

Outsourcing Business to India & The Third-World Countries

Financial Protection for Acts of Executives & Employees



William Gallagher Associates
Phone: 888.261.8884
www.WGAins.com

Outsourcing transactional and technical work to other countries is a common and growing practice in the world of high tech. Entities that provide these services are known as business process outsourcing firms (BPOs). Those that rely heavily on broadband Internet resources are frequently referred to as information technology enabled services (ITES) or BPO-ITES. The five major global BPO sectors are information technology (43%), financial services (17%), telecommunications (16%), consumer goods and services (15%), and manufacturing (9%).

India is the undisputed leader in providing outsourced, offshore services, with about 63 percent share. Well known U.S. internationals that have employed BPOs in India include Accenture, Aetna, American Express, AOL, Blue Cross & Blue Shield Association, Cisco, Citibank, Dell, Delta Airlines, GE, Hewlett Packard, IBM, Motorola, Verizon, and Yahoo.

India relies on an abundant, well-trained, English-speaking workforce, many of whom are college-graduated engineers, for the critical mass necessary to make the industry the success that it is. The country is blessed with a good infrastructure and a healthy telecom industry; with adherence to international standards for quality, security, training, and the protection of intellectual property; with a tax-friendly environment; and with relatively low labor costs, though the gap in labor costs is closing.

With government support and encouragement, more than 400,000 Indians provide outsourcing services, primarily in finance, human resources, and customer services – such as call centers and technical support, medical transcriptions, data processing, billing services, and network engineering and management support. Other emergent areas of interest are pharmaceuticals and offshore legal services. With the change in the 1990s from government monopolies to privatization, India capitalized on outsourcing; and the industry has since grown dramatically. During the 1990s multinationals created wholly owned subsidiaries in India to provide some of their back office and customer support services. Today there are independent companies that have taken advantage of economies of scale to provide services to multiple customers.

Outsourcing work is frequently exercised in conjunction with a service level agreement (SLA) that is incorporated into the outsourcing contract. SLAs are used to measure the quality of work performed, and the result may determine the price paid by the outsourcer.

William Gallagher Associates, a leading provider of insurance brokerage, risk management and employee benefits services to firms with complex risks, within industries that include high technology, life sciences, financial risks, healthcare services, energy, and environmental services. WGA has offices in Boston, MA; New York, NY; Hartford, CT; Princeton, NJ; Columbia, MD; Atlanta, GA; and Paris France.

Bangalore in Karnataka state is the center for U.S.-based software companies in India. This city has both a skilled workforce and a well-developed telecommunications infrastructure. The center for U.S. companies engaged in the life sciences is Hyderabad. New outsource centers are developing in many other locales in India where labor costs are lower than in the established metropolitan centers, especially for senior employees. Cities gaining substantial U.S. business include Pune, Chennai, New Delhi-NCR (National Capital Region), and Mumbai.

Some firms specialize in knowledge process outsourcing (KPO) or legal process outsourcing (LPO). Knowledge transfers often involve core business processes and intellectual property, and therefore represent a higher level of risk for the outsourcing company. An important business consideration for companies that send work offshore is the sanctity of their intellectual property. In India there are two legal routes, statutory protection and written party-to-party agreements. Both methods are used for copyright, patent, and trade/service mark protection. For the protection of trade secrets, companies rely on agreements. While copyright protection is available in India for software, patent protection is less certain.

Intellectual Property

Protection under Indian copyright law grants the author the right to retain the integrity of his or her work and to claim authorship of the work, unless waived. Without a waiver, protected work that is modified, distorted, or mutilated, and which harms the author's reputation or honor, is treated as an infringement of the author's moral rights, even if the work is created as part of the author's employment. Moral rights may be waived by the author, in whole or in part, but not assigned. This is an important aspect of Indian law for companies that outsource some of their development work. Irrevocable waivers should be obtained from employees and contractors.

Research and development work is usually protected by invention assignment and confidentiality agreements between the India subsidiary and its employees. A separate R&D agreement between a captive subsidiary and its American parent is typically used to grant to the parent company the ownership of any intellectual property developed by the subsidiary. There are distinctions in Indian law as to the rights of employees of a subsidiary and the rights of employees of a contractor. The parent company can protect its rights against either, but it is more challenging with contractors. Ownership, service agreements, and assignments are tricky because the copyright laws of India are not the same as those of the U.S. Whenever possible, it is preferable to use a subsidiary to develop intellectual property.

How to Outsource

The BPO industry is evolving. New services are being created, such as biotech research, tele-radiological services, design and engineering, and tax processing. Outsourcing companies now have choices. They can create a local subsidiary (captive) or buy needed services directly from a local service provider. There are joint ventures, and BOTs (build, operate, and transfer) that begin as outsourcing company entities and evolve into independents or are transferred or sold to local businesses. BPO transitions usually involve some form of performance testing during the transition stage, a process sometimes referred to as "base-lining."

There are convincing business reasons for outsourcing, not the least of which is the cost of skilled and unskilled labor and economies of scale. The offshore BPO industry flourished in its early years because of the substantial disparity in labor costs between first world and third world countries. That gap has narrowed in the past couple of years. The direct costs of labor, however, represent only part of the total cost of outsourcing. The gap in salaries and benefits is offset to some degree by other enterprise costs, such as management, employee training, communications, control, productivity, security, preservation of intellectual property rights, and transportation.

A major cost factor that employers are having difficulty resolving is employee turnover. The annual turnover rate among employees of business process outsourcing (BPO) centers in India has reached epidemic levels, averaging 40 percent in recent years. There is not only a direct cost associated with recruiting and training, but also the costs of productivity and efficiency associated with learning curves, and the cost of errors, which can lead to lost business.

Potential Exposures

There are other more insidious costs associated with off shoring lurking in the shadows, such as the costs of discrimination and errors of judgment. These errors may be contractual, legal, or cultural.

Non-adherence to standards or contracts can have major consequences for both parties to a contract. Consider the economic and political damage caused by product contamination in China, first in the production of pet food contaminated with melamine, and then by the use of lead paint in the manufacture of toys. Both blunders caused huge recalls. As a consequence, U.S. companies had to dispose of thousands of tons of contaminated products. Sales of toys during the all important Christmas season were severely impacted; and today many consumers will not buy toys made in China, even from companies not involved in the lead paint fiasco. These problems hurt the American companies that bought the contaminated products, the Chinese companies that made them, and China itself.

One important consideration for companies that offshore work is that they must assure compliance with various U.S. and international accounting and certification standards. The U.S. Sarbanes Oxley Act imposes certain financial reporting and certification obligations on U.S. companies that are listed on a U.S. stock exchange. Companies may also have to comply with Statement of Audit Standards No. 70 and Basel II, an international financial accounting standard. The requirements created by these standards may compel some super-contractual certification obligations for some offshore operations. International quality controls standards (e.g., ISO) may also apply.

Errors involving regulatory and statutory compliance have recently become headline news in India. While such violations may have a criminal aspect, civil lawsuits may also impact the enterprise and its managers or executives. American companies that establish divisions or subsidiaries in foreign countries could be at risk for decisions made at the local or corporate level.

A case currently going through the courts in India illustrates the expediency of management oversight and corporate audits. In December, 2005, a night shift employee of Hewlett-Packard GlobalSoft, a BPO, was raped and murdered by the driver of a taxi cab hired to transport her between her job and her home. India has a statute that prohibits women from working night shifts unless the employer provides transportation to and from work and provides a security person to accompany the vehicle to ensure the safety of female employees while in transit. The government charged the BPO's managing director with failure to fully comply with the statute because it did not provide the requisite security escort while the employee was in transit. This incident also exposes GlobalSoft to a negligence lawsuit. While this case may not reach the level of cost or notoriety that followed Union Carbide's methyl isocyanate gas disaster in Bhopal, India, in 1984, it is a management problem nevertheless. (Bhopal cases are still in litigation, twenty-three years after the event.)

Attention to detail is not something that can be relegated with impunity. Covering all bases may seem like an impossible task, especially for executives thousands of miles away from the operation. But when failures cause harm, legal arguments about the difficulty of oversight are unlikely to be persuasive as a defense in local courts of justice. A good example is the Bhopal incident. Best practices developed for international financial reporting may have equal importance and application in all other aspects of entity operations. These practices include company policies, operations and management procedures, corporate oversight, and audits.

Errors of a cultural nature are especially important with regard to employment practices. American employers doing business in foreign countries are subject to local cultural norms as well as host country statutes. Violations of those norms can result in penalties or expulsion from the country. Cultural issues are important in the Middle East, Asia, Africa, and elsewhere.

Cultural differences can create some unusual situations. Last October it was reported that American actor Richard Gere and well-known Indian actress Shilpa Shetty were being sued in India because the two, who were attending a function to promote AIDS awareness, kissed several times in public. Such public displays are considered obscene acts in India. And in Saudi Arabia, flirting in public is a crime. Who would have known?

Cultural differences can undermine otherwise good policies and procedures. Consider this fictitious scenario. During an outsource service audit in India, the local managing director innocently tells the auditor that a specific procedure derived from an SLA is affirmatively being utilized for a particular task. But a subordinate who is attending the meeting knows that employees are taking many exceptions to the procedure to reduce the time it takes to complete each transaction. However, the employee does not interrupt or correct the manager because that etiquette would be considered disrespectful in Indian culture.

Another cultural problem in India and elsewhere is the unwillingness of employees to say "no." So misunderstandings and mistakes can occur. For example, although an employee may not be able to comply with a verbal directive, he may not inform his superior that there is a problem. This same reluctance to confront and a sense of shame have caused many victims of sexual harassment to quit their jobs rather than file a sexual harassment grievance with their employer.

Indian companies recently became painfully aware of a need to address the issue of discrimination, especially for their employees in the U.S., Canada, and Europe. In December 2001, a U.S. employee filed a sexual harassment and wrongful termination lawsuit in California against Phaneesh Murthy, a top executive and board member of Infosys Technologies, a leading Indian software provider based in Bangalore. The plaintiff, Mr. Murthy's executive assistant, contended that the defendant, an Indian citizen headquartered in California, subjected her to verbal and visual sexual harassment and unwanted sexual advances. She also asserted that the company failed to take appropriate action.

Indian culture is by nature risk averse. Perhaps that is why Indians do not like to deliver bad news, resulting in problems not being identified until it is impossible to ignore them. Indian companies have tens of thousands of workers, many in the software business, working in the United States, Canada, and Europe. Until 2002, many ignored employee issues such as discrimination, sweeping them under the carpet as was the practice in India. The Infosys case shocked those companies into action. Leading software companies began appointing U.S. citizens to manage their American entities and European executives to oversee their European operations in order to breach the cultural gap. They instituted multi-cultural training programs for employees who are assigned overseas and established better governance over their operations.

American subsidiaries can be sued in India for company errors or negligent acts. A recent incident in India highlights the risk. In this case an Indian software engineer in Bangalore was wrongfully accused of an Internet crime and spent 50 days in jail under horrible, inhumane conditions before he was finally released – three weeks after the real offenders were found and jailed. The engineer was arrested by a cyber crimes police unit because his Internet service provider (ISP) mistakenly supplied the police with his IP address. Initially he was jailed but not told of the charges against him, and he was denied the opportunity to contact his family or a lawyer. Later he learned that he was being charged with posting lascivious material on a social networking site and with committing a deliberate and malicious act with the intent to outrage religious feelings. It was a case of mistaken identity by the ISP.

The engineer is now suing the CEO of the ISP, the police, and others for violations of his civil rights, indignities, deterioration of his health, disgrace and the damage to his reputation, and criminal negligence. He is asking for about \$5 million in damages. American companies in India and elsewhere should be as keenly aware of negligence, civil rights, and privacy exposures as they are of those exposures in the U.S.

Even China is adopting Western principles. In August 2007, China passed a new employment law that advances employment, establishes fair employment conditions, and bans employment discrimination. The China Employment Promotion Law, which became effective January 1, 2008, prohibits discrimination based on ethnicity, gender, physical disabilities, race, or religion. Victims of discrimination may file lawsuits in the People's Court.

Insurance

Most American companies buy insurance to cover defense costs and settlements for cases like those mentioned above. They do not always do that for their foreign subsidiaries. Depending on the allegations and circumstances of the case, coverage might exist under a company's Commercial General Liability policy (CGL), a Directors' & Officers' Liability policy (D&O), an Errors and Omissions policy (E&O), or an Employment Practices Liability policy (EPL). It should be noted that Americans working abroad who are subjected to abuse may sue their American employers for violations of their American rights even though the particular practice is prevalent or legal in the host country.

India requires insurance to be placed on a locally admitted basis. The maturing Indian insurance marketplace has opened its doors to global insurers either through direct appointments or joint ventures with established Indian insurers. Local coverage can be placed and integrated into a Controlled Master Program (DIC/DIL). The increase in the number of insurers offering local solutions has resulted in a competitive pricing environment that favors the buyer.

In some instances, there may be some protections afforded by treaties between the United States and foreign countries that reduce or limit certain liabilities. These treaties are generally known as Friendship Commerce and Navigation (FCN) treaties. They are often used to protect foreign companies from having to meet strict host country employment laws regarding some employees.

There are other risks associated with off shoring work. Some of them are insurable risks, such as data security, property, liability, workers' compensation, kidnapping, extortion, expropriation, nationalization and other country risks. Other risks, such as interest rates and currency exchange, can be hedged. Some risks have to be dealt with internally, such as governance, cultural differences, damage to brand name, loss of process and operation control, and transition risks.

Trade with India is substantial. More than 400 companies in India – both captives of multinationals and third-party service providers – performed BPO services in 2005. The U.S. exported more than \$5 billion in private services that included business and professional, financial, insurance, telecommunications, and technical services – and imported about \$5 billion in services. Approximately 60 percent of the transactions between the two countries in 2005 were for services between affiliated companies. An affiliate is one in which there is at least 10 percent ownership or control, direct or indirect, of voting securities.

Business process outsourcing in India in FY 2006 was about \$36 billion. About \$7 billion of that was from offshore business – mostly from the U.S. and Europe –or about 63 percent of the worldwide offshore BPO industry. Total worldwide BPO business, which includes both offshore and onshore work, is estimated to have been between \$120 billion and \$150 billion in 2006 and could reach \$310 billion this year.

Because no system is perfect or free of all risk, American enterprises with financial exposures in India, China, or anywhere else in the world, should have their corporate counsel and their risk manager review all liability insurance policies for coverage gaps and limits of liability for their foreign operations. Whether dealing with an overseas or a domestic risk, the first step is always loss prevention and loss control. The second step is to insure the risk as comprehensively as possible.

