of 2008 have irreversibly changed risk/reward calculations. Destinations of offshore processes and technology now dictate in-depth evaluation."[8] Black Book Research then identifies a range of factors that should be considered when selecting an offshoring destination:

- Local strife and obstructive forces to capitalism.
- Corruption and organized crime.
- Transnational and geopolitical issues.
- Unstable currency.
- Personal crime rate and police to citizen ratio.
- Unsecured and unprotected networks, infrastructure, technology and telephone.
- Uncontrolled environmental waste and pollution.
- Terrorist or rebel target threats.
- Legal system immaturity.
- Weather and climate hazards.

[6] See, e.g., *China's Eroding Advantage*, Businessweek, June 15, 2009, p. 54: "A growing number of companies are moving beyond the usual considerations of labor and raw material costs in deciding where to produce goods to calculate the 'total cost of ownership.' That means tallying expenses associated with things such as storage and delays."

[7] Arie Y. Lewin, *supra* note 3, p. 20.

[8] *2009 The Year of Outsourcing Dangerously*, Black Book Research, http://www.theblackbookofoutsourcing.com/docs/2009%20Year%20of%20Outsourcing%20Dangerously.pdf.

Managing risk obviously involves much more than selecting the most appropriate offshoring destination. In that regard, Black Book Research does offer "15 key steps to mitigating current global business threats." For example, conduct thorough due diligence on prospective providers; understand the provider's policies, procedures and controls; create a crises contingency plan; have a plan for bringing the operations back in house; invest in governance; closely monitor performance; etc. This checklist is helpful, but more rigorous analytic frameworks are available to assess and manage risk in offshoring; in particular, the COSO Enterprise Risk Management ("ERM") Framework, and the FFIEC's Outsourcing Technology Services IT Examination Handbook.

1. COSO ERM Framework

COSO is an acronym that stands for The Committee of Sponsoring Organizations of the Treadway Commission. This private-sector organization was established in 1985 to study the causal factors of fraudulent financial reporting.[9] COSO, therefore, did not originally focus on risk management; instead, it focused on internal control systems and their effectiveness. COSO released its first report, *Internal Control – Integrated Framework*, in 1992. Three years later, the Auditing Standards Board of the American Institute of Certified Public Accounts ("AICPA") endorsed the internal control framework contemplated in this report with the release of SAS 78, an auditing standard that essentially mandated its use.[10] SAS 78 was subsequently endorsed by the Public Company Accounting Oversight Board ("PCAOB") after it assumed responsibility for setting auditing standards from the AICPA under the Sarbanes Oxley Act ("SOx").

The 1992 COSO report essentially sets forth a common framework for defining internal control and a procedure for evaluating the control activities. Specifically, it defines internal control as "a *process*, effected by an entity's board of directors, management and other personnel, *designed to provide reasonable assurance* regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; *reliability of financial reporting*; and compliance with applicable laws and regulations."[11] This definition formed the basis of the internal control assessment contemplated under Section 404 of SOx. Moreover, it became the springboard for COSO's next, more ambitious endeavor (which commenced before the enactment of SOx): establishing a common framework for defining risk management. In 2001, COSO retained PricewaterhouseCoopers ("PwC") to develop an ERM framework. PwC released the final report, *Enterprise Risk Management – Integrated Framework*, three years later in September 2004.

Like the 1992 report, the 2004 report begins by defining its subject matter – in this case, a risk management framework:

> "Enterprise risk management is a *process*, effected by an entity's board of directors, management and other personnel, applied in a strategy setting and across the enterprise, *designed to identify potential events* that may affect the entity, *and manage risk* to be within its risk appetite, *to provide reasonable assurance regarding the achievement of entity objectives*."[12]

[9] See, http://www.coso.org/aboutus.htm. The sponsoring organizations are the American Accounting Association, American Institute of Certified Public Accountants, Financial Executives International, Institute of Management Accountants, and The Institute of Internal Auditors.

[10] See, Robert R. Moeller, *COSO Enterprise Risk Management – Understanding the New Integrated ERM Framework*, John Wiley & Sons, Inc. (2007), pp. 17-18.

[11] *Internal Control – Integrated Framework*, The Committee of Sponsoring Organizations of the Treadway Committee, New York, 1992, emphasis added.

[12] *Enterprise Risk Management – Integrated Framework*, The Committee of Sponsoring Organizations of the Treadway Committee, New York, 2004, emphasis added.

Based on this definition, COSO framed an ERM model. It has three dimensions: four vertical columns representing an enterprise's risk management objectives; eight horizontal rows representing the discrete steps of a risk analysis; and an essentially unlimited set of entity-level organizational dimensions at which this two-dimensional risk analysis can be applied. For simplicity's sake, this last dimension is not graphically illustrated below; it is less relevant to this discussion.

COSO Enterprise Risk Management

	Strategic Risk	**Operational Risk**	**Reporting Risk**	**Compliance Risk**
Environment	Risk appetite			
Objectives	Mission statement			
Events	Internal/external			
Assessment	Likelihood/impact			
Response	Avoid, reduce, share, accept			
Controls	Design/tests			
Communication	Tools/dashboards			
Monitoring	Reports/audits			

As shown above, the COSO ERM model distinguishes among four types of risk: strategic; operational; reporting; and compliance. Strategic risk is the possibility that the enterprise may not achieve its strategic objectives; for example, its offshoring initiative fails to generate anticipated cost savings. Operational risk is the possibility that a critical step or process within the enterprise may fail; for example, network connectivity with the enterprise's Indian captive is lost. Reporting risk is the possibility that financial or non-financial data may not be communicated accurately or timely within the enterprise or to outside parties; for example, a provider's service level performance at a remote facility is not reported in time to claim an available credit. Compliance risk is the possibility that the enterprise's activities may not be conducted in accordance with applicable law and regulations; for example, its offshore application development and maintenance ("ADM") provider uses the enterprise's controlled technology in discharging assignments for its Iranian customers in violation of the U.S. export control rules.

After identifying a particular risk, whether strategic, operational, reporting or compliance, the risk can then be analyzed using the model's methodology. The analysis begins at the highest level of the enterprise by considering such factors as its philosophy, values and organization in order to ascertain management's risk appetite. With this background, management establishes specific goals and objectives with respect to the risk – what is the enterprise's mission? Next, the model calls for identifying the various internal and external events that may impact the achievement of those goals and objectives. What follows is the risk assessment: how likely is the risk, and what might be its potential impact? Management then decides whether to avoid, reduce, share (e.g., insure) or accept the risk. Unless the risk is accepted or avoided (e.g., the relevant initiative is abandoned), the effort now turns to developing and placing in operation control activities designed to reduce the risk, along with supporting communication tools and protocols and auditing, testing and other monitoring procedures.

How can this model help manage risk in offshoring? This question needs to be addressed in the context of a specific arrangement. The COSO ERM model is only a framework for thinking about risk in a particular factual context. Its application ultimately leads to the identification and implementation of control, communication and monitoring activities that hopefully bring risk within range of the particular enterprise's appetite. Moreover, the answers are not static: the focus and nature of these activities will necessarily shift over time with changes in the economic, political and social environment. These shifts have lately been occurring at a very rapid pace. To illustrate these points, let's briefly consider several scenarios: an offshore contract manufacturing arrangement; an offshore back office captive; and an offshore legal process outsourcing arrangement.

a. Contract Manufacturing

Some might argue that, until recently, the key risks in the contract manufacturing scenario were delivery of contaminated or otherwise defective product and non-compliance with the enterprise's code of social responsibility ("CSR").[13] Numerous enterprises, therefore, took affirmative steps to improve their quality assurance programs, develop supplier codes, implement CSR monitoring mechanisms, and the like.

In today's economic climate, many consider the key strategic risk to be the possibility that a critical offshore manufacturer, or one of its major suppliers, may become insolvent or otherwise suffer a business interruption.[14] This risk may be considered to be intolerable (i.e., zero risk appetite). External events, such as a continuing decline in demand for the manufacturer's products, may be expected to heighten it. A risk assessment indicates that the likelihood of manufacturer insolvency is moderately high, and its impact on the enterprise would be severe. This risk cannot be avoided, shared or accepted, so it must be reduced. Consequently, the enterprise has launched an urgent effort to, among other things, develop and place in operation a range of control, communication and monitoring activities that are designed to manage this risk. To reduce the potential impact of this risk, the enterprise is also exploring additional contract manufacturing arrangements.

Business continuity may presently constitute a major concern, but compliance also remains a key area of focus for many enterprises with contract manufacturing arrangements. In part, this has been fueled by external events; for example, the sweeping bribery investigation of Siemens, and the more recent accounting fraud scandal at Satyam. A more direct driver may be the U.S. Department of Justice's pronouncements that anti-corruption enforcement efforts are at an all-time high and will likely remain there.[15] In light of these events, our hypothetical enterprise conducted a risk assessment, which

[13] See, e.g., *Jane Doe I, et al. v. Wal-Mart Stores, Inc.*, Case 05-7307-AG (C.A. Cal., December 11, 2006, dismissed March 30, 2007). This case was an action brought against Wal-Mart in California on behalf of the employees of numerous offshore contract manufacturers alleging that they had been injured due to Wal-Mart's failure to actively enforce its supplier code of social responsibility against the contract manufacturers.

[14] Consider, for example, the recent Satyam scandal, where a number of key clients terminated their relationship with Satyam in light of financial improprieties on the part of top executives.

[15] In late January 2009, Mark Mendelsohn, Deputy Chief, Fraud Section, Criminal Division, U.S. Department of Justice, at an anti-corruption conference in Frankfurt that included speakers from the DOJ, SEC and prosecutors from Germany, the United Kingdom and Switzerland, identified the following top ten trends for 2009: the level of enforcement is at an all-time high and is likely to remain there; prosecuting senior company executives in their individual capacities will be a priority; the U.S will investigate U.S. and foreign issuers equally, as well as companies operating within the U.S. territory; multi-jurisdictional investigations are on the rise; informal international cooperation will continue to improve, together with increased mutual legal assistance; the DOJ and FBI are committing more resources to FCPA enforcement, including eight full-time, dedicated FBI investigators; the DOJ will coordinate, where appropriate, sector-wide investigations, as it has in the oil and gas, medical devices and freight forwarding industries; the pace of voluntary disclosures is likely to continue; FCPA due diligence will be a regular feature of mergers and acquisitions and transactional work; and increased enforcement of other crimes, alongside FCPA violations, is expected, including money-laundering, export control violations and false accounting.

revealed that it is "not unlikely" that its contract manufacture may, among other things, be making illicit payments to customs officials in order to expedite the importation of component parts. As a result, the enterprise has now initiated an effort to reinforce its written agreements with, require periodic certifications from, and regularly audit its contract manufactures, among other things. These compliance measures ultimately may not prevent acts of bribery from occurring; under applicable charging guidelines, however, they should lessen the impact that any such occurrence may have on the enterprise in terms of prosecutorial action.[16]

b. Back Office Captive

Offshore back office captives have long been favored by enterprises in regulated sectors largely because they were viewed to offer an effective means for addressing key operational risks: confidentiality, security and control. With the enactment of SOx, moreover, control became an even more compelling factor where the offshored activities could impact financial reporting – imposing control activity requirements on an independent service provider, as opposed to a captive, was night and day. Meanwhile, various countries actively competed to attract foreign investment in offshore captives by, among other things, establishing attractive tax incentive regimes – in essence, trading direct tax revenue for job creation. However, this paradigm has been shifting for numerous reasons: some beleaguered financial institutions are now shedding offshore assets in order to raise cash or refocus on core competencies; at the same time, judging from the actions of certain tax authorities, host nations may be rethinking the job creation/tax revenue foregone trade-off, especially as tax incentives begin to expire.[17]

Tax compliance has generally become a higher risk for enterprises operating globally due to various factors. As the OECD has observed, "[n]ot long ago, transfer pricing was a subject for tax administrators and one or two other specialists. But recently, politicians, economists and businesspeople, as well as NGOs, have been waking up to the importance of who pays tax on what in international business transactions between different arms of the same corporation."[18] Under OECD guidelines, the global allocation of profit should be based on the arm's length principle, but applying this rule is neither simple nor non-contentious.[19] With budget deficits growing around the world, and given recent pronouncements of the Obama administration, governments may increasingly challenge the global enterprise's apportionment of income and expenses. To better manage this risk, therefore, the enterprise has undertaken a comprehensive review of its intercompany transfer pricing and supporting documentation. This study may not preclude a tax audit; however, it should better position the enterprise for any such discussions and help to minimize potential penalties and assessments.

In addition to challenging the apportionment of income and expenses, tax authorities in some host nations have been more aggressively applying other concepts in order to increase revenue. Several years ago, for example, the Indian tax authorities assessed Morgan Stanley & Co. ("MS&C") for income tax on the grounds that its Indian back office captive, a separate subsidiary, constituted a taxable "service permanent establishment" ("service PE") of MS&C in India. The case was ultimately taken to the Indian Supreme Court. To the surprise of many, the Supreme Court held that

[16] See, e.g., U.S. Department of Justice's Federal Prosecution of Corporations (2000) and Federal Prosecution of Business Organizations (2003).

[17] Consider, e.g., Citibank's recent sale of its Indian back office captive to Tata Consulting Services. See, *Citigroup Sells Back-Office Unit to Tata Consultancy*, Harichandan Arakali, Bloomberg.com, last updated October 8, 2008, http://www.bloomberg.com/apps/news?pid=20601091&sid=arEyAzMytvyU&refer=india

[18] *Transfer pricing: Keeping it at arm's length*, OECD Observer, last updated July 3, 2008, http://www.oecdobserver.org/news/fullstory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html.

[19] Query whether the extending nature of outsourcing into more business processes is indirectly generating arm's length comparable pricing for these intercompany transfer pricing exercises, where none previously existed (assuming, of course, this data becomes publicly available).

MS&C indeed had a service PE in India, because it regularly seconded various employees to the Indian subsidiary who performed functions other than pure "stewardship" (i.e., monitoring and quality control). Fortunately, MS&C had previously undertaken a transfer pricing study in establishing the captive's remuneration. After reviewing this study, the Supreme Court determined that such remuneration represented an arm's length price for the captive's services. Based on that determination, it decided not to attribute any additional income to MS&C's service PE.[20] This story illustrates how effective risk management can pay off!

Tax compliance risks extend beyond income tax issues for enterprises operating offshore captives. They also include the possibility that applicable value added tax ("VAT"), service tax or other transactional taxes are not being properly calculated and paid. Under some VAT regimes, services performed for a beneficiary situated outside of the country will be tax exempt or zero-rated as an "export of service." In other countries, the captive may be obligated to charge VAT or service tax on the value of its services even if "exported," at least under certain circumstances; alternatively, it may be required to "self assess" the tax (i.e., the "reverse charge" mechanism). These rules are considerably less uniform around the world than the income tax rules – outside of the European Economic Union, there is no OECD-style "model VAT treaty" – and they too are subject to change. Accordingly, prudent risk management would include not only initially investigating the applicable laws and regulations, but also monitoring them on an ongoing basis.

c. Legal Process Outsourcing

Just a few years ago (2005), legal process outsourcing ("LPO") provoked comments that today seem almost primordial, at least in part:

- *"The most important challenge to this newly born sector is the need for Indian lawyers to pass U.S. Bar exams."*
- *"On the flip side, the Indian Advocates Act … does not support work for other countries."*
- *"There is strong political opposition in the U.S. against outsourcing as it may affect the livelihood of U.S. attorneys."*[21]

Today's comments are world apart. Consider what Richard Susskind, author of The End of Lawyers?, said when commenting on the Australian giant Rio Tinto's recent decision to sign a long-term LPO agreement with one of India's leading providers:

"It is evidence of a profound change in the legal world. In-house lawyers are under great pressure to reduce head count and to spend less on external law firms, but, at the same time, their workload is increasing. Clients, in short, need their advisers to provide more-for-less."[22]

A sea change in less than five years. No more talk about ethical obstacles; instead, it is all economics now. According to the U.S. Census Bureau, the U.S. legal services industry generated more than

[20] Director of Income Tax (Mumbai) v. Morgan Stanley & Co. Inc., C.A. No. 2914 of 2007. The Supreme Court dismissed the government's petition to review the decision on January 24, 2008. It should be noted that this case was decided under the US/India tax treaty, which does not place any threshold on the amount of time that an individual must remain in India when rendering services for a related company before his or her presence may be deemed to constitute a service PE.

[21] Quotes draw from 2005 story that purported ran in the Economic Times of India, entitled *Legal outsourcing – bubble or reality*, according to LPO blog, http://legallyours.blogspot.com/search?updated-min=2005-01-01T00%3A00%3A00%2B05%3A30&updated-max=2006-01-01T00%3A00%3A00%2B05%3A30&max-results=18.

[22] *Rio Tinto deal heralds huge changes*, Richard Susskind, Times Online, June, 18 2009, http://business.timesonline.co.uk/tol/business/law/ article6523920.ece

$184 billion in revenue back in 2002.[23] Today, well over one hundred companies (not all of them Indian) are competing for a share of this market. Some specialize exclusively on LPO; others have grafted LPO service offerings onto a broader range of BPO and/or KPO capabilities. The industry has been growing rapidly (i.e., 6-7% per annum), and many believe this growth will accelerate not despite, but because of, the current recession.[24] Forrester Research estimated that legal process outsourcing would reach $4 billion by 2015, which though significant still only represents about 2% of the U.S. legal service industry in 2002.[25] This forecast, however, may not have fully anticipated the wave of cost-cutting efforts now rushing through enterprises around the world, including their legal departments.

In the United States, the key compliance risk – possible ethical constraints on the use of LPOs – was effectively put to bed in August 2008 when the American Bar Association ("ABA") issued Formal Opinion 08-45, *Lawyer's Obligations When Outsourcing Legal and Nonlegal Support Services ("ABA Opinion")*.[26] The ABA Opinion establishes that a lawyer may outsource virtually any task, so long as two fundamental conditions are met: first, "she makes a reasonable effort to ensure that the [provider's] conduct … is compatible with her own professional obligations as a lawyer"; and, second, she maintains "direct supervisory authority" over the provider.[27]

Subject to these conditions, a U.S. lawyer may offshore work, but remains responsible for rendering competent legal services to her client. She should take appropriate steps to ensure that the provider is competent to perform the delegated tasks and ascribes to core ethical principles similar to those in the United States; additionally, she should consider whether the host country respects U.S.-style notions of confidentiality. Client confidential information cannot be disclosed to the provider without the client's informed consent. Also, the outsourced services should be billed at cost, although the lawyer may add "a reasonable allocation of the cost of supervising those services if not otherwise covered by the fees being charged for legal services."[28]

Proper due diligence and supervision, therefore, are core requirements under the ABA Opinion. But what constitutes proper supervision? What is the applicable standard of care? Here, the ABA Opinion is understandably more directional than prescriptive: the lawyer should "oversee the execution of the project adequately and appropriately."[29] Adequacy and appropriateness: these are highly fact-specific determinations ideally suited for a COSO ERM analysis. Fortunately, our lawyer is familiar with this model.[30]

Noting the ABA's edict on who bears ultimate responsibility for rendering competent legal services, our lawyer understandably settles on a low level of risk tolerance. She identifies the various tasks that might be delegated to the LPO provider and then runs them through a risk assessment. With respect to each task, the lawyer weighs the likelihood that the provider may perform inadequately (e.g.,

[23] *Legal Services Among Top Professional Businesses in Revenues*" U.S. Census Bureau News, CB01-10, January 22,2004, http://www.census.gov/Press-Release/www/releases/archives/economic_surveys/001658.html

[24] *Legal Process Outsourcing—Hype vs. Reality,* E-ValueServe, cited in *LPO industry in India*, Rahul Jindal, Legallyyours.blogspot.co, http://legallyyours.blogspot.com/2009/04/lpo-industry-in-india.html/.

[25] *Id.*

[26] *Lawyer's Obligations When Outsourcing Legal and Nonlegal Support Services,* Formal Opinion 08-45, American Bar Association, Standing Committee on Ethics and Professional Responsibility, August 5, 2008.

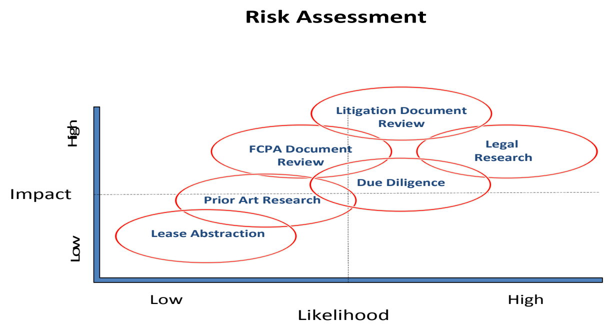
[27] *Id.* at p. 2.

[28] *Id.* at p. 6.

[29] *Id.* at p. 3.

[30] Lawyers are increasingly using risk management techniques for any number of purposes. See, e.g., Archibald, Jull and Roach, *Regulatory and Corporate Liability: From Due Diligence to Risk Management*, Canada Law Book 2004, updated annually.

commit an error), and considers its potential impact in the context of her particular organizational and workstream structures. This exercise yields the following graph:



In this hypothetical, lease abstraction ranks low on the risk continuum (i.e., first quadrant); accordingly, our lawyer determines that a LPO provider would not require substantially more supervision than she provides to in-house staff currently performing the same task. In contrast, legal research, due diligence and document review each present a risk profile that exceeds her appetite. For these workstreams, therefore, she now focuses on how, if possible, to reduce the likelihood that the provider's may perform poorly, since there is little, if anything, that she can do to reduce the impact of any such faulty performance other than not outsourcing the task.

What ongoing control activities can be developed and placed in operation to reduce the risk of inadequate performance – project supervision, staff selection, training, sample testing, second reviews, "Chinese Walls," and other security measures? What communication protocols can be implemented to support these controls and promote their effective operation – extranets, regular teleconferences, electronic dashboards, site visits, periodic 360° reviews, and the like? What sort of ongoing monitoring will be required to ensure that these controls are in fact operating effectively over time – performance reports, SAS 70 reports, internal and/or external audits, business continuity/disaster recovery planning reviews and testing, etc.?

Designing, implementing and executing such control, communication and monitoring activities involves real blood, sweat and tears. Yet, these "hidden costs" are too often underestimated, if not overlooked. They need to be better anticipated, somehow quantified, and then added to the provider's charges in order to arrive at the true "total cost of ownership" ("TCO") of any offshoring initiative.[31] For at least certain complex tasks, the TCO of offshoring might actually exceed the benefits; stated differently, the expense of implementing the control and other activities necessary to bring risk into an acceptable range may chew up the savings that were expected to be realized from offshoring the task.[32]

[31] As mentioned above, where an outside lawyer retains the LPO provider to discharge work for her client, the ABA Opinion provides that she may charge the client "a reasonable allocation of the costs of supervising those services," but does not offer any guidance for determining such allocation. See note 25.

[32] This is sometimes referred to as the "inverted Coase scenario." Ronald Coase was an economist who in the 1930s published a paper that some argue planted the seeds of the outsourcing phenomenon: the rationale for a business organization ceases to exist where a function can be performed more cheaply externally, as opposed to internally. Here, the suggestion is that if all transaction costs of offshoring certain tasks are taken into account, then perhaps in some cases it may be economically rational to keep the activity in-house. Alternatively, it may be possible to somehow re-shape or re-configure the outsourced task in order to reduce the cumulative risk factor to the point that appropriate control activities can be placed in operation at a lower cost.

Despite placing in operation appropriate control and other activities designed to reduce risk, some degree of risk will invariably persist. This is called "residual risk": "the risk that remains after management responses to risk threats and countermeasures have been applied."[33] In LPO arrangements, the ABA Opinion clearly allocates residual risk to the lawyer who retains the outside provider. This lawyer may not be able to pass on the risk of disbarment to her service provider; however, she should be able to negotiate appropriate warranties and indemnities with the provider that address the economic consequences of its faulty performance.[34]

As this discussion indicates, the LPO market is rapidly evolving. The applicable ethical requirements have now been clarified, at least here in the United States: proper due diligence and supervision. But what other risks does LPO present? According to one recent study, the top two concerns among U.S. and U.K. law firms are quality of work and data security.[35] The first concern, quality of work, overlaps with the ethical compliance risk. The second concern, data security, points to another key compliance risk: privacy and data protection. Here, the issues extend beyond ensuring appropriate confidentiality, as required under the ABA Opinion. The question becomes whether sharing documents, email or other data that contain personally identifiable information with the LPO provider, whether offshore on onshore, triggers any affirmative obligation for either the lawyer or her client under applicable privacy or data protection laws. A good risk management program would also explore and analyze this question.

2. FFIEC Examination Handbook

FFIEC is an acronym that stands for Federal Financial Institutions Examination Council. This interagency body was created in 1979 "to prescribe uniform principles, standards and report forms for the examination of financial institutions by the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS)," among other things.[36] One of its handbooks, *Outsourcing Technology Services Booklet*, provides guidance and examination procedures to assist examiners and bankers in evaluating a financial institution's risk management processes to establish, manage and monitor IT outsourcing relationships ("OTS Booklet").[37] Of particular interest here is Appendix C, which sets forth additional considerations for financial institutions that are procuring services from "foreign-based third parties."[38]

As described earlier, Black Book Research offers a checklist of steps to mitigate risk in offshoring. In contrast, COSO provides an expansive framework for identifying, assessing and managing risk in specific factual settings that can be readily applied to offshoring in virtually any of its flavors. The OTS Booklet lies somewhere between a checklist and a conceptual model: it defines the specific issues that senior managers of a regulated financial institution are expected to consider when outsourcing to any provider, domestic or foreign, "whose servicing operations are located in and

[33] Moeller, *supra* note 9, p. 74.

[34] Query to what extent the lawyer can also negotiate an agreement with her client that qualifies her obligation to supervise the LPO provider and/or disclaims or limits her liability in the event that the LPO provider commits an error which the lawyer does not catch, without running afoul of her ethical obligation to render legal services with the "legal knowledge, skill thoroughness and preparation reasonably necessary for the representation." *Model Rules of Professional Conduct*, American Bar Association, Rule 1.1, http://www.abanet.org/cpr/mrpc/rule_1_1.html.

[35] *Legal Services Outsourcing: What Do Law Firms Think?*, ValueNotes, May 2009, http://www.sourcingnotes.com/content/view/489/54/.

[36] *About the FFIEC*, FFIEC home page, http://www.ffiec.gov/

[37] *Information Technology Examination Handbook (IT Handbook) – Outsourcing Technology Services Booklet*, Federal Financial Institutions Examination Counsel (FFIEC), June 2004.

[38] *Id.*, Appendix C: Foreign-Based Third Party Service Providers, pp. C-1 – C-6.

subject to the laws of any country other than the United States," in addition to those that should be considered in all information technology outsourcing transactions.[39] These issues are useful to review because they may be relevant, in whole or in part, to other enterprises that are offshoring technology-enabled or other functions. However, they also may need to be updated to reflect more recent developments.

Before offshoring, the FFIEC states, "[m]anagement should determine if … it can mitigate identified risks adequately."[40] Two categories of risk that require special attention are "country risk" and "compliance risk." The OTS Booklet describes country risk as "an exposure to economic, social, and political conditions … that could adversely affect a vendor's ability to meet its service level requirements" or "result in the loss of an organization's data, research, or development efforts."[41] According to the FFIEC, such risks may be mitigated by establishing "contingency, service continuity, and exit strategies in the event of unexpected disruptions in service."[42] Compliance risk, in turn, involves "the impact foreign-based arrangements could have on an organization's compliance with applicable U.S. and foreign laws and regulations."[43] In particular, the OTS Booklet identifies consumer protection, privacy, data protection, security, bank secrecy, trade sanction, and export control laws and regulations for special consideration.[44] It then instructs management to include appropriate provisions that ensure compliance with these legal requirements in their contracts with offshore service providers.[45]

In addition to properly assessing country and compliance risks, management of a regulated financial institution "should perform appropriate due diligence similar to domestic outsourcing arrangement before selecting or contracting with a service provider."[46] This process should consider the provider's financial stability and commitment to quality as well as the host country's laws, accounting standards and business practices and their potential impact on the outsourcing arrangement. Management should consider how physical distance, cultural differences and possible social, economic or political changes might affect the service provider's performance. They should also consider "the ongoing costs of managing and monitoring cross-border and foreign-based provider relationships."[47]

The FFIEC next turns to the outsourcing contract and identifies specific topics that it should address. First, the contract should properly address security, confidentiality and ownership of data. Specifically, the OTS Booklet refers to the FDIC's *Interagency Guidelines Establishing Information*

[39] *Id.* at p. C-1, note 6

[40] *Id.* at p. C-1.

[41] *Id.* at p. C-2. In the COSO ERM framework, these "country risks" would likely be characterized as "operational risks."

[42] *Id.*

[43] *Id.*

[44] On privacy, the OTS Booklet refers to the Gramm-Leach-Bliley Act, 15 USC 6801, Section 501(b); interestingly, it also refers in a footnote to foreign laws that might inhibit the onward transfer of personally identifiable information to an offshore service provider (see, *Id.*, note 9, p C-2). On bank secrecy, the OTS Booklet refers to Section 319 of the USA Patriot Act, Pub. L. No. 107-56 (Oct. 26, 2001), which requires a financial institution to make information on anti-money laundering compliance by the institution or its customers available within 12 hours of a government request. On trade sanctions, the OTS Booklet refers to the Office of Foreign Assets Control of the U.S. Department of the Treasury and its website, www.treas.gov/ofac. On export control, it underscores the special importance of encryption software, and refers to the Bureau of Industry and Security of the Department of Commerce and its website, www.bis.doc.gov.

[45] How to rationally allocate compliance responsibilities between customer and provider probably remains one of the greatest challenges in structuring and negotiating an outsourcing arrangement, especially the newer, less mature types of arrangements where the issue tends to be more unsettled. On the whole, the legal duty will be non-delegable, but the burden of correctly ascertaining, complying and monitoring the legal duty, and the economic consequences of not doing so, can normally be allocated by private agreement.

[46] *Outsourcing Technology Services Booklet*, *supra*, note 35, p. C-3.

[47] *Id.*

Security Standards, which provides that a regulated financial institution must "[r]equire its service provider by contract to implement appropriate measures designed to meet the objectives of these Guidelines."[48] These objectives are to (i) ensure the security and confidentiality of customer information; (ii) protect against any anticipated threats or hazards to the security or integrity of such information; (iii) protect against the unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer; and (iv) ensure the proper disposal of such information. During the term of the contract, moreover, management should periodically evaluate whether its provider is effectively applying the administrative, technical and/or physical measures that may be implemented to achieve these objectives.

Second, the contract should contain a provision "acknowledging the authority of U.S. regulatory authorities … to examine the services performed by the provider."[49] Federal financial regulators have broad statutory authority to examine the activities and records of regulated financial institutions; this authority "should not be hindered by … having another organization carry out all or part of the financial institution's functions."[50] In this regard, the OTS Booklet notes "organizations should not establish servicing arrangements with entities where local laws or regulations would interfere with U.S. regulatory agencies' full and complete access to data or other relevant information."[51] Any analysis of foreign legal issues should "include a discussion regarding regulatory access to information for supervisory purposes."[52]

Third, the contract should specify the choice of law and forum for resolving disputes. The FFIEC does not express a preference for U.S. law; instead, it emphasizes the importance of ensuring that the contract is effectively enforceable. The contract will include various provisions that are intended to address country and compliance risks; ensure security, confidentiality and ownership of data; provide regulatory authorities with examination rights; etc. These provisions will presumably have been drafted so as to be enforceable under the express governing law of the contract. Yet, "[t]he laws of the foreign country may not recognize choice of law provisions and may differ from U.S. law regarding what they require of organizations or how they protect bank customers."[53] As part of the due diligence exercise, therefore, management should obtain an "analysis of [the] country's local laws by legal counsel competent in assessing the enforceability of all aspects of the contract."[54]

The OTS Booklet was published in 2004 – five years ago and well before the recent economic turmoil. At that time, some of the key concerns about offshoring involved continuity of service, unauthorized disclosure and loss of confidentiality, and anti-terrorism. These concerns are still relevant today, but a new imperative has since emerged: "our top obligations," Homeland Security Secretary Janet Napolitano recently declared, "are to American workers, making sure American workers have jobs."[55] This is a laudable goal for any number of reasons. For purposes of this discussion, however, the relevant question is: what impact might the pursuit of this goal have on offshoring? What new compliance risks do financial institutions that offshore, directly or through third parties, already confront as a result of this new imperative (even if not mentioned in the OTS

[48] *Interagency Guidelines Establishing Information Security Standards,* 12 CFR part 364, Appendix B, Section III.D.2.

[49] *Outsourcing Technology Services Booklet, supra,* note 35, p. C-4.

[50] *Id.* at p. 2.

[51] *Id.* at p. C-6.

[52] *Id.*

[53] *Id.* at p. C-4.

[54] *Id.*

[55] *U.S. gov't: 'Top obligation' is to U.S. worker,* Patrick Thibodeau, Networkworld, May 7, 2009, http://www.networkworld.com/news/2009/050709-us-govt-top-obligation-is.html

Booklet)? What additional risks might arise for these and other enterprises in the future in view of current legislative initiatives?

As has been widely reported, following the publication of an Associated Press ("AP") article in February 2009 entitled *Banks Look Overseas for Workers,* Senators Bernie Sanders (I-VT) and Charles Grassley (R-IA) pushed for legislation that limits the ability of employers who receive funds under the Troubled Asset Relief Program ("TARP") to hire foreign workers.[56] Specifically, such employers ("H-1B dependent employers") must now and for the next two years take additional steps whenever they seek to hire a new H-1B foreign worker (i.e., foreign specialty occupation worker):

- The employer must have made a good faith effort to recruit for the position in the U.S. using industry-wide standard practices.

- The employer must have offered, at a minimum, the prevailing wage during this recruitment effort.

- The employer must have offered the job to any U.S. worker who applied and is equally or better qualified than the H-1B worker.

- The H-1B worker must not be displacing a U.S. worker employed within the period beginning 90 days before and ending 90 days after the date of filing the H-1B petition.[57]

The actual impact of these new rules on financial institutions remains the subject of some debate. In one report, for example, the National Foundation for American Policy ("NFAP") takes issue with the February AP article, observing that "none among 12 large recipients of TARP funds hired more than a negligible number of new H-1B visa holders" in 2007.[58] According to this report, the aggregate number of H-1B petitions issued to these 12 institutions in 2007 was only 1,074, which represents less than 2% of the annual cap of 65,000. Regardless of the actual numbers, the new rules clearly impose additional compliance burdens and constraints on H-1B dependent employers. Indeed, some have argued that these burdens and constraints may very well have the unintended consequence of inducing such employers to outsource and offshore more work, rather than less.[59]

Foreign outsourcing companies have consistently been among the largest users of the H-1B visa program. Indeed, Infosys, Wipro, Satyam and Tata Consulting Services were the top petitioners in 2008.[60] Infosys alone received 4,559 new H-1B petitions, which represents about 4 times the total number of petitions issued to the 12 largest TARP recipients in 2007.[61] As a whole, Indian companies

[56] *AP Investigation: Banks Look Overseas for Workers,* Frank Bass, ABC News, February 2, 2009, http://i.abcnews.com/US/wireStory?id=6784066

[57] *American Recovery and Reinvestment Act of 2009 Treats Recipients of Stimulus Funding as H-1B "Dependent," While E-Verify Mandate is Not Enacted,* Elizabeth Espin Stern and Luke P Bellocchi, Baker & McKenzie Global Migration and Executive Transfers Client Alert, February 17, 2009. See, also, *Stimulus Clarification by USCIS re H.R. 1 Section 1611,* Elizabeth Espin Stern and Luke P. Bellocchi, Baker & McKenzie Immigration Client Alert, March 2009.

[58] *H-1B Visas and Financial Institutions*, NFAP Policy Brief, National Foundation for American Policy, February 2009, http://www.nfap.com/pdf/090205policybrief.pdf. The ratio of H-1B workers to total workforce at the financial institution that received the largest number of H-B petitions in 2007, Goldman Sachs, was 0.74%.

[59] See, e.g., *H-1B Visas and Job Creation,* NFAP Policy Brief, National Foundation for American Policy, March 2008, http://www.nfap.com/pdf/080311h1b.pdf

[60] *H-1B Visas by the Numbers,* NFAP Policy Brief, National Foundation for American Policy, March 2009, p. 7, http://www.nfap.com/pdf/0903h1bpb.pdf. For comparison, the top U.S. petitioner, Microsoft, received just over 1,000 in 2008.

[61] *Id.*

have received roughly 10% to 15% of all H-1B petitions issued in each of the last three years.[62] A considerable number of these H-1B workers presumably are placed at customer sites for short transitional periods (e.g., “knowledge transfer”) or longer-term deployments. These arrangements were not directly impacted by the new H-1B rules. However, the same will not be true if Congress enacts *The H-1B and L-1 Visa Reform Act of 2009 (S-887)*, as currently proposed by Senators Dick Durbin (D-IL) and Charles Grassley (R-IA) (“2009 Visa Reform Act”).

The 2009 Visa Reform Act would introduce various significant changes. First, it would substantially enhance the enforcement of immigration laws in a number of ways (e.g., new penalties). Second, it would essentially extend and make permanent most of the new burdens and constraints that now only apply to employers who received TARP funding. In particular, the bill would (i) prohibit employers from displacing a qualified U.S. worker for the job offered to an H-1B visa holder; (ii) require employers to make a good faith recruitment attempt prior to filing an H-1B petition, including posting the job, with a detailed job description, on the Department of Labor (“DOL”) website for at least 30 days; and (iii) require employers to pay wages at certain rates that, as a practical matter, would inhibit using the H-1B or L-1 for entry or junior level positions.[63] Third, the bill would limit the placement of H-1B and L-1 workers at another employer’s workplace (e.g., customer site), without first obtaining a waiver from the DOL. Finally, it would restrict employers with over 50 employees from hiring additional H-1B or L-1 workers if more than 50% of their employees hold such visas.

These proposals would have a material impact on the outsourcing industry. They openly target offshoring. As Elizabeth Stern and Luke Bellocchi have observed, the 2009 Visa Reform Act “seeks to curtail enterprises from moving U.S. services or production to low-cost jurisdictions abroad, assuming that the H-1B need is primarily for short-term guest workers gearing up for such a transition offshore.”[64] Yet this assumption is only partially correct – many H-1B and L-1 workers remain in the country longer term as part of the provider’s onshore delivery team.[65] By restricting these programs and inhibiting the deployment of such workers to customer sites, the bill would surely provoke a fundamental rethinking of these service delivery models. In the short run, these shifts might succeed to “keep [some] jobs in America”; in the longer term, however, they would invariably result in more offshoring and not less. The persistent drive to “do more for less” is not likely to yield to statutory obstacles where talent and technology can be combined in novel ways to achieve new efficiencies and cost savings.

[62] *Id.* at p. 14.

[63] See, *White House Summit on Comprehensive Immigration Reform Delayed; Capitol Hill, Immigration Agencies Seek to Expand Tourism but Limit Admission of Foreign Workers*, Elizabeth Espin Stern and Luke P Bellocchi, Baker & McKenzie Global Migration and Executive Transfers Client Alert, June 15, 2009.

[64] *Id.* at p. 2.

[65] See, e.g., *Impact of Satyam Scandal on H-1B Employees*, Danielle Rizzo, Immigration Daily, January 19, 2009, http://www.ilw.com/articles/2009,0210-rizzo.shtm, which describes the predicament that many of Satyam’s H-1B’s experienced after certain of its U.S. clients cancelled their contracts in the wake of the recent accounting scandal.

*   *   *

Offshoring is an inherent feature of today's extended enterprise. It manifests itself at increasingly deeper layers of the organization; in many areas, the line between onshore and offshore has become largely blurred. The growth in offshoring may have slowed in more recent times, but it has not stopped and will re-accelerate on the back of the enterprise imperatives to reduce costs and improve efficiency. In this environment, it is critical to effectively manage risk.

Various checklists, handbooks and frameworks are available to guide an enterprise's risk management program. A review of these resources underscores that "one shoe doesn't fit all": the key risks will vary depending on the circumstances; moreover, they change over time. Risk management, therefore, must be viewed as an ongoing process, where control and other activities placed in operation to manage risk today will invariably require some adjustment later.

Some of the key current risks have been described in this article: potential insolvency or other business interruption in the supply chain; bribery, fraud or other corruption committed by agents of the enterprise in the conduct of its business and increasing prosecution of such infractions; increasingly aggressive challenges by tax authorities of how global profits are allocated among members of the extended enterprise; and possible new restrictions on global workforce mobility.

The importance of implementing appropriate control, communication and monitoring activities was explored in the context of legal process outsourcing. LPO is one of the latest extensions of the offshoring phenomenon. It represents a good example of how offshoring today can be part of a globally integrated effort that involves multiple inter-dependent players operating in close collaboration from various locations around the world. The impact that LPO will have on the legal industry remains to be seen.