

# The Impact of Insolvency on Outsourcing Transactions

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March 28, 2008



## **The Impact of Insolvency on Outsourcing Transactions**

1. Welcome and Introduction
2. The Effect of Canadian and United States Insolvency Proceedings on Outsourcing Transactions
3. Due Diligence (Before and During Outsourcing Engagement)
4. Contractual Provisions
5. Maintaining Outsourcing Services After an Insolvency Has Occurred



# 1. Welcome and Introduction

- Presentation based on present state of *Bankruptcy and Insolvency Act* (“BIA”) and the *Companies’ Creditors Arrangement Act* (“CCAA”)
- Bill C-12 proposes amendments to BIA and CCAA
- Amendments will affect rights of parties to outsourcing contracts
- First Reading on October 29, 2007
- Not yet law, referred to Senate for review
- Amendments supported by all parties
- Effective date unknown – most likely after January 1, 2009



## **2. The Effect of Canadian and United States Insolvency Proceedings On Outsourcing Transactions**

- a) Canadian Liquidation Proceedings
- b) Canadian Reorganization Proceedings
- c) United States Proceedings



## a. Canadian Liquidation Proceedings

(a) *Bankruptcy and Insolvency Act (BIA) Canada*

(i) Assignment in Bankruptcy

- Voluntary Proceeding
- Licensed Trustee in Bankruptcy Appointed (usually chosen by debtor)

(ii) Bankruptcy Order (formerly called a Receiving Order)

- Involuntary Proceeding by Unsecured Creditor
- Licensed Trustee in Bankruptcy Appointed (usually chosen by unsecured creditor)

(iii) Effect of Bankruptcy Proceedings

- Proceedings by unsecured creditors stayed
- Trustee takes possession of assets of debtor subject to rights of secured creditors



## a. Canadian Liquidation Proceedings (cont.)

### (b) Interim Receivership

#### (i) Interim Receiving Orders, section 47 of BIA

- Usually at the request of secured creditor
- Licensed Trustee in Bankruptcy appointed
- Interim Receiver usually acts in close collaboration with secured creditor

#### (ii) Effect of Appointment of Interim Receiver:

- Most orders contain broad provisions staying proceedings by secured and unsecured creditors and other parties
- Interim Receiver given right to possession of the assets of the debtor
- Interim Receiver permitted, but not required, to carry on business of debtor
- Acts of Interim Receiver approved by court
- Term “interim” is misleading, normally no further insolvency proceedings



## a. Canadian Liquidation Proceedings (cont.)

### (c) Appointment of Receiver

- Application by secured creditor under section 101 of the *Courts of Justice Act* of Ontario
- Proceedings controlled by Receiver appointed by court

### (i) Effect of Appointment of Receiver:

- Same as appointment of Interim Receiver except order of provincial court must be obtained in each province where Receiver needs to exercise its powers
- Normally provisions in most orders appointing a Receiver are usually the same as in orders appointing an Interim Receiver



## **b. Canadian Reorganization Proceedings**

### *(a) Companies' Creditors Arrangement Act*

- Insolvent company obtains court order staying all proceedings, initial order in effect for up to thirty days
- Monitor (usually a licensed trustee chosen by debtor) appointed by court
- Normal practice to apply for a second order continuing stay of proceedings for a period specified by court
- Debtor prepares restructuring plan
- Plan must be approved by 66 2/3 in value and majority in number of all creditors in each class
- Not necessary to have plan cover all classes of creditors
- After approval by creditors, the court must sanction (approve) the plan



## **b. Canadian Reorganization Proceedings (cont.)**

### **(i) Effect of CCAA Order**

- Debtor remains in possession of its assets
- Most orders contain broad provisions staying proceedings by secured and unsecured creditors and other parties
- Rights of other contracting parties to terminate a contract with the debtor usually prohibited unless leave of the court is obtained



## **b. Canadian Reorganization Proceedings (cont.)**

### **(b) Proposals under Part III of BIA**

- Insolvent party files notice of intent to make a proposal or a proposal
- Unless time period extended, debtor must file proposal to its creditors within thirty days after the filing of a notice of intent
- Trustee chosen by debtor is appointed
- Proposal must be approved by 66 2/3 in value and majority in number of unsecured creditors
- Debtor becomes bankrupt if proposal not accepted by creditors or approved by the court



## **b. Canadian Reorganization Proceedings (cont.)**

- (i) Effect of Filing of Notice of Intent to Make a Proposal or a Proposal
  - All proceedings by secured and unsecured creditors are stayed
  - No right to terminate contract on basis that debtor is insolvent



## c. United States Proceedings

(i) Chapter 7, *United States Bankruptcy Code*

- Functional equivalent of BIA bankruptcy, although differences in detail



## c. United States Proceedings (cont.)

### (ii) Chapter 11, United States Bankruptcy Code

- Functional equivalent of CCAA, although numerous differences in detail
- May be voluntary (debtor's petition), which is the norm, or involuntary (creditors' petition – need 3 creditors, unless there are fewer than 12 in total)
- All proceedings by creditors automatically stayed
- Ordinarily the debtor remains in possession of its property and makes most of the decisions (subject, where applicable, to requirements for court approval)
- Mandatory committee of unsecured creditors (other committees optional)
- the role of the mandatory committee is to consult with the debtor, investigate all matters relevant to the case, participate in the formulation of a plan and take any other actions as may be beneficial to the unsecured creditors
- Plan requires acceptance, in each class of affected creditors, by at least 66-2/3% of the value voted and more than 50% of the claims voted in that class, plus court approval (“confirmation”)



## 3. Due Diligence

- Pre-contract and ongoing
- Preparing for the RFP
- Competition
- History and references
- Governance
- Reporting and review
- Audits
- Guarantees
- Third party relationships
- Risk analysis



## Preparing for the RFP

- Your requirements for minimizing insolvency risk, e.g. references, financial reports, governance, internal processes and controls, audit, assignability, source code escrow, etc.
- Perhaps draft agreement or key contract terms
- Distribute RFP to many potential vendors
- Evaluate responses based on RFP criteria
- Beware of procurement law issues – duties of fairness
- Select vendor(s) and start negotiation of final agreements based on RFP and responses
- Parallel negotiations



# Competition

- Other vendors and suppliers
- Other products
- Compatibility, scalability, functionality
- Cost of transitioning
- Cost of obtaining new licenses and negotiating new contracts



## History and references

- Quality of service
- Speed of response time
- SLA compliance
- Error reports
- Downtime, both scheduled and unscheduled
- Preventative maintenance
- Business resumption plans (BRP)
- Customer references



## Governance

- Openness and reporting
- Frequency of meetings
- Constituency, use of experts
- Commitment of key personnel and senior management
- Dispute resolution escalation process
- Willingness to align with Your internal processes
- A long-term relationship requires stability and flexibility
- Change order and management processes
- Pricing formulas, cost adjustments, renegotiation, renewal
- Document and update operational procedures, standards



## Reporting and review

- Frequency of reports, applicable time period, retention
- Type, format and content
- Availability, access by Your advisors
- Reporting by subcontractors
- Metrics and measurement tools
- Is data meaningful?
- On-site inspections
- Review of vendor's internal governance and business processes
- Audits: technical, operational, security and financial



# Audits

- Statement on Auditing Standards No. 70 (SAS 70):
  - an auditing statement issued by the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA), officially titled “Reports on the Processing of Transactions by Service Organizations”.
  - SAS 70 defines the professional standards used by a service auditor to assess the internal controls of a service organization and issue a service auditor’s report.
  - Service organizations are typically entities that provide outsourcing services that impact the control environment of their customers.
  - growing in popularity and are being used by customers, prospective customers and financiers to gain an understanding of the control environment of outsourcing companies.



# Audits

- Section 5970 report
  - In Canada, a similar report known as a Section 5970 report may be issued by an independent auditor
  - Opinions on the design, effective operation and continuity of control procedures in place
  - You may request specific control processes
  - Annual report, associated working papers and recommendations
  - Time frame for correcting
  - At minimum cover controls for SOX domains: plan, organize, acquire and implement, deliver, support, monitor and evaluate



# Audits

- Alternatives to audits
  - Pay for expenses
  - Copies of audited financial statements or review engagements
  - Notice of threatened claims or lawsuits affecting agreement, services, deliverables, IP, networks, etc.
  - Records or certificates of compliance with security, confidentiality and operational procedures
  - Maintenance of records and reporting under GAAP
  - Receivable and payable metrics
  - Aged reports
  - Management certificates



# Guarantees

- By parent, affiliate, owner or partner
- Alternatives:
  - Add parties to the contract to accept responsibility for performance
  - Affiliate's directors' resolution to accept obligations and perform vendor's services under contract
  - Performance bond
  - Milestone payments



## Third party relationships

- Complete list of current contracts with third parties, both upstream and downstream
- Due diligence review of key contracts
  - Practical implications of asset/IP/knowledge transfer
  - key personnel, contacts, permitted hiring/solicitation
  - Does scope (e.g. of license) permit You to easily step into shoes of vendor or get direct benefit? Pass-through rights and obligations?
  - Confidentiality restrictions?
  - Assignable to You? Consent? Cost? Term?



## Third party relationships (cont.)

- Jointly owned or licensed IP may require consent of joint owner or licensor for transfer or future licensing
- Licenses that are silent as to transferability and sublicensability are not implicitly transferable, like other commercial contracts
- Rights are restricted by type, scope, territory, duration, transferability, sublicensability, non-disclosure
- Rights of “use” don’t correspond to statutory IP rights



# Risk analysis

- continuous analysis of risk of vendor insolvency
- vendor's willingness to overperform or take on a financially poor deal should raise red flag
- compare reports over time
- dovetail with contract provisions permitting termination and exercise of other remedies (e.g. source code release or assignment) in advance of insolvency
- loss of control, risk of liability, losses, interruptions
- business/mission-critical services will have different thresholds of risk tolerance; affects negotiations
- other factors: foreign legal, political, economic and social implications



## 4. Contractual Provisions

- Warranties and indemnities
- Source code escrow
- Termination rights
- Insurance
- SLAs
- Contract management
- Benchmarking
- Guarantees
- Ownership, labeling and registration of interests in assets and IP
- Transitioning
- BRP and contingency planning
- Notices



## Warranties and indemnities

- Financial condition and history
- No violation of agreements, litigation, claims
- Credit ratings
- Information disclosure, completeness and accuracy of lists
- Controls and processes
- Authority, guarantees and resolutions
- Insurance
- Required consents, right to license/assign
- No prior assignments, options, joint owners, exclusive licenses, encumbrances, security interests



## Source code escrow

- Your possession is better than in hands of third party escrow agent
- Suitability of facilities for storage
- 2-party vs. 3-party escrow contracts
- Multiple beneficiaries
- Trust vs. escrow
- Watch out for vendor consent for release
- Scope of what is held in escrow to include code AND related know-how, e.g. working papers, flow charts, technical contacts
- Ability to solicit/hire programmers
- Current and completeness, requires covenant for regular deposit of updates and notice to You
- Testing and review of escrowed materials
- Triggering event



# Termination rights

- for convenience
- change in control, merger, acquisition
- events of default, failure to meet SLAs
- materiality, repeated, cure and notice provisions
- force majeure
- material adverse change to legislation, regulations or market/business
- termination matrix e.g. event, impact, options, fees, damages, transition
- survival of certain terms



# Insurance

- consult with insurance expert/broker
- disclose general terms and conditions of insurance coverage; provide proof of policy
- required coverage, e.g.:
  - commercial general liability
  - workers compensation insurance and employment practices liability
  - automotive
  - comprehensive, professional liability
  - employee dishonesty and fraud
  - property



## Insurance (cont.)

- during term and transitioning-out
- limits and occurrences
- named beneficiary
- notice of changes or cancellations
- qualifying insurers



## SLAs

- Important because ties into remedies pre-insolvency
- Functions, infrastructure, processes
- In-scope, out-of-scope, exclusions, dependencies
- Availability, performance, compatibility, meeting of critical milestones
- End user surveys



# Contract management

- Assigned (vendor party) vs. managed contracts
- assignment and confidentiality issues
- beware of silence in licenses: does not mean assignable or sublicenseable
- Powers of attorney
- Knowledge of and involvement in supplier relationships
- Requirement on vendor to maintain software at most current version
- Requirement on vendor to obtain new releases and related licenses
- Payment of third party fees, e.g. for license, maintenance, etc. (by vendor or by You if flow-through)
- Step-in rights and assignability (warranties and covenants)
- Notice of vendor's defaults and right to appoint manager



# Benchmarking

- comparison of price against other organizations
- comparison of costs against in-house cost, history
- sets baseline and maintains pricing
- independent benchmarker
- sample of well-managed organizations in same industry
- procedure and costs
- definition of benchmark; relevant data – who collects?
- measure costs, charges, performance, quality, resource utilization
- maximum and minimum size of sample
- inclusions and exclusions
- service tower basis vs. total services basis (hard to compare)
- non-disclosure and ownership of results



# Guarantees

- Covenants to obtain guarantees
- Warranties as to directors' resolutions adopting contract and liability and performance obligations



## Ownership, labeling and registration of interests in assets and IP

- Options to purchase, conditional sales contracts
- Beware of joint ownership and authors' moral rights
- Lease or license at fair market value (e.g. premises, equipment, software)
- Obligation on vendor to label, not co-mingle, retain dedicated equipment/facilities
- Registration of Your sublicenses with IP registries
- Triggering events for options and licenses (pre-insolvency, e.g. for breach of SLA or other obligation)



# Transitioning

- Vendor likely cannot pay
- Assistance of key personnel
- Access to facilities, equipment, IP, assets
- Preparation - complete documentation and info, list of all assets
- Knowledge transfer, triggering of escrows
- Triggering of third party contract assignments
- Powers of attorney
- If a transfer of employees, consult with employment lawyer
- Period
- Remedies if late or failure
- Progress reports
- Survival of terms



# BRP and contingency planning

- system breakdowns, repairs and maintenance, natural disasters, other events, temporary or permanent
- Your possession vs. access to assets, IP, records and data
- continuation of outsourced business activity vs. resumption
- availability vs. recovery
- redundancy vs. backup
- notification, time-lines, impact on service levels
- regular testing of business recovery system and reporting results
- notification and approval by You of any significant changes to contingency or resumption plans or impact
- beware of *force majeure*: disaster recovery obligations should not be excused



# Notices

- Of reports, deviations, audits
- Of vendor defaults, interruptions, disasters, *force majeure*
- Of intent to make a proposal under BIA
- Of appointment of trustee or monitor
- Of claims
- Of escrow deposits, requests and releases
- Of creditors, security interests, liens, encumbrances
- Of commencement of liquidation, reorganization or bankruptcy proceedings



## Conclusion

- outsourcing is neither a simple service contract nor a one-time acquisition
- many complex insolvency issues
- requires adequate time and planning, implementation within the corporate structure along with changes to internal processes
- get early involvement of experienced outsourcing counsel



## 5. Maintaining Outsourcing Services After an Insolvency Has Occurred

### Insolvency Issues

- Trustee/receiver takes possession of assets of debtor subject to rights of secured creditors
- Proceedings by unsecured creditors stayed
- Right to terminate a contract with the debtor may be prohibited unless leave of the court is obtained
- Interim Receiver permitted, but not required, to carry on business of debtor



# Maintaining Outsourcing Services After an Insolvency Has Occurred (cont.)

## Business Issues

- Loss of IP licenses, access to assets controlled by Trustee, options to purchase
- Loss of confidential information (Your's, other licensors', customers')
- Service level problems or potentially no service, with no requirement to assist with transitioning
- Third party liability risks
- Loss of termination rights



# Dealing with the situation

- Review of contract to determine remedies
  - Ability to in-source, appoint manager or transfer to third party
  - Receive assistance from debtor for transitioning
  - Managed contracts – dealing directly with upstream vendors; ensure no breach of third party contracts
  - Relocation or purchase of assets and IP
  - Termination rights, e.g. for service level breach, breach of covenant or warranty, force majeure, convenience, material adverse change
  - Claims for damages
  - Cure and notice periods
  - Renegotiation, pricing formulas, cost adjustment
  - Indemnities, guarantees or performance bonds
  - Confidentiality restrictions



## Dealing with the situation

- Importance of governance and controls
  - Monitoring service performance and SLA compliance
  - Error reports
  - Repeated breaches
  - Cure periods
  - On-site inspections
  - Notice of commencement of liquidation, reorganization or bankruptcy proceedings
  - Notice of intent to make a proposal under BIA
  - Notice of appointment of trustee or monitor



## Dealing with the situation

- Request permitted audits: technical, operational, security and financial
  - SAS 70 defines the professional standards used by a service auditor to assess the internal controls of a service organization and issue a service auditor's report
  - Section 5970 report on the design, effective operation and continuity of control procedures



## Dealing with the situation

- Due diligence of key contracts and key personnel
  - Assignability and transferability
  - Costs
  - Non-solicitation clauses
  - Confidentiality restrictions



## Dealing with the situation

- Review of source code escrow arrangements
  - Ensure deposits made up to date and complete (all code and related know-how and programming documentation)
  - Testing and review of escrowed materials
  - Triggering events
  - Source code release or assignment
  - Problems if only 2-party contract, or requirement of vendor consent for release
  - Ability to solicit/hire programmers



## Dealing with the situation

- Document operational procedures and service level measurements
  - Ensure all updates and upgrades have been implemented
  - Manuals to assist in transitioning service and know-how
  - Reports on current service levels and comparisons



## Dealing with the situation

- Business continuity planning
  - Search for alternate vendors
  - Compatibility, scalability, functionality
  - Cost of transitioning and new contracts
  - Knowledge transfer
  - Purchase at FMV



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