

EMERGING TRENDS Q&A: MAINTAINING CORE SOURCING FUNCTIONS IN THE WAKE OF BANKRUPTCY

Q&A



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Overview

As more financial institutions get swallowed up by better-positioned industry competitors or find themselves forced to file for bankruptcy, many of these institutions' technology providers also are being impacted by the worsening economic crisis. As part of Pillsbury's multidisciplinary Global Business Evolution Team, the firm recently launched an Outsourcing, Technology & Insolvency Solutions initiative, which takes an integrated approach to tackling the tough issues that outsourcing and technology suppliers and customers face in a rapidly deteriorating economy. New York sourcing and technology partner Josh Konvisser and bankruptcy partner Leo Crowley, co-heads of this new initiative, answer questions about how to ensure that a company's outsourced functions continue operating in the event of a bankruptcy.

Q. What's the current situation right now for technology companies and other sourcing providers?

Konvisser: Traditionally, financial institutions have been among the most reliable and biggest users of technology products and services, often outsourcing their IT, communications, finance and accounting,

HR, and document review functions as well as other higher-order business processes. However, as more and more major investment banks and other corporations file for bankruptcy or fall prey to a merger, many tech companies are seeing work disappear, putting their own income streams at risk.

Q. But if outsourcing core functions actually saves companies money, why wouldn't tech companies be busier during a recession?

Konvisser: While it's too soon to know for sure, no doubt some technology companies and other service providers will benefit as organizations seek alternatives to reduce costs. Generally, sourcing essential functions is highly cost-effective and strategic. However, keep in mind that there is usually a high up-front transition cost to enter an outsourcing arrangement. To the extent capital is scarce, it may be hard for a company to invest in a large outsourcing agreement—even where the long-term savings case is clear. Moreover, as more financial institutions fail or are absorbed by more successful competitors, the number of institutions requiring tech, accounting or human resources support decreases and sourcing providers might find themselves

becoming redundant. This poses problems for both sourcing provider and customer alike.

Q. What types of problems do they face?

Crowley: A customer may have agreements with a technology or other sourcing provider that has been forced into bankruptcy due to a decline in clients, overextended credit or numerous other reasons. Where an agreement is “executory” (i.e., has ongoing performance obligations by both parties), the debtor, in this case, the sourcing provider and the provider alone, has the right to reject or assign the agreement. If the provider opts to reject the agreement, the customer may find itself without a service provider with little notice. This can be disastrous for a customer that has outsourced a mission-critical function and no longer has the ability to perform the function in-house, destabilizing the customer’s ability to perform so much that, in turn, it too winds up filing for bankruptcy. Thus the vicious cycle continues.

Q. But what if the service provider opts to assume and assign the agreement?

Crowley: That’s generally a win-win for both customer and provider, whereby the debtor assigns the agreement to another solvent entity that is taking over the debtor’s business. It also may give the customer the opportunity to re-negotiate better terms. But it’s important to understand that the decision to reject or assign the

contract is solely at the discretion of the debtor, and the customer will have no say over to whom the agreement is assigned. There may be real concerns with the assignee, for example, in situations where the assignee is a competitor of the customer.

Q. What can a customer do to protect itself?

Konvisser: Customers can include certain provisions in the contract that can help mitigate disruption of service or ameliorate loss from an unexpected assignment. For example, a customer may include anti-assignment provisions to help protect against the agreement being transferred to an undesirable third party, may mandate financial and/or performance guarantees from one or more affiliates of the provider entity, or may request source code escrow, which will grant the customer at least some access to critical software even if they no longer have someone to run or maintain it.

Q. That’s all well and good for a new contract, but it doesn’t help much with companies already in distress.

Konvisser: Once the agreement has been executed and a service provider has filed for bankruptcy, the customer has certainly lost most of its options. However, all is not lost. The attention shifts to managing the insolvency proceedings to ensure that the customer’s rights are protected and that any claims are not inadvertently lost.

Q. What about the sourcing supplier if the customer goes bankrupt? Is there any way to ensure the supplier retains the work if the customer-debtor assigns the agreement?

Konvisser: Again, once the customer has filed for bankruptcy, it is likely too late to do more than manage the bankruptcy process. However, as with the customer, the supplier has a number of options available to it if it plans ahead for affiliate guarantees and liquidated damages tied to objective criteria signaling an insolvency risk.

“Emerging Trends” is a monthly feature from Pillsbury that explores complex business and legal issues that may impact a company’s goals now or in the near future.

Initially established in March 2007 to counsel clients affected by the subprime industry meltdown, Pillsbury’s Global Business Evolution Team advises clients across multiple practices and industries about how to survive, negotiate and, in certain cases, even thrive in a down economy and in anticipation of the increased regulatory oversight that will inevitably result. Outsourcing Technology & Insolvency Solutions is just one of several initiatives organized by that Team.

For more information or to schedule an interview with any of our Emerging Trends lawyers, please contact Sandi Sonnenfeld, Director of Public Relations, at 212/858-1741 or via email at sandi.sonnenfeld@pillsburylaw.com