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# New IT Security: Protecting Your Company Against Outsourcing Supplier Insolvency

by Rick B. Antonoff, Leo T. Crowley, Joshua B. Konvisser, Vipul N. Nishawala, Erica E. Carrig and Kent P. Woods

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*Conventional wisdom was that bankruptcy was not a major consideration when outsourcing to “blue chip” sourcing suppliers. However, with recent market changes characterized by giant corporations effectively disappearing in a cloud of insolvency over a weekend—and with the proliferation of smaller, less well-capitalized suppliers—the rules of the game have changed.*

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The challenges to the sourcing marketplace are exacerbated by the reliance of many sourcing suppliers on the financial services industry as a client base. As the number of financial services clients shrinks, the portfolios of sourcing suppliers will shrink as well. While many sourcing suppliers will weather this crisis, some may not.

This client advisory identifies new risks to companies that use outsourcing services or are licensees under technology licensing agreements. The advisory also suggests some possible means to reduce these risks.

## What Happens to the Outsourcing Agreement in Bankruptcy?

Where an agreement is “executory” (i.e., has ongoing performance obligations by both parties), the debtor (supplier), once it has filed for bankruptcy, may generally elect either to reject or to assume the agreement. Rejection by the debtor (in this case the supplier) normally leaves the non-debtor party (in this case the customer) with no contract—only an unsecured claim for damages that will yield only partial payment in the debtor’s restructuring. An outsourcing agreement would almost assuredly qualify as executory because the supplier has an ongoing obligation to provide the services and the customer has an ongoing obligation to pay and perform ancillary obligations. Because only the debtor has rejection power (subject to bankruptcy court approval, which is rarely withheld), the bankrupt supplier effectively controls the ongoing business relationship between the supplier and the customer.

Where the bankrupt supplier opts to reject a contract, the customer has little recourse. The customer may find itself without a service provider on very short notice—likely significantly less than is required to perform an orderly transition. This can be catastrophic for a customer that has outsourced a mission-critical function and no longer has the ability to perform the function in-house. Bankruptcy allows for rejection on

the debtor's timeline with little regard to the implications on the non-debtor party, but it can take six months to a year to reprocur or insource a major outsourced function.<sup>1</sup> In fact, most well-negotiated agreements include 12 months of transition assistance from the supplier upon termination to facilitate such a transition, and include only extremely limited termination rights for the supplier.

On the other hand, if the supplier elects to assume the agreement, the supplier is obligated to continue to perform under the agreement. At first blush, this is a good result for the customer because the services will continue to be performed as they were just before the bankruptcy. But this situation is not without risk. The supplier is obligated to continue operating in compliance with the agreement, but if the supplier had been over-performing, performance may degrade due to pressures of bankruptcy. Moreover, if reorganization under Chapter 11 is not successful, the supplier may suddenly move to a Chapter 7 liquidation, and the customer will have lost significant time that it could have used to arrange for an orderly transition.

Additionally, although the debtor is generally required to assume or reject agreements in whole, there may be situations in which the debtor is able to sever and separately assume or reject different provisions of its contracts. One such situation is where a supplier is performing two different types of services under an agreement and tries to disaggregate the services by arguing that they are actually separate agreements, assuming the most cost-effective portion of the agreement while rejecting the more burdensome. For example, if the supplier is providing both remote and on-site maintenance, the supplier could try to reject one aspect of the service, leaving the customer with an incomplete service. The temptation to do this may be particularly strong for the supplier if one service is subsidizing the other.

The best result for the customer may be where the debtor assumes the agreement and assigns it, pursuant to Section 365 of the Bankruptcy Code, to another solvent entity that is taking over the business of the debtor. Again, however, the election is largely within the debtor's control. Also, there may be circumstances in which the customer would prefer not to have its agreement assigned to the third party (e.g., where there are performance, privacy, or competitive concerns).

Where the customer is the licensee of software or other intellectual property under its sourcing contract, Section 365(n) of the Bankruptcy Code provides the customer special protections. Even where the supplier chooses to reject the license, the customer may elect to retain the right to use the intellectual property for the full term of the license, including any renewal terms. However, in that case the customer abandons any right to require the supplier to update or otherwise maintain the licensed property. Depending on the terms of the license and the exact property involved, this may be an attractive option for a customer whose supplier rejects a license of necessary or particularly valuable intellectual property.

### How Can the Customer Protect Itself?

Certain provisions can be included in an agreement to help ameliorate (although not eliminate) loss from rejection or improvident assignment. For example, a customer may include:

- Provisions that allow for the customer to terminate in an orderly manner based on some objective criteria that occur prior to the supplier filing for bankruptcy (once the supplier has filed its petition in bankruptcy, the stay in bankruptcy prevents a contractually permitted termination right from being invoked without court permission);

<sup>1</sup> The debtor could make a decision to assume or reject very quickly—in some cases within days of the filing. In other cases it could take months for a debtor to decide what to do with its contracts. If a debtor does not decide quickly, the customer could be in a situation of not knowing for an uncertain period of time whether its agreement will be accepted or rejected, making it difficult to plan a course of action without risking the immediate consequences of rejection.

- Financial and/or performance guarantees from one or more affiliates of the supplier entity;
- Source code escrow;<sup>2</sup>
- Liquidated damages tied to early termination that approximate the cost of the rush transition that would be required on rejection in bankruptcy;
- Security interest(s) in relevant collateral to the extent available;<sup>3</sup>
- Waiver of any restrictions on competition, exclusivity, or solicitation of personnel to facilitate transition to an alternate provider where the supplier seeks to assume and assign the agreement;
- Inclusion of supplier conditions and qualifications that limit the debtor-supplier from assigning to undesirable third parties;<sup>4</sup> and
- Provisions to limit the bankrupt supplier from attempting to disaggregate the agreement and then cherry-pick the services to retain only the most profitable components of the agreement while rejecting the rest of the agreement in bankruptcy.

Of course, which of these strategies is appropriate in any transaction will depend on the specific circumstances. Moreover, these strategies will not eliminate the entire bankruptcy risk. Finally, these strategies are most effective if implemented well in advance of the supplier filing for bankruptcy in order to avoid being unwound.<sup>5</sup> Thus, planning for insolvency becomes the most important step in limiting the risk of a supplier's insolvency.

Careful pre-bankruptcy planning can help create a favorable procedural situation for a customer. Additionally, planning for bankruptcy beforehand will help to ease a customer through the transition to dealing with bankruptcy procedures, thereby reducing response times and increasing the likelihood of a favorable outcome.

### Live Links

Satyam: A Timely Warning for Outsourcing Customers; Pillsbury Advisory; 8-Jan-2009

Satyam: Next Steps for Sourcing Customers; Pillsbury Advisory; 16-Jan-2009



- 2 Although this will not eliminate the transition risk, at least the customer will have some access (albeit imperfect) to critical software.
- 3 Because of the capital structure of many suppliers, this mitigation may be more theoretical than practical, but should be evaluated in appropriate circumstances.
- 4 While the Bankruptcy Code invalidates many types of anti-assignment provisions, the non-debtor can establish elements critical to the relationship so as to restrict the potential assignees that would be approved by the bankruptcy court.
- 5 In most cases, a transaction that improves a party's position within 90 days prior to a debtor's filing for bankruptcy protection can be avoided after the bankruptcy filing by the debtor.

For further information, please contact:

Rick B. Antonoff **(bio)**

New York

+1.212.858.1110

rick.antonoff@pillsburylaw.com

Joshua B. Konvisser **(bio)**

New York

+1.212.858.1027

joshua.konvisser@pillsburylaw.com

Erica E. Carrig **(bio)**

New York

+1.212.858.1479

erica.carrig@pillsburylaw.com

Leo T. Crowley **(bio)**

New York

+1.212.858.1740

leo.crowley@pillsburylaw.com

Vipul N. Nishawala **(bio)**

New York

+1.212.858.1021

vipul.nishawala@pillsburylaw.com

Kent P. Woods **(bio)**

New York

+ 1.212.858.1836

kent.woods@pillsburylaw.com

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