

Rightsourcing: Seeking a Balance Between Insourcing and Outsourcing

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A Practice Note discussing rightsourcing, or the process a company may use to evaluate whether to perform certain functions internally or outsource them to a third-party service provider. The Note identifies key business benefits and risks of outsourcing and outsourcing agreement provisions that can help a company minimize those risks by providing flexibility to bring some or all services back in-house if the relationship does not meet the company's expectations or the company's needs change.

Conventional wisdom views outsourcing as a way for companies to save money and improve service levels. Common reasons for outsourcing include:

- Cost reduction or control.
- Gaining access to information technology (IT) resources that are unavailable internally.
- Saving resources to improve customer focus.
- Reducing time to market.
- Accelerating a company's transformation.

Companies generally outsource non-core competencies. For example, a pharmaceutical company is unlikely to outsource drug research but may outsource payroll and other support functions. Some gray areas may exist, such as clinical trials, which are close to a pharmaceutical company's core business but may be outsourced.

However, a growing number of senior managers have come to believe that organizations should keep processing in-house, recognizing:

- The business risks associated with outsourcing.
- The failure of many outsourcing deals to live up to expectations.

For example, executives at [Ford](#), [Apple](#), and [Virgin Media](#), among numerous other companies have publicly championed insourcing for their companies. For instance, Ford's CEO commented in [an interview](#) that Ford has insourced the software and technology components for producing its electric vehicles. More companies are

evaluating their outsourcing strategies in a process called "rightsourcing" as they seek to balance maintaining their in-house skill set at a certain level with taking advantage of service providers with the best technology and an attractive price point. This article describes the rightsourcing process and explains how companies can obtain rightsourcing flexibility by negotiating appropriate provisions in their outsourcing agreements.

What is Rightsourcing?

In rightsourcing, a company considers whether it is best served by:

- Moving its non-core functions to a third-party service provider (outsourcing).
- Bringing all functions back in-house (insourcing).
- Using a combination of both outsourcing and insourcing.

Rightsourcing is an ongoing process that involves not just an initial decision whether to outsource certain functions, but also ongoing evaluations whether to change course. That is, a company may decide at any time to outsource additional functions or bring outsourced functions back in-house.

Factors affecting this determination may include:

- Changes in circumstances or market conditions.
- Failure of the selected solution, whether insourced or outsourced, to meet expectations.



Whatever the company decides initially, retaining the ability to make changes can help manage associated risks (see Box, Business Risks Associated with Outsourcing). Sourcing agreements must be structured to provide the flexibility necessary to make different choices in the future, as circumstances and requirements change.

Rightsourcing Contract Considerations

A company's ability to effectively rightsource generally depends on how easily and cost-effectively it can change course. A company that wishes to bring outsourced services back in-house may find its objectives frustrated if, for example, it:

- Remains obligated to pay fees, including a possible termination fee, under the outsourcing agreement.
- Must migrate to a new software solution because it does not have rights to the service provider's solution.
- Loses access to data it has stored on the outsourcing service provider's system.

Addressing end-of-contract issues in the outsourcing agreement at the beginning of the relationship is generally in the customer's interest. Customers tend to have more negotiating power when the service provider is seeking to secure revenues and other potential contract benefits than at the end of the relationship which, in some cases, may have become acrimonious. In addition, obtaining this flexibility can minimize some of the risks associated with outsourcing.

There are several provisions in an outsourcing agreement that can help the customer retain rightsourcing options. These include provisions relating to:

- The agreement's term (see Agreement Term).
- Customer termination rights (see Termination for Convenience).
- Rights to service software and other technology (see Continued Access to Service Software).
- Data rights, including data ownership and access (see Data Rights).
- Knowledge transfer obligations (see Knowledge Transfer Obligations).
- Transition services (see Transition Services).
- Regulatory compliance (see Regulatory Compliance).
- Force majeure (see Force Majeure).

Agreement Term

Customers may seek to avoid being locked into an outsourcing arrangement beyond its usefulness by managing the agreement's term or providing for early termination rights in the outsourcing agreement (see Termination for Convenience), or both.

Most outsourcing agreements are for a term of years. Initial terms typically range between:

- Three years for a smaller agreement.
- Five to seven years for a more comprehensive contract.

Initial terms of as long as ten years were once common. However, such lengthy terms have become rare.

A long-term outsourcing agreement can provide certain advantages to the customer, including:

- Certainty of service availability.
- Cost stability
- Avoiding the transaction costs and administrative burden of continually negotiating new agreements.

In addition, service providers often offer lower fees for longer term agreements. However, the customer also risks being committed to using or paying for services that do not meet its expectations or are no longer useful. To balance these considerations, a customer may be best served by having an agreement that:

- Has a shorter initial term.
- Gives the customer a unilateral right to renew for one or more additional terms (for example, a five-year agreement may give the customer the right to renew for two renewal terms of one year each).

For a sample provision giving a customer unilateral renewal rights, see [Standard Document, Website Hosting Agreement \(Pro-Customer\): Section 12.2](#).

Termination for Convenience

The customer also can maintain flexibility by securing liberal termination rights. The right to terminate an agreement without cause, or "for convenience," enables the customer to terminate early without having to show a breach by the service provider. The service provider may be fully performing under the agreement, but the customer's priorities may have changed for business, market, or economic reasons.

For example, the customer may reorganize its business, divest subsidiaries, or bring in a new CEO who believes

that the customer should control all business processes and not cede that control to a third party. The customer generally wants the right to end the outsourcing relationship if:

- The services are not being provided as planned.
- Cheaper, higher quality, or otherwise more suitable services become available in-house or from another third-party service provider.
- The company's strategic goals change.

Termination for convenience provides a clean end to contractual obligations and helps avoid the uncertainty of potential claims for breach and risk of the service provider withholding support for a smooth transition.

However, a customer seeking a right to terminate for convenience generally must weigh the benefit of this right against its cost. The amount the customer must pay to obtain or exercise the right can be one of the most heavily negotiated provisions in an outsourcing agreement.

In one instance, the customer concluded that it could not initially terminate for convenience because the attendant costs would be too high, though it later terminated and ended up owing the service provider more than \$14 million in such costs. The customer should carefully consider the termination fee, or it may find itself unable to exercise its right of termination for convenience because the attendant costs are too high.

Allowing a customer to terminate an outsourcing agreement early for convenience generally creates significant business risks for the service provider, including:

- Failure to recoup up-front costs.
- Underutilized personnel and other resources.
- Lost economies of scale.
- Severance costs for terminating unnecessary personnel.
- Uncertainty in business planning and budgeting.

Service Providers' Up-Front Costs

Outsourcing relationships usually involve significant up-front expenses that the service provider expects to recoup over the life of the contract. For example, during the build-out of the outsourced service the service provider may have additional costs to:

- Transition personnel.
- Secure and build out additional workspace.

- Purchase, configure, and network equipment.
- Customize systems.

Instead of requiring the customer to pay for these up-front costs as incurred, outsourcing providers often factor them into their periodic service fees to recoup them over the term of the contract. For example, a service provider that budgets \$480,000 in build-out costs for a four-year outsourcing agreement may recoup these expenses by allocating an additional \$10,000 (or more to cover overhead or provide for profit) to each monthly fee. If the customer can terminate the agreement early, the service provider risks failing to recover its investment.

Outsourcing providers generally manage this risk through a fee structure that may include:

- Up-front fees.
- Higher service fees.
- A termination fee, payable only if the customer exercises its right to terminate.

Depending on the fee structure, a service provider may be able to recoup its up-front costs, which would otherwise be amortized over the life of the agreement, immediately on early termination.

Termination Fees

The amount and structure of termination fees vary based on the circumstances. Often the fee is based on a sliding scale where the amount payable for early termination declines over the term of the contract. For example, an agreement with a five-year initial term may provide for:

- No right of termination for convenience in the first year.
- A termination fee for the customer's termination in the second year in an amount sufficient for the service provider to recapture its up-front investment, pay its committed costs (including severance costs) and, in some cases, realize some or all of its anticipated profits.
- Termination fees that decline proportionately in each successive year.

Termination fees also may vary based on the customer's reason for terminating. For example, a service provider might charge a lower fee if the customer is insourcing the services or abandoning the outsourced function entirely than if the customer is transferring them to another service provider.

From a rightsourcing perspective, the early termination right is generally valuable to the customer only if the arrangement enables the customer to avoid paying at least some of the fees that would be payable if the contract were not terminated early. However, it generally must also enable the service provider to at least recover its costs and pay severance or relocate employees.

Termination Notices

The amount of advance notice the customer must provide to terminate the outsourcing agreement is another key variable. The right to terminate for convenience usually requires the customer to provide the service provider with a stated minimum period of advance notice. This helps the service provider reduce the costs associated with early termination, including by:

- Allowing the service provider to collect fees through the notice period.
- Enabling a more orderly transfer of employees to another project.
- Minimizing downtime between projects.

Generally, service providers require a minimum of 90 days' notice and, based on the circumstances, may require 180 days' notice or longer notice for termination for convenience.

Longer notice periods for termination may reduce a customer's flexibility to insource. However, in practice, the customer often requires a similar amount of time to smoothly transition the customer's services in-house or to another service provider.

Continued Access to Service Software

In many outsourcing relationships, the service provider uses mission critical software to operate portions of the customer's business. This may include software that is either:

- Proprietary to the service provider.
- Licensed from third parties.

To migrate outsourced services smoothly and cost-effectively in-house or to a new service provider, the customer may require direct access to this software after the agreement terminates. However, the service provider's third-party software license agreements may not allow that access, for example, if they:

- Limit or prohibit assignment and sublicensing.

- Authorize use of the software only at a specified location, by certain named users, or by a specific limited number of users.

In addition, for both third-party and service-provider owned software, it can be difficult to negotiate and agree on favorable software license terms at the time of termination. Therefore, the customer should address post-termination software license rights in the outsourcing agreement at the outset, to minimize risks that it will either be unable to directly license mission critical software if the agreement terminates or be able to do so only at a substantial cost.

To prepare for a possible rightsourcing event, when entering into an outsourcing agreement, the customer should:

- Obtain from the service provider, for mission critical functions such as order processing, engineering, cash applications, or inventory:
 - an inventory of the service software, identifying whether each program is owned by the service provider or a third party; and
 - copies of applicable license agreements for all third-party software.
- Review all applicable license agreements to ensure that the licenses:
 - are granted directly to the customer, are transferable, or allow for sublicensing to the customer;
 - survive termination of the outsourcing relationship; and
 - authorize the customer or any of the customer's successor service providers to run the application.

Because the service provider often has a volume discount with the licensor, the customer should also identify whether its license fees under any of these third-party license agreements may change as a result of a rightsourcing event, and by how much.

In any outsourcing termination scenario, any mission critical software licenses and their terms must also be addressed as part of the transition plan (see Transition Services).

In-House Software License Agreements

The same considerations are relevant when a company licenses software to perform in-house functions. In that case, to remain flexible for a rightsourcing event (in this

case, a later decision to outsource), the company must ensure that the license explicitly allows:

- Outsourcing. If the license does not expressly permit outsourcing, the customer may face both breach of contract and copyright infringement claims from the licensor.
- The customer to transfer the software to a service provider.
- A service provider to operate the software on its own systems.
- The licenses to be assigned back to the customer (if, for example, the customer changes direction and seeks to take the software's operation back in-house).

Usually, the software can be transitioned back to the customer, but because the assignment fees payable to the licensor are often substantial, the customer should determine at the time of contracting the amount of these fees and which entity will be responsible for paying them.

Existing software license agreements may need to be renegotiated to accommodate and provide for the outsourcing relationship and potential future insourcing. Failing to address these issues up front can result in substantial costs.

Data Rights

Companies often overlook or fail to adequately address the right to data when negotiating outsourcing agreements. This right includes two key components:

- Ownership (see Data Ownership).
- Access (see Access to Data).

A customer generally must be able to obtain its own data both:

- On demand, while the agreement remains in effect. Depending on the nature and importance of the services, this may be on a 24/7 basis.
- When the agreement terminates.

If a customer is to transition a system back in-house as part of a rightsourcing event, it will need its outsourced data for testing, conversion, and ultimately operation. If the customer cannot obtain control over its own data, the consequences may include:

- Being locked into the outsourcing arrangement for the term of the agreement.

- Incurring substantial costs and diversion of resources to migrate or recreate its data when the agreement expires.
- Business interruptions.

For more information on data ownership, licensing and use, see [Practice Note, Data as IP and Data License Agreements](#).

Data Ownership

Parties to an outsourcing agreement typically do not dispute that the customer owns its input data (or has priority of ownership over the service provider). However, they may disagree about who owns the data that results when the service provider's system processes the customer's data. This new data typically includes, for example:

- The results of calculations or analytics performed on the customer's data.
- Data that has been aggregated, de-identified (made anonymous), or converted into a different format.
- Integrated data that combines the customer's data with the service provider's or third-party data or software code.

Many customers may assume that they own rights in this resulting data, particularly when it is only their input data converted to a different format. However, the service provider may claim ownership. To gain clarity, the customer should ensure the outsourcing agreement addresses ownership of the new data.

For a customer to have full ownership of the data, the customer should ensure that the outsourcing agreement:

- Clearly states that the customer owns all data.
- Defines data to include both:
 - raw data as provided by the customer; and
 - all data modified or produced by the service system or the service provider.

Access to Data

To be prepared for a potential rightsourcing, the customer must also have access to its data in a usable form both:

- When testing for a system to be brought in-house.
- To implement processing when a system is brought in-house.

Lack of this access may restrict the customer's options when deciding to bring processing in-house.

The customer should therefore ensure the outsourcing agreement requires the service provider to provide the customer, at any time on 24 hours' notice, with a copy of the data in an electronic format that is specified either:

- By the customer.
- In the agreement, in which case the customer should seek to include in the agreement the right to specify a new format.

Knowledge Transfer Obligations

In an outsourcing arrangement, employees are often transferred, or re-badged, to the outsourcer. That is, they are essentially simultaneously terminated by the customer and hired by the service provider. Where employees are not re-badged, an outsourcing customer may simply terminate their employment either when the function is first outsourced or over time. In addition, when a company has outsourced certain functions to a third party, even if it does not terminate or re-badge employees, it typically does not continue developing skills, knowledge, and expertise in its processing environment.

If and when the company brings the processing back in-house, it generally must regain this knowledge. The most efficient way to do this is usually through a knowledge transfer from the service provider directly to the customer. As with other issues, the customer is generally in the best position to address this at the beginning of the outsourcing relationship. Therefore, the customer should ensure that the outsourcing agreement provides for full knowledge transfer back to it when the agreement terminates or expires. This transfer can take several forms, including:

- Requiring the service provider to make its managers and people knowledgeable about specific topics (often referred to as subject matter experts or SMEs) available to the customer for knowledge transfer and training.
- An express right for the customer to hire (or re-hire) the SMEs so that their skill set can be brought back in-house.

To be prepared for an involuntary insourcing (for example, if a force majeure event occurs) or a contentious insourcing, the customer should consider requiring ongoing knowledge transfers and training throughout the term of the outsourcing arrangement.

Transition Services

Another key provision to include in any outsourcing agreement addresses transition services or migration assistance. Outsourcing relationships can be so complex that there often is not a single termination point when services are halted at the service provider and started at the customer without overlap. Instead, a seamless migration may require a transition plan that can take several months to bring all functions back to the customer's in-house operations gradually and efficiently. During the transition, the service provider may provide:

- Redundant services until the customer's environment is fully operational.
- Consulting, troubleshooting, and other support to facilitate the customer's in-house implementation.

The various types of operations that may be involved in a single outsourcing relationship but are not necessarily related to each other in a processing environment (often referred to as towers) may include:

- The data center.
- The help desk.
- Software applications and maintenance.
- Benefits.
- Finance and accounting.
- Telecommunications.

In many cases, the customer may decide to bring one or two towers in-house in a rightsourcing initiative while keeping other towers outsourced to the service provider. Regardless of whether the customer reclaims all or just selected towers from the service provider, the transition to the customer can take several months. It can be difficult to negotiate transition services at the time the agreement is terminating and, unless the customer is keeping substantial services with the service provider, it is likely to lack meaningful negotiating leverage. Therefore, the customer should seek to address transition services in some detail at time of contracting. The agreement's transition services provisions should take into account:

- The definition of transition services.
- The timeframe of transition services.
- The number of service provider personnel involved.
- The fees the customer must pay for transition services.

Depending on the circumstances, transition services may be included in the monthly fees, as long as personnel are available to perform the transition, or provided for by separate fees.

Regulatory Compliance

Regulatory compliance is another key element of many outsourcing arrangements. The agreement should:

- Assign initial responsibility for compliance with regulatory requirements.
- Address continuing responsibility for regulatory compliance during the life of the agreement.
- Establish a process to transfer responsibility for compliance from the service provider to the customer if the customer reclaims the related processing function.

Both the service provider and the customer may have regulatory exposure to investigations and enforcement actions. A company cannot risk being out of regulatory compliance, which could lead to enforcement actions by regulators. Some companies or functions are subject to industry-specific regulations, for example:

- A bank must comply with federal and state banking regulations.
- A healthcare provider must comply with the Health Insurance Portability and Accountability Act (HIPAA).
- Pharmaceutical companies are subject to Food and Drug Administration oversight.
- Businesses across industry sectors may face Federal Trade Commission enforcement actions if they fail to protect customers' information.

Therefore, at the time of contracting, each party to an outsourcing arrangement should insist on a commitment from the other party that it will comply with all federal and state laws and regulations. While this may seem to be a simple requirement, it can be a contentious issue. For example, when a bank outsources certain functions the service provider may claim that it is simply an information processor, and that the bank is the entity familiar with banking regulations and responsible for compliance.

The bank, however, may take the position that since the service provider is in the business of supporting banks, the service provider must take responsibility for complying with the banking regulations.

When transitioning services in-house, the customer must be able to take over and control systems that support compliance in its industry. Both the customer and the

service provider may have liability if there is a gap in regulatory compliance.

Force Majeure

Some insourcing decisions are not voluntary but are triggered by a catastrophic event that causes a service provider to suspend or cease operating entirely or in a particular geographic region. Therefore, although force majeure clauses are often not heavily negotiated, they can be crucial to providing rightsourcing flexibility. Disputes over ambiguous force majeure clauses can also lead to litigation.

The global COVID-19 pandemic in 2020 and 2021 disrupted outsourcing providers' ability to perform as governments banned travel, closed workplaces and required workforces worldwide to work remotely. These events refocused attention on outsourcing contract clauses that had previously often been overlooked. In particular, providers and their clients scrutinized force majeure, choice of law and forum selection clauses. Parties' rights under force majeure differ in accordance with the law of the jurisdiction they agreed to apply to contract interpretation and the forum in which they agreed that any disputes will be adjudicated. The full extent of disruption may not be known for years.

Some disaster-related issues that should be addressed in the outsourcing agreement in anticipation of insourcing following a crisis include:

- **The continuity of operations following a disaster.** The outsourcing agreement should address how destruction of the service centers could affect the companies' operations in the US and elsewhere. Steps should be outlined in the agreement, likely in the force majeure clause, to allow a customer to take immediate control of its operations in the event of a disaster (for example, hurricane, earthquake, fire, or flooding).
- **Back-up procedures and substitute service locations.** The outsourcing agreement should address what back-up procedures the service provider has in place to ensure continued access to data. It should also address whether the service provider has "hot sites" at a separate location ready to be put into operation within several hours of a disaster and whether the customer's critical data is being backed up in a real time environment.
- **The transition of affected processes in-house.** The agreement's force majeure clause should address whether the customer's processes can be transitioned to an in-house environment to maintain productivity

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without negatively affecting profitability, in the event of disaster. To some extent, this issue can overlap with provisions for transition services and software licenses but the services may need to be transitioned only partially or temporarily in the event of a disaster.

- **The existence of an effective disaster recovery plan.** The outsourcing agreement should address whether the service provider has a realistic and operational disaster recovery plan. Often, an outsourcing agreement obligates the service provider to provide a formal written disaster recovery plan once or twice a year. The customer should:
 - review the plan and even visit the hot sites referenced in the plan;
 - fully understand the options that will be available in the event of a disaster and ask to modify the plan if it is not satisfactory; and
 - maintain the plan in a form and location that can be easily accessed if a disaster occurs, when the service provider may be unavailable to provide a copy and guidance.

Business Risks Associated with Outsourcing

Outsourcing arrangements expose the customer to certain intrinsic risks, including:

- The customer's greater vulnerability arising from the service provider's control and operation of a segment of the customer's business.
- Less control over data privacy, security, and other regulatory compliance resulting from the cost-driven placement of outsourcing operations to increasingly remote overseas locations. For example, India and China, which have been the principal destinations of such arrangements, have experienced increased labor costs that

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have steered outsourcing processing centers to Pakistan, Bangladesh, and Vietnam.

- Being locked into a long-term outsourcing agreement that no longer meets the customer's needs.
- Inability to obtain the rights to direct access to and use of the outsourcing service provider's software.
- Loss of control over and potential inability to access or retrieve its outsourced data.
- Losing its skill set in the outsourced areas and, as a result, becoming less competitive.

All of this underscores the customer's need to retain the necessary flexibility to allow management to adapt a company's business model to changing circumstances.

Sample Clauses for Outsourcing Agreements

For pro-customer examples of certain key definitions and provisions that should be included in an outsourcing agreement, see the following provisions in [Standard Document, Software as a Service \(SaaS\) Agreement \(Pro-Customer\)](#):

Topic	Applicable Sections
Customer Data Access and Ownership	Section 1 (definition of "Customer Data"); Section 10.1; Section 10.2; Section 10.4; Section 14.5(a)
Termination and Effect of Termination	Section 14.3; Section 14.4; Section 14.5
Compliance with Privacy and Other Laws and Regulations	Section 2.6
Data Security and Disaster Recovery	Section 6; Section 7