Client Alert

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Satyam: Next Steps for Sourcing Customers

Last week we alerted clients to the need for a rapid assessment of their exposure to Satyam in the wake of the much-publicized acknowledgement of fraud and mis-reporting of financial results by the company's founder and former Chairman. In this second Client Alert, we further explore the actions that should be considered to protect Satyam outsourcing customers in a worst-case scenario.

Reports from India indicate that the situation for Satyam Computer Services, Ltd.—one of India's largest software exporters and a significant supplier of outsourcing services—continues to deteriorate in the wake of the company's accounting scandal. The Indian government recently dismissed Satyam's board of directors and installed a three-member board to assess and repair the damage, and also is reviewing options to salvage the firm. Nevertheless, press reports indicate serious concerns remain about whether the company has adequate working capital to meet payroll and to continue operations.

Customers of Satyam now face the very real possibility that the company may not survive in its current form. In light of the company's uncertain future, Satyam's customers should (1) immediately assess their potential operational, financial and legal exposure if Satyam should fail, (2) develop contingency plans to in-source services or transition services to another supplier, and (3) be ready to put those plans into effect immediately if it becomes clear that Satyam cannot provide adequate assurances that its services will be unaffected.

Below is a list of contractual and operational issues that customers should keep in mind when developing contingency plans.

Timing Considerations

There is significant downside risk in deferring action until a formal insolvency administration occurs.

Indian insolvency law differs markedly from United States law and, in particular, does not have the equivalent of a "Chapter 11" bankruptcy process. One possible outcome is that Satyam could be deemed a "sick company" within the meaning of the Indian Companies Act, 1956. The Board of Directors of a sick company must apply to the Indian Board of Industrial and Financial Reconstruction ("BIFR") for determination as to its future path. BIFR will then determine whether the sick company will be allowed to continue to operate pursuant to a plan of restructuring or whether it will be directed to wind up. Throughout an oftentimes lengthy procedure, BIFR may suspend all legal proceedings against the sick company.

Many U.S.-based outsourcing customers have signed contracts with Satyam's Indian operating company and, if that company were to come under the jurisdiction of BIFR, U.S. customers may find it substantially more difficult to exercise their contractual rights, including debt recovery and the right to receive transition assistance.

Satyam also might be able to block efforts by creditors to seize its U.S. assets (such as bank accounts) by filing for Chapter 15 protection under U.S. bankruptcy laws. Chapter 15 in essence allows a foreign company like Satyam to use the U.S. bankruptcy court to prohibit creditors from taking action against the company's U.S. assets while an insolvency proceeding is pending in the company's home country. Chapter 15 could also prevent U.S. creditors from taking action against Satyam anywhere outside of the Indian insolvency proceeding. Moreover, Satyam may protect its U.S. affiliates by causing them to seek protection under U.S. bankruptcy laws. As a result, customers who have entered into contracts with Satyam's U.S. affiliate will also be affected by any failure.

The legal analysis can become complicated based on the specific contractual arrangements between the parties. Key issues include: Which Satyam entity signed the contract, where is it incorporated, and which jurisdiction will control any insolvency proceeding? Is that entity shielded in any way from the circumstances that are causing Satyam's Indian parent company to unravel? What assets does it own and where are they? What does the contract say about choice of forum for enforcing the customer's rights, and the governing law?

Termination Rights and Transition Assistance

Satyam customers should review their termination and transition rights under their contracts. Key issues include:

- Can the customer terminate for cause as a result of Satyam's current difficulties (e.g., due to a downgrade in credit ratings or per a material adverse change clause) without paying a termination fee? Note that provisions that allow customers to terminate *because* the supplier has entered into bankruptcy generally are not enforceable under U.S. law. We, however, understand that the entering of a "sick company" into the Indian form of "bankruptcy" will generally **not** affect a customer's contractual right to terminate a contract under prevailing interpretations of Indian law.

- Is there an option to terminate for convenience? If there is, do the operational, financial and legal risks of continuing with Satyam outweigh the expense of any termination fees/transition costs and transition-related risks to service delivery? How much notice must the customer provide?

- How much time will it take for the customer either to in-source the services or enter into a contract with a new supplier to transition the services? What transition assistance is Satyam obligated to provide and for how long? During any transition, is Satyam obligated to work only with the customer or must it also work with any new supplier designated by the customer?

Customers with exercisable termination rights in their contracts should consider sending Satyam an initial notification that termination is a possibility and that Satyam should start working with customer personnel to formulate transition plans that address the issues described below. Because the process of transitioning services in-house or to a new supplier can take months, the customer should consider acting sooner rather than later. Note however that such a notice may not be advisable if the contract does not provide a termination right that is exercisable under the circumstances because such a notice could be viewed by Satyam as an anticipatory breach by the customer.

Key Satyam Personnel

Customers should identify those Satyam personnel on their accounts, whether onshore or offshore, who are key to the smooth delivery of services (and the potential transfer of services) and who possess intellectual capital that is important to the customer. Key issues include:

- What is the likelihood of departures? Does the contract prevent the customer (or its designee) from soliciting some or all of the Satyam personnel working on the account? If so, is it for the duration of the term or only for specified periods of time?

- What is the immigration status of those U.S.-based Satyam personnel who are critical to the customer? Will this immigration status affect the customer's (or its designee's) ability to hire these people? If they are forced to leave the U.S., will service delivery be affected?

Notwithstanding anything to the contrary in the agreement, in any initial notification sent to Satyam, the customer should consider proposing to Satyam that either it or its designee will immediately engage key Satyam personnel to avoid a mass exodus and to protect critical intellectual capital. Customers also should note that U.S. immigration laws provide no "grace period" to protect the employment status of foreign nationals working in the United States pursuant to nonimmigrant visa status such as the H-1b or L-1 classifications. To remain in the U.S. after separation from Satyam, foreign nationals holding nonimmigrant status must have their status re-associated to a new petitioning employer, request their status be changed to that of a lawful visitor, or depart the U.S. on the same day their employment with Satyam ends. Customers with Satyam's foreign nonimmigrant personnel performing services at their work sites should maintain an action plan to implement if it becomes necessary to protect the nonimmigrant's employability.

Alternate Supplier

Transitioning outsourced services from one supplier to another presents significant operational risks and challenges even under "normal" circumstances. These risks increase in magnitude if the customer is looking to make a switch in fairly short order.

Key issues include: What existing service relationships can the customer leverage to quickly establish an alternate source of services? To what extent are alternate suppliers ready and able to pick up work from Satyam? In particular, how quickly could those suppliers transfer personnel from Satyam?

Customers should consider having contracts and transition plans in place with an alternate supplier in the event the alternate supplier needs to step in quickly to assume responsibility for service delivery.

Customer IP, Confidential and Personal Information

To what customer-owned or jointly-owned IP (including code), customer confidential information and personally identifiable information does Satyam have possession or access? Does the customer have complete copies of all of the foregoing? How is this material transmitted, stored and secured? Is the source code in escrow, if any, up to date?

In any initial notification sent to Satyam, customers should consider asking Satyam to provide an inventory of, and operational and security details regarding, IP and confidential information. With regard to IP ownership, consider asking Satyam to confirm its assignment of any relevant IP to the customer in writing. With regard to personally identifiable information and confidential business information in Satyam's possession, the customer should also remind Satyam of its obligations to protect such data so that they are not improperly disclosed or transferred in any attempts to salvage Satyam or its assets.

Computing Infrastructure

Customers should have a detailed understanding of the computing infrastructure that Satyam uses to provide the services. Key issues include:

- What hardware, software and other IP will the customer or its designee need to transition the services from Satyam and provide them on an ongoing basis? Can either the customer or its designee fulfill these requirements?
- Does the contract require Satyam to sell to the customer any hardware upon termination or assign to the customer any software (and supporting documentation) or other IP? Do these rights extend to the customer's designee?
- Has Satyam kept up to date all service delivery documentation (e.g., procedures manual or change control procedure)? Does the customer have the latest copies?

In any initial notification sent to Satyam, customers should consider asking Satyam to provide a detailed inventory of the hardware, software and other IP that it uses to provide the services and to specify which assets are transferable.

Customer Claims

Does the customer have financial claims against Satyam (e.g., fee refunds, service level credits or disputed fees)? Does the customer have a right to set off amounts under the contract?

If so, the customer should consider setting off such amounts against any existing unpaid fees. If Satyam were to enter into bankruptcy, the customer may not be able to recover such amounts. The customer also should consider whether it would be willing to accept a credit enhancement (consisting, for example, of a standby letter of credit).

Live Link

Satyam: A Timely Warning for Outsourcing Customers; Pillsbury Client Alert; 08-Jan-2009

For further information, please contact:

Michael Murphy (bio)
San Francisco
+1.415.983.1303
michael.murphy@pillsburylaw.com

Rick B. Antonoff (bio)
New York
+1.212.858.1110
rick.antonoff@pillsburylaw.com

David I. Kussin
Los Angeles
+1.213.488.7278
david.kussin@pillsburylaw.com

Vipul N. Nishawala (bio)
New York
+1.212.858.1021
vipul.nishawala@pillsburylaw.com

Yusuf H. Safdari (bio)
Silicon Valley
+1.650.233.4672
yusuf.safdari@pillsburylaw.com

Joshua B. Konvisser (bio)
New York
+1.212.858.1027
joshua.konvisser@pillsburylaw.com