



# Legal & Compliance Chapter

## Implications of Counterparty Risks on Compliance Issues in Outsourcing Engagements

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# Agenda

1. Introduction to the Legal & Compliance Chapter
2. Overview – Compliance & Counterparty Risks
3. Bankruptcy Basics
4. Strategies to Minimize Exposure During the Contracting Stage
5. Managing Counterparty Risks During the Engagement



# Chapter Introduction

- Chapter Co-Chairs

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# Chapter Introduction

- Legal, regulatory, and compliance issues can arise in many aspects of outsourcing engagements
- Chapter will cover a broad spectrum of issues, including:
  - notable laws and regulations
  - accounting rules
  - standards bodies
  - technology transfer requirements and restrictions
  - performance issues relating to requirements of customers and service providers, especially in highly regulated industries (e.g., financial and health services)



# Chapter Introduction

- Potential topics for Legal & Compliance Chapter meetings
  - Implementation of Compliance and Risk Management Strategies, including:
    - US , EU, and other Data Privacy Regimes
    - Industry-Specific Presentations (e.g., Financial Institutions)
    - Function-Specific Topics (e.g., Human Resources)
    - Foreign Corrupt Practices Act
    - Export Control Regulations
    - Termination of Employees



# Chapter Introduction

- Potential topics for Legal & Compliance Chapter meetings
  - Impact of HITECH Act on HIPAA Compliance Obligations
  - Restructuring Implications for International Counterparties
  - Counterparty Risks in Domestic and Cross-Border Transactions
  - Trends in Global Accounting Standards (e.g., GAAP v IFRS standards)
  - Outsourcing Standards and Certification Bodies



# Chapter Introduction

- Future Legal & Compliance Chapter Meetings
  - Email the Chapter Co-Chairs if you would like to participate in leading the discussion for one of these topics or to propose an additional topic for consideration.
  - IAOP members interested in speaking at, or sponsoring, an upcoming meeting of the Legal & Compliance Chapter are encouraged to contact the Chapter Co-Chairs.
  - Meetings will be conducted live through local on-site participation and via webinar or video or audio conference.



# OVERVIEW – COMPLIANCE & COUNTERPARTY RISKS



- Customers and Service Providers alike are facing challenging times
  - General financial instability and uncertainty
  - Limited access to credit markets
  - Deteriorating performance
  - Numerous bankruptcy filings
  - Fraud and scandals
- Stakeholders need to pay special attention to regulatory and compliance issues now more than ever
  - Governments around the globe have an ever-increasing appetites for regulation
  - Dynamic landscape for legal, regulatory, and compliance issues

- Concerns regarding counterparty more pronounced in this distressed environment under commonly used business models
  - Outsourcing and Services Agreements
  - Supply Chain, Contract Manufacturing, Supply and Distribution, and Customer Agreements
  - License Agreements and Strategic Alliance / Joint Ventures Agreements
- Exacerbating factors
  - Multi-tier supply chains
  - Just-in-time inventory models
  - Credit crunch
- No longer solely a single counterparty risk but now viral in nature



# Overview

- Risks on all sides of the deal. Examples include:
- Outsourcing Agreements
  - Concerns of Customer include loss of services and know-how, degradation in quality of services, risk of transfer<sup>1</sup>
  - Concerns of Service Provider include risk of nonpayment, risk of transfer to undesirable third party
- If a counterparty enters into bankruptcy, the rules of the game may change, heightening these concerns and impairing the other party's rights without recourse that would otherwise be available under the agreement

# Overview

- One party's inability to perform under the outsourcing agreement may affect the other party's ability to comply with applicable laws, such as:
  - Regulatory reporting requirements
  - Data privacy laws
  - Employment laws (e.g., TUPE)
- Distress of a counterparty may create other legal issues
  - Accounting
  - Loss of IP rights
- Some industries are considering outsourcing-specific regulations in place to address counterparty risks (e.g., insurance)
  - May require that a regulator have access to the facilities, books and records of the service provider (e.g., draft EU insurance regulations)

- Customers and Service Providers should consider the effect that distress of a counterparty could have on the engagement (e.g., inability to pay for services or inability to provide certain services)
  - A party's rights under, and ability to enforce, an agreement could be significantly impaired by the counterparty's distress
- Termination may be undesirable
  - Could cause a party to be unable to maintain compliance with applicable regulatory regimes
  - Could cause a party to incur significant additional cost to maintain compliance
- Termination may not be an option because of the applicable law in the jurisdiction

- In these Interesting Times . . .
  - What deal structures and other strategies should you consider?
  - What extra diligence should you be doing?
  - What contract provisions should you be considering?
- Many Proverbs Are Applicable:
  - “Don’t put all your eggs in one basket”
  - “Possession is nine-tenths of the law”
  - “Look before you leap”
  - “An ounce of prevention is worth a pound of cure”
- Use of a disciplined risk assessment and mitigation analysis

## Risk Assessment and Mitigation Matrix Examples

Risk	Impact/Mission Criticality	Mitigation	Cost of Mitigation
Service Interruption	Loss of Business Continuity	Multi-source Shorter term	What cost? Which party bears costs?
Service Provider Bankruptcy	Loss of Business Continuity	Multi-source Non-exclusivity Provision of financing to Service Provider	What cost? Which party bears costs?



# BANKRUPTCY BASICS



## Bankruptcy Basics

- Goal of Chapter 11 is to achieve “plan” that resolves claims, distributes value of Debtor, and structures the continuing business
- Case generally commenced voluntarily (Sec. 301), but can be filed involuntarily by three unsecured creditors (Sec. 303)
- Filing creates “estate” comprising all legal and equitable property interests of Debtor (Sec. 541)
- Company becomes “Debtor-in-Possession” authorized to continue operating its business and administer its estate
  - Company permitted to operate in the ordinary course without further court approval
  - Transactions out of ordinary course (*e.g.*, sales of significant assets) require court approval (Sec. 363)

## Bankruptcy Basics

- Debtor protected by “automatic stay”
  - Generally prohibits enforcement of claims or contract by non-Debtor party against Debtor upon bankruptcy filing (Sec. 362); non-Debtor must comply with its obligations under the contract. Gives Debtor time to decide whether to “assume” or “reject” contracts
- Debtor can recover “preferences” and “fraudulent transfers”

## Treatment of Executory Contracts

- Executory contract = contract where performance remains due by both parties
- Non-Debtor party must continue to perform post-petition contractual obligations
- Administrative expense priority for value of services/goods provided to Debtor post-petition

## Treatment of Executory Contracts

- Debtor has three options (Sec. 365(a)):
  - Rejection
  - Assumption
  - Assumption and Assignment
- In Chapter 11, election may be made at any time up to confirmation of plan, but non-Debtor party may petition court to order Debtor to make election within a specified period
- Election is subject to bankruptcy court approval

## Rejection

- Debtor refuses to be bound by contract
- Rejection is considered a breach of contract at time immediately prior to bankruptcy filing
- Non-Debtor party will have right to a general, unsecured claim for damages from breach (both breach by rejection and other pre-bankruptcy breach – e.g., nonpayment)

## Assumption

- Debtor continues contract and must fulfill all obligations post-petition
- Debtor must cure outstanding defaults
- In certain jurisdictions, Section 365(c) prohibits a Debtor from assuming an executory contract if:
  - *applicable non-bankruptcy law* excuses non-Debtor from accepting performance from or rendering performance to a third party (*i.e.*, contract is non-assignable under non-bankruptcy law); and
  - non-Debtor party does not consent to such assumption and assignment
- Circuit Split
  - 3<sup>rd</sup>, 4<sup>th</sup>, 9<sup>th</sup>, and 11<sup>th</sup> Circuits – Hypothetical Test (consent required to assume)
  - 1<sup>st</sup>, 5<sup>th</sup>, and probably 2<sup>nd</sup> Circuits – Actual Test (consent not required to assume)

## Applicable Law

- Governing law in an IP license agreement is not the applicable law for Section 365(c)(1)
- Predominantly viewed as Federal law
  - Trademarks – Federal law (Lanham Act)
  - Patents – Federal law (Patent Act)
  - Copyrights – Federal law (Copyright Act) and Federal common law
  - Trade Secrets – State law
  - Services/Supply Contracts – State law
- General Rule - IP licenses are not assignable by Licensee without consent from Licensor (silence does not mean consent)

## Assumption and Assignment

- Debtor assumes contract and then assigns (*i.e.*, “transfers”) contract to third party
- Debtor must provide adequate assurances that assignee will perform



## Termination Rights - Section 365(e)

- Many agreements provide for termination or modification of the agreement conditioned on the Debtor's insolvency or financial condition, the commencement of bankruptcy proceeding or the appointment of a receiver or custodian
- Section 365(e)(1) of the Bankruptcy Code renders such so-called *ipso facto* provisions unenforceable in an executory contract after commencement of the bankruptcy case

## Termination Rights - Section 365(e) (cont'd)

- However, Section 365(e)(2)(A) of the Bankruptcy Code states:
  - Paragraph (1) of this Section 365(e) does not apply to an executory contract or unexpired lease of the Debtor... if
  - ***applicable law*** excuses a party from accepting performance from or rendering performance to a trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties (*i.e.*, contract is non-assignable under non-bankruptcy law); and
  - such party does not consent to such assumption or assignment
- Same analysis with respect to whether applicable law prevents assignment
- If non-Debtor should seek termination based upon Section 365(e), automatic stay still applies

## Section 365(n)

- Section 365(n) provides special protection to Licensees against the impact of rejection by a Debtor-Licenser
- Section 365(n) applies to licenses of “intellectual property” as defined in the Bankruptcy Code
  - Does apply to patents, patent applications, trade secrets, copyrights and mask works
  - Does not apply to trademarks
  - Does apply to agreements “supplementary to” IP licenses (*e.g.*, source code escrow)
  - Arguably does not apply to covenants not to sue
- Section 365(n) does not apply to other performance obligations, namely future performance obligations

## Section 365(n)

- Under Section 365(n)(4), upon the written request of a Licensee, Debtor/Licensors is obligated to continue to perform under the license agreement or provide the IP to the Licensee during the period prior to the Debtor/Licensors's decision to assume or reject
- Licensee can bring motion to compel assumption/rejection by Debtor/Licensors; court will give Debtor/Licensors "reasonable" amount of time to make a decision
- If Debtor/Licensors chooses to reject agreement, Licensee of IP has two options under Section 365(n): terminate or "retain rights"

## Section 365(n)

- If Licensee terminates...
  - Licensee has a general, unsecured claim for damages from breach
  - Licensee forfeits rights to continued use of the licensed IP
  - Sublicensee likely has no protection if Licensee does not retain rights

## Section 365(n)

- If Licensee “retains rights” ...
  - Licensee can continue to use IP for duration of contract and for any extension periods provided for in contract
  - Licensee still has right to general, unsecured claim for damages from rejection
  - Must provide timely notice of intent to retain rights
  - Must continue to pay “royalties”
  - But there are limitations ...
    - Licensee has no right to ongoing services, maintenance or updates
    - License is only to IP as it existed immediately before filing of petition
    - Licensee waives rights to setoff or administrative priority expense status claims
- Not a good solution for exclusive strategic licensee



## International Considerations

- Foregoing is based on U.S. law
- Law in other jurisdictions is different
- Many jurisdictions do not have continued right in licensed IP after a license agreement is rejected
- Licensee often may not have a right to intervene in the bankruptcy proceeding of a licensor

## Bankruptcy Basics Take-aways

- Once your counterparty is in bankruptcy, you are essentially in a court proceeding and you will not have a quick and easy way to terminate your agreement
- If you are a Customer of a bankrupt Service Provider, in-bound licenses to that Service Provider may be subject to termination risk
- If you are a Licensee of IP from a bankrupt Licensor, Section 365(n) provides some protection for certain types of IP
- If your counterparty is heading into financial difficulties, contract modifications may be subject to legal challenge in a later bankruptcy, so last minute deals are hard to do





# STRATEGIES TO MINIMIZE COUNTERPARTY RISK EXPOSURE DURING THE CONTRACTING STAGE

## Counterparty Risk Due Diligence

- Anticipating the potential sources of the counterparty's issues before entering into a transaction better informs the analysis and strategies for dealing with the issues
  - Overall infrastructure stability and risks to means of production
  - Business model viability
  - Financial strength, access to credit, and accounting policies
  - Key employee retention
  - Third party dependencies (supply chain tiers, licensors, subcontractors)
  - Lawsuits and governmental investigations
  - Scope and amount of insurance coverage (company's and counterparty's coverages)

## Counterparty Risk Due Diligence (cont'd)

- Considering each party's risk tolerance also informs the analysis
  - Compliance requirements
  - Importance or mission-criticality of products/services
  - Importance of revenue recognition
  - Ease of ability to replace with substitutes
    - Insurmountable obstacles (e.g., regulatory prohibition)
    - Practical obstacles (e.g., cost, time, IP)
  - Term of the relationship
  - Integration of third party products / services
  - Reputational risk

## Counterparty Risk Due Diligence (cont'd)

- Expanding the scope of diligence review (depends on subject matter) reduces uncertainty
  - Counterparty internal records and reports
  - Financial statements (plus)
  - Industry-wide evaluations and/or reports
  - Agreements with third party licensors and suppliers
  - Agreements with key employees and/or contractors
  - IP portfolio and/or IT systems
  - Litigation/investigations
  - Corporate/securities/financing filings
  - Other public record documents
  - Websites and other materials on the Internet
  - Insurance

## Counterparty Risk Due Diligence (cont'd)

- Courtship: Get to Know one Another
  - Assess the parties' respective track records of service commitment, flexibility, and ability to achieve objectives
  - Communicate thoroughly throughout the process
    - Management, operational personnel, subject matter experts, affected personnel
    - Regular meetings, broad access
    - Sensitivities (depending on customer's internal communications)

## Counterparty Risk Due Diligence (cont'd)

- Courtship: Get to Know one Another (cont'd)
  - Interview existing/current customers of Service Provider; interview different business constituencies of customer
  - Assess quality of parties' respective infrastructures and personnel
  - Conduct "background checks" -- security measures, privacy, protection of confidential information and intellectual property, etc.



# DRAFTING CONSIDERATIONS

- **Considerations for Customer (Debtor is Service Provider)**
  - In the event that the Service Provider enters into bankruptcy proceedings will Customer continue to receive critical products and services at the same quality/service levels?
  - **Fundamental Provisions**
    - Include clear specifications, performance requirements, and service levels
    - Include termination for failure to meet such requirements (or specify that failure constitutes material breach) and termination for convenience
    - Structure payment to withhold cash--golden rule
    - Consider self-executing remedies



- **Considerations for Customer (Debtor is Service Provider)**
  - Bankruptcy-related Provisions
    - Include a provision invoking Section 365(n)
    - Negate (or limit) Service Provider's ability to assume and to assume and assign the agreement
    - Provide that Customer is entering into the agreement based on personal characteristics of, and trust and confidence in, Service Provider (Section 365(c)(1))
    - Include a current license grant to Service Provider's IP and right to have third party use it on Customer's behalf
    - Include disincentives for Service Provider to reject the agreement, including security interest in IP, payment structure and specific remedies for breach

- **Considerations for Customer (Debtor is Service Provider)**
  - Flexible Sourcing Provisions
    - Limit term (with unilateral renewal options) and expand termination rights
    - Consider march-in rights and/or a bankruptcy-remote-entity to hold assets and to provide the services
    - Include a business continuity plan requirement
    - Consider a security interest in means of production used to provide services
    - Include ongoing provision of data, manuals, and other needed materials
    - Require acknowledgement of internal-, second-, or multi-sourcing with strong cooperation and termination transition assistance covenants

- **Considerations for Customer (Debtor is Customer)**
  - In the event the Customer enters into bankruptcy proceedings will Customer continue to receive critical services at the same quality/service levels?
  - Drafting Considerations
    - Include precise assignment, assumption and assignment language
    - Limit Service Provider's discretion to prevent assumption and assignment (e.g., an express right, include a provision that states "consent shall not be unreasonably withheld," or define what constitutes an acceptable assignee)
    - Consider longer term contracts with lock-ins

- **Considerations for Service Provider (Debtor is Customer)**
  - In the event the Customer enters into bankruptcy proceedings --
    - Will Service Provider receive payment?
    - Will Service Provider be protected from Customer breach?
    - Can Customer assign the agreement to an undesirable third party?

- **Considerations for Service Provider (Debtor is Customer)**
  - **Drafting Considerations**
    - Include the right to suspend provision of services for breach or nonpayment
      - Consider pre-payment or payment on delivery
      - Use structured payment terms
    - Include clear definitions of material breach, including payment
    - Limit Customer's ability to assign, assume, or assume and assign the agreement
    - Include an express personal license to use IP so that it may be more difficult for Customer to assign the agreement

- **Considerations for Service Provider (Debtor is Service Provider)**
  - In the event the Service Provider enters into bankruptcy proceedings, will Service Provider receive payment and be able to assign the agreement to a third party?
  - Drafting Considerations
    - Include precise assumption and assignment provisions
    - Structure fee payments to Service Provider



# STRUCTURAL CONSIDERATIONS

## Bankruptcy Considerations if Debtor is Service Provider

- Exclude licensed IP or other key assets from the bankruptcy estate
  - Sale or absolute assignment
  - Intellectual property trusts
  - Bankruptcy remote entities
  - Joint venture entities
- Include disincentives for Service Provider to reject the agreement
  - Payment structure
  - Security interest in licensed IP to secure obligations (and perfect)



## Business Strategies

- Flexible sourcing models
  - Nonexclusive relationship
  - Shorter terms
  - Expanded termination rights
  - Second sourcing rights
  - March-in rights
- Alternative deal structures (e.g., JV, SPV/ BRE)
- Alternative service delivery models
  - Multi-sourcing
  - Redundant systems and capabilities
  - Onshore versus offshore
- Alternative payment models
  - Escrow
  - Currency
  - COD / in advance / in arrears / milestones



## Special Purpose Vehicles / Bankruptcy Remote Entities

- Isolate needed assets from operating business
- May act as Service Provider/Licenser entity
- Provide structural and ownership limitations on ability to seek bankruptcy protection
- Consider structuring as a Trust or LLC
- Consider jointly owned entity
- Example: IT holding company

## Other Considerations

- Control/posses the assets/rights needed
  - Possession of goods/means of production
  - Access to technology/facilities/personnel
  - Ownership of IP/current grant of license
  - Provision of data
  - Duplication of systems
  - Third party warehouse
- Contract terms for such strategies



# MANAGING COUNTERPARTY RISKS DURING THE ENGAGEMENT

## Dealing with a Financially Troubled Counterparty

- What do you do when things start to look bad?
  - Review the contract
    - Is either party in breach?
    - What opportunities are there for self-help?
    - Has a party actually exercised its rights?
    - What are the termination rights?
    - What does the contract say about assignment and change of control?
    - What does the contract say about the effect of bankruptcy and is it enforceable?

## Dealing with a Financially Troubled Counterparty (cont'd)

- What to do when things start to look bad?
  - Assess the risks
  - Develop a strategy
    - How can business value be preserved?
    - May need to petition court to protect rights
  - ***Better to act sooner rather than later!***

## Dealing with a Distressed Service Provider

- Options for Customer
  - Continue services
    - Evaluate whether will be able to meet volume and quality requirements
  - Set up watch service to monitor bankruptcy filings made by Service Provider

## Options for Customer (cont'd)

- Terminate agreement prior to bankruptcy
  - Review agreement and monitor performance for potential means to terminate
  - Terminate under clauses that are specific to financial conditions
    - Actively monitor financial condition - conduct audit if permitted
    - Terminate before Service Provider enters bankruptcy
  - Terminate for material breach



## Options for Customer (cont'd)

- Replace the services
  - Evaluate own ability to operate technology or provide services
  - Evaluate ability to transfer services to third party service provider
    - Timeline
      - How long will it take to transfer and how much will it cost?
      - What to do in the meantime?
    - Equipment and documentation
      - What equipment is required?
      - Does Customer have full set of documentation?

## Options for Customer (cont'd)

- Replace the services (cont'd)
  - Space
    - Is there server space available to store data?
    - Is there office space available to accommodate new personnel?
  - People
    - Are there any contractual limits to hiring Service Provider's personnel?
    - Do own employees have the necessary expertise to provide services? How steep is the learning curve? Who will provide the knowledge transfer?
  - Technology
    - Is the technology available if Service Provider files for bankruptcy and inbound licenses to it are terminated?
    - Can licenses that may be subject to termination be replaced?

## Options for Customer (cont'd)

- Follow up on Source Code Escrow Agreement (if applicable)
  - Ensure deposit of escrow materials
  - Conduct audit of software (confirm software in escrow is up-to-date)
- Obtain copy of data



## Options for Customer (cont'd)

- Request and perfect first-priority security interest in licensed IP
- Exercise right to acquire IP (if provided under the agreement)
  - Risk of avoidance action
- Consider contract modifications
  - Subject to challenge as fraudulent conveyance

## Considerations if Customer is in Financial Trouble

- Options for Customer
  - Review all inbound service agreements/licenses to determine whether Service Provider's consent would be required to assume or to assume and assign in bankruptcy
  - If consent is required, begin to actively seek consent

## Dealing with a Distressed Customer

- Options for Service Provider
  - Terminate agreement prior to bankruptcy
    - Review agreement and monitor performance for potential means to terminate
    - Terminate under clauses that are specific to financial conditions
      - Actively monitor financial condition - conduct audit if permitted
    - Terminate for material breach

## Options for Service Provider (cont'd)

- Set up watch service to monitor bankruptcy filings made by Customer
- Repossess any equipment or documentation
- Obtain a guaranty or letter of credit to ensure payment
- Retain and perfect a first priority security interest in embodiments of IP held by Customer
- Consider contract modifications
  - Would they be subject to legal challenge in bankruptcy court?

## Mitigating Voidable Preference Risk

- Voidable preferences
  - Generally, voidable preferences are payments made by an insolvent company prior to its bankruptcy filing that enable a creditor to recover more than others in its class (90 day look back for most creditors; one year for “insiders”)
- Relevant defenses to preference actions
  - “Ordinary course of business” payment
  - Subsequent value provided
  - Contemporaneous exchange



## Mitigating Voidable Preference Risk

- Steps to mitigate preference risk
  - Retain a security interest in the IP that generated payment, which can lessen or defeat potential preference recovery
  - Record transfer in appropriate location (U.S. patent and trademark office, U.S. copyright office or appropriate U.C.C. location) within 30 days of transaction
    - Failure to do so will result in transaction having been deemed to occur on the earlier of the date of perfection and the date of the commencement of the bankruptcy case, which can invalidate subsequent value/contemporaneous exchange defenses
  - Structure payments/transfers to take advantage of subsequent value and contemporaneous exchange defenses
    - Inclusion of statement of subsequent value and contemporaneous exchange language in recitals
  - Maintain detailed records that can establish payment was in the “ordinary course of business”

## Mitigating Fraudulent Transfer Risk

- A fraudulent transfer is generally a:
  - transaction that was made with intent to hinder, delay or defraud others; or
  - transfer of property for less than reasonably equivalent value while insolvent, or if transfer rendered Debtor insolvent (two year look period under Bankruptcy Code; longer period under similar state laws)
- Steps to mitigate fraudulent transfer risk
  - Provide third-party valuation or fairness opinions at time of transaction
  - Include solvency representation as condition to closing
  - Be cautious when entering into “bargain” or “fire-sale” type transactions

## Take Away Points

- Focus on counterparty due diligence and practical risk mitigation
- Proactively draft agreements – give special consideration to rights needed to maintain compliance (e.g., termination, march-in rights, and assignment)
  - Focus on how deal structure affects impact of bankruptcy
  - Remember the bankruptcy basics in contract drafting
  - Rejection, assumption, or assumption and assignment of license/services
- Consider pre-bankruptcy options when counterparty becomes distressed
  - Termination rights
  - Back-up resources (e.g., internal or third parties)



# Implications of Counterparty Risks on Compliance Issues in Outsourcing Engagements

Questions?

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