

Outsourcing: some legal aspects

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1. Introduction

Outsourcing is a term that is commonly used and most people understand the principle linked to this term, but the related terminology such as insourcing, offshoring, multisourcing, co-sourcing, rightsourcing or smart-sourcing becomes more confusing as sometimes such terms are used interchangeably.

This article aims at outlining the general principles of outsourcing and giving an overview on the related activities mentioned above. However, the special focus of this article will be IT outsourcing and the main corresponding legal aspects.

a) What is IT outsourcing?

In order to understand what information technologies (“IT”) outsourcing is, it is of course useful to define the term, but it is as equally useful to distinguish it from related activities and to know the different outsourcing “variations” referred to above.

i) Definition of IT outsourcing

Outsourcing is a management mode having nowadays more and more success.

The question to know what IT outsourcing is necessarily implies the question of what outsourcing represents in general.

Neither the outsourcing activity in general, nor the IT outsourcing in particular are legally defined under Luxembourg laws and regulations. However, IT outsourcing is referred to in the applicable regulations regarding the financial sector¹ which implies the general acceptance of IT outsourcing under Luxembourg laws.

Outsourcing may be defined as the transfer of internal activities not being part of the core business of the outsourcer to a third provider, without being linked by any kind of subordination.² Activities that may be outsourced for instance are the management of employees, accounting, information technology or day-to-day

¹ See 2 a) ii) below.

² In accordance with the definition provided for by M. Fontaine, D. Philippe and C. Delforge in “Les aspects juridiques de l’ “Outsourcing”, Brussels, 2002, pages 16 and 17.

execution of an entire business function to an external service provider. Business segments typically outsourced include information technology, human resources, facilities, real estate management, and accounting. Many companies also outsource customer support and call centre functions like telemarketing, cad drafting, customer service, market research, manufacturing, designing, web development, content writing, ghostwriting and engineering.

A company usually reverts to outsourcing in order to concentrate its resources on activities in which it wishes to be more efficient, as for instance the production or distribution of its products or services belonging to its core business.

IT outsourcing is thus the transfer of an IT related activity of a company, in whole or in part to a third person. IT outsourcing is also referred to as facilities management.³ Today, the term information technology encompasses many aspects of computing and technology, covering many different fields. In the IT outsourcing sector, outsourcing may range from whole infrastructures, maintenance and service management to server management help desk or back office services. In practice, IT outsourcing may for instance consist in the takeover by the service provider of all or part of the outsourcing organization's IT, hosting, help desk services, back office services.

ii) Related activities

Outsourcing and offshoring are sometimes used interchangeably despite important technical differences between both. Whereas outsourcing involves contracting with a supplier, offshoring is the transfer of an organizational function to another country, regardless of whether the work is outsourced or remains within the same organization. Outsourcing may also involve some degree of offshoring.

Needles to say, due to the increasing globalization of outsourcing companies, the distinction between outsourcing and offshoring may become less clear over time.

Moreover, insourcing and cosourcing will be defined below. However, it should be noted that cosourcing is also referred to as multisourcing, rightsourcing or as selective sourcing.

For the sake of completeness, selective sourcing, also known as smart sourcing and sometimes referred to as multisourcing, should also be defined here. Selective sourcing refers to an outsourcing strategy in which a customer employs one or more service providers to assist in the assessment, architecture, implementation and/or management of their IT solutions. Selective sourcing

³ Marcellin S., Costes L. et autres "Lamy droit de l'informatique et des réseaux", édition Wolters Kluwer, 2008, no. 3816.

allows the customer to determine how many service providers they participate with, how integrated a service provider becomes with their solution, what operations or technologies they are responsible for addressing and what goals they set for success in their engagement.⁴

Furthermore, outsourcing should be distinguished from other legal operations with which it seems to have certain similarities.

Entrusting the accomplishment of certain tasks or duties to someone else, could this not for instance be qualified as subcontracting or even as entering into a joint venture?⁵

The difference between outsourcing and subcontracting is that the outsourced activity does not consist of an execution of all or part of a contract entered into by a company and a third person, but it refers to internal functions of the outsourcing company itself.⁶ Moreover, whereas outsourcing generally implies the transfer of human resources or materials, subcontracting in principle, does not involve such transfer.

Moreover, the demarcation between outsourcing and a joint venture is made according to the nature of the activities and the way they are being carried out. Whereas by outsourcing the entity discharges one or more of its internal activities to a third party, in a joint venture (and also a collaboration agreement) the parties have decided to undertake a determined activity together.⁷

c) Who usually outsource IT activities?

The entities deciding to outsource their IT activities may range from small and mid-sized businesses to very large structured organizations or even public authorities. Moreover, entities being active in any sector may decide to approach a supplier for the handling of different IT activities.

To date, we have predominantly provided legal advice and assistance to entities active in the banking, insurance, telecommunication sectors and public fields.

⁴ Henin P., “Sun Smart Sourcing” (by Sun Microsystems), presented at the AmCham ComIT event dated 25 September 2008 (available on www.amcham.lu).

⁵ There are of course more than only these two legal concepts from which outsourcing could be demarked. In addition to the chosen two examples, outsourcing may for instance also be distinguished of the concession and franchising.

⁶ Fontaine, Philippe and Delforge, *op.cit.*, page 12.

⁷ Fontaine, Philippe and Delforge, *op.cit.*, page 14.

The decision to outsource an activity is usually a strategic decision which is based on many factors and is taken by every organization based on its own particular needs and priorities.

b) What are the reasons for outsourcing IT activities?

Whether to outsource all or part of the company's IT organization is one of the key decisions that today's corporate executives must make.

There may be multiple reasons for outsourcing may be multiple. The decision to outsource IT activities may be founded on strategic aspects (such as a business policy towards a concentration on the core business), contextual (existence of a trustable service offer in proximity), organizational (lack of resources or internal competences), qualitative (assurance to benefit from a defined quality level), financial (the desire for having a better overview on the IT related costs, perception or reality of internal excessive costs).⁸

IT outsourcing can notably eliminate the need to upgrade both, technology and IT skills by turning over the IT operations to a company that focuses strictly on provision of IT services and, therefore has both, people and systems that are on the cutting edge of IT capabilities.

Moreover, outsourcing removes legacy systems from management's plate and enables the internal IT organization to focus on ramping up its people's technology skills to the cutting edge.⁹

Furthermore, outsourcing may help achieve an improvement of quality through contracting out a service with a service level agreement, demanding a higher quality than the internal services actually provide (which will thus necessarily imply a transformation phase, as there is no reason, except maybe experience, that the service provider will be able to provide higher quality service with the same IT system and human resources). The outsourcing company may thus benefit from the wider experience and knowledge of the service provider, notably by the benefit of the operational expertise of the service provider, by having access to operational best practice that could be too complex or time consuming to develop in-house.

⁸ A.-L. Mention, "Outsourcing IT dans le secteur bancaire – Etat des lieux sur le recours à l'outsourcing IT dans le secteur bancaire", article of 21 March 2007, published *inter alia* on www.spiral.lu, page 1.

⁹ M. D. Lutchen, "Managing IT as a Business – A Survival Guide for CEOs", United States of America, 2004, page 74.

IT outsourcing may for instance be offered by the service provider in the form of a one-stop, per-head, full-scope PC utility service arrangement (e.g., PC provisioning, service, maintenance, replacement, asset management).

Because outsourcing is a negotiated arrangement, clients can build in whatever level of flexibility the company desires, in essence buying services *by the pound*.¹⁰

Finally, in difficult times, obtaining IT services using outsourcing arrangements may provide a company with maximum flexibility for workforce reductions.

2. Legal & Regulatory aspects

a) Outline of the applicable laws and sector specific regulations

There are no laws or regulations dealing with the legal requirements of outsourcing in particular. However, some main legal provisions applying to outsourcing, as the case may be, are outlined below.

i) Applicable law

The major regulations applicable to outsourcing in general and IT outsourcing in particular consists of the Law of 5 April 1993 on the financial sector, as modified (the "**Financial Act**"), which defines the concept of professional of the financial sector ("**PFS**").

The Financial Act has recently been significantly modified by the Law of 13 July 2007 relating to markets in financial instruments (the "**MiFiD Act**") and implementing among others the Directive 2004/39/EC relating to markets in financial instruments (so called "**MiFiD**"). The MiFiD Act notably provided for amendments to the Financial Act as to the definition of the PFS.

A significant amendment which is notably important in the frame of IT outsourcing is the creation of the following two new categories of service providers:

- article 29-3 of the Financial Act not only regulates operators of primary IT systems of the financial sector (i.e. those operators who are in charge of running information systems allowing the setting up of accounts and of financial statements). These providers are also able to carry out the

¹⁰ M. D. Lutchen, *op.cit.*, page 186.

activities provided for in the new Article 29-4 of the Financial Act (see below).

- the new Article 29-4 of the Act applies to operators of secondary IT systems and communication networks of the financial sector, those operators who are in charge of information systems not covered by new Article 29-3 of the Financial Act.

Further to the MiFiD Act, PFS are no longer required to provide their services exclusively to companies of the financial sector.

Moreover, PFS are called support PFS when they have been granted a license by the “*Commission de surveillance du secteur financier*” (Luxembourg’s Commission for the supervision of the financial sector - the “**CSSF**”) for acting as operators of financial sector information technology systems and communication networks for providing IT services to other professionals of the financial sector.

For the sake of completeness, it may be noted that following the modification of the Financial Act by the MiFiD Act, there now exist the following four support PFS, which have to be legal persons and all render their respective services on behalf of or to credit institutions, PFS, UCIs, pension funds, insurance undertakings or reinsurance undertakings established under Luxembourg law or foreign law (the “**Beneficiaries**”):

- art. 29-1 of the Financial Act: Client communication agents

Communication agents engage in the provision of services such as the production, in tangible form or in the form of electronic data, of confidential documents intended for the personal attention of clients of the Beneficiaries, the archiving or destruction of documents, the communication of documents to clients of the Beneficiaries, management of mail giving access to confidential data of clients of the Beneficiaries, and so on.

- art. 29-2 of the Financial Act: Financial sector administrative agents

Administrative agents provide administration services which form an integral part of the business activities of the prime contractor pursuant to a sub-contract.

- art. 29-3 of the Financial Act: Primary IT systems operators of the financial sector

These service providers are responsible for the operation of IT systems belonging to the Beneficiaries and allowing for the drawing-up of accounts and financial statements (without these services having an impact on the professional activity of the Beneficiaries).

- art. 29-4 of the Financial Act: Secondary IT systems and communication networks operators of the financial sector

These service providers are responsible for the operation of IT systems other than those belonging to the Beneficiaries and allowing for the drawing-up of accounts and financial statements and for the operation of communication networks.

Moreover, the provisions of the act of 14 August 2000 on electronic commerce (the "**E-Commerce Act**"), the act of 27 July 1991 on electronic media (the "**Electronic Media Act**") and the act of 2 August 2002 on the protection of individuals with regard to the processing of personal data (the "**Data Protection Act**"), as well as several legislation on competition may also apply to IT outsourcing projects.

In addition to the laws referred to above, the common rules notably stemming from the Civil Code, applicable to any contractual relationship, will still be applicable for all aspects not specifically regulated elsewhere, notably the provisions of the Civil Code (e.g. in relation the contractual rules to be respected).

The common rules will also apply to any IT outsourcing that does not fall within the scope of the Financial Act.

ii) Applicable regulations

The main CSSF's circulars regarding IT outsourcing in the financial sector are the following:

- Circular IML 96/126 of 11 April 1996 on administrative and accounting organization ("**Circular 96/126**");
- Circular CSSF 05/178 of 11 April 2005 on administrative and accounting organization; outsourcing of IT services; and abrogation of point 4.5.2. of circular IML 96/126 and replacement by point 4.5.2. of this circular ("**Circular 05/178**");
- Circular CSSF 06/240 of 22 March 2006 on administrative and accounting organization; IT outsourcing and details regarding services provided under the status of support PFS, articles 29-1, 29-2 and 29-3 of the law of 5 April 1993 on the financial sector as amended; and modification of IT outsourcing conditions for branches located abroad ("**Circular 06/240**").
- Circular CSSF 08/350 Details relating to the amendments introduced by the Law of 13 July 2007 on markets in financial instruments to the PFS statuses referred to in articles 29-1, 29-2, 29-3 or 29-4 and designated as "support

PFS"; Amendment to the prudential supervisory procedures for support PFS ("Circular 06/240").

b) Regulator's position insight

The question of whether a support PFS status is required mainly depends on the possibility of the service provider being able to regularly access confidential data.

In other words, the main principle is that the service provider, not having support PFS status, may not have access to confidential data.¹¹ This requirement is important as the Beneficiaries of the services and support PFS are subject to the same professional secrecy.¹²

Circular 96/126 (as modified by Circular 05/178) of the CSSF sets out the rules governing the outsourcing of services to third parties not having a support PFS status.

Certain circumstances may be raised as to know whether the outsourcing has to be undertaken by a support PFS or not, e.g. will the service provider have regular access to confidential data, will there be unaccompanied access to the beneficiaries' premises, work in a production environment (as opposed to development or test environments), etc.

3. Impact of outsourcing in practice

a) Technologies and IP – selected legal issues

The general principle of outsourcing is that the client organization and the supplier enter into a contractual agreement that defines the transferred services. Under the agreement the supplier generally acquires the means of production in the form of a transfer of people, assets and other resources from the client (many other forms of outsourcing exist, not automatically leading to such resources transfer, such as for example the recourse to application service providers, also known as ASP, who use their own existing infrastructure to provide services to the client on a pay-per-use basis). The client agrees to procure the services from the supplier for the term of the contract.

¹¹ Circular 05/178, section 4.5.2, page 4.

¹² See article 41 of the Financial Act for banking institutions and PFS and article 111-1 of the Law of 6 December 1991 on the insurance sector.

i) General legal issues

The life of any outsourcing relation usually starts with the selection of the service provider, sometimes further to a call for tenders. Once the service provider is chosen, the negotiations of the terms of the outsourcing agreements start. This implies a determination of the services usually accompanied by a letter of intention, defining the scope of the services.

Thereafter, the production period starts and usually begins with a transition period. At the termination of the agreement a smooth and secure transfer should be ensured, and notably the reversibility of the service. The cases of termination of the agreement and reversibility procedure are extremely important and the relating clauses in the outsourcing agreement should be carefully drafted. Reversibility can result in either the transfer of the outsourced activity to a third service provider or back to the client's internal services.

Special attention should also be paid to other contractual aspects such as the validity of the contract (comprising data protection and IP issues), the scope of the agreement, financial aspects including the definition of the prices, eventually a benchmarking procedure, consequences of late payment, etc.

Particular attention should be paid to the so-called service level agreement (the "SLA") which usually is annexed to the outsourcing agreement. It describes exactly the type of services to be provided, the obligations of the service provider to grant special support in case a problem arises, the time frame that the service provider has to solve such problem, and so on.

It is extremely important to ensure strong governance during the execution of the outsourcing agreement, notably by arranging for regular meetings between competent representatives of the parties to the outsourcing agreement, the assessment of the level of the rendered services, and so on.

However, it should be noted that the client might not necessarily benefit from a too rigidly negotiated outsourcing agreement because one can win many battles in the contract negotiation but will then have to face difficulties in its implementation and execution. This applies notably in the case of offshoring where governance might be even more difficult, particularly in certain countries. Another issue could for instance be the case that the turnover was negotiated with one person at the time of the entering into agreement, but it might not be the same person which applies it. Moreover, some clauses, inserted in order to obtain a certain balance while the contract negotiations might not be assessed by persons that have not participated in the negotiation.

ii) Technologies and IP related aspects

Concerning IT outsourcing, in addition to the above, there are several technologies and IP specific aspects, to which a particular attention should be paid.

One very important aspect that should be covered from an intellectual property point of view is to determine from the outset in the outsourcing agreement, who will be the author of the IP that is created during the service provision period. This avoids numerous problems, once the agreement is terminated.

Other IP related issues to be considered in an outsourcing agreement are those relating to software licenses.

Software licenses granted by third parties' editors to the client of the outsourcing service are often granted for personal or internal purpose only and in theory, the service provider is not allowed to use this software. To solve this issue, the client can negotiate – prior to the entering into the outsourcing agreement – with the editor the possibility for the service provider to use the software solely for the purposes of providing outsourcing services to the client and in return, the service provider can demand from the client a guarantee.

Moreover it is possible that the service provider grants a software license to the client for the purpose of the outsourcing project. The outsourcing agreement shall thus establish the conditions and price of the use of the concerned software.

Furthermore, contractual particularities apply in the case where outsourcing services are ruled by the Financial Act and the CSSF circulars referred to above.

The PFS having an outsourcing project must contractually ensure:

- with special attention, the continuity of its business, the possibility to terminate the outsourcing and the integrity of internal and external control;
- that responsibilities of both parties are clearly defined;
- that clear conditions are defined as regards the possibility for the service provider to sub-contract activities that are outsourced to third parties;
- that it will be able to takeover itself or transfer to another service provider the outsourced activities, each time continuity or quality of the service might be compromised.

The continuity of the business implies the reversibility of the outsourcing and the reversibility procedure must be set out in the contract as from the execution of the agreement.

The reversibility provision must be precise as to:

- the materials, hardware, software, network infrastructure elements, and , data that are transferred;
- as the case may be, the staff that is transferred (which triggers labour law issues)¹³;
- the price for the reversibility;
- the scope of the transfer;
- the price of “extra” services (i.e. not provided for at the date of entering into the outsourcing agreement) during the course of the outsourcing;
- as the case may be, intervention of a third party (“reversibility officer”).

A PFS may call on a non-Support PFS for advice, programming or maintenance of their systems, as provided by and according to the rules set out under Circular 96/126. To the contrary, only Support PFS may carry out system management on behalf of the PFS (i.e. the use of IT services of a non-Support PFS third party may not result in the transfer of the financial task of the PFS, including data input, to this third party).

Therefore, as regards IT outsourcing to non-Support PFS, the PFS must more specifically for instance:

- organize its computing system so that the PFS have control over it, ensures its quality and in a manner that strictly ensures protection of the confidential data of clients;
- ensure reliability of the data produced by the computing system and its compatibility with the financial and internal control rules;
- provide that any intervention by a non-Support PSF, notably modifications to the software, must be submitted to the PFS prior authorization;
- ensure that the service provider does not have access to confidential data (if, in case of a breakdown that requires on site intervention, access to confidential data may not be avoided, the PFS must ensure that the person is accompanied during the entire period of its mission by a person with IT knowledge); and so on.

¹³ See 3 b) i) below.

b) Significant employment law aspects

Outsourcing in practice raises two main employment law issues:

- on the one hand, outsourcing may in some cases be regarded as a “transfer of undertaking” in the meaning of Articles 127-1 and following of the Luxembourg Labour Code;¹⁴
- on the other hand, often the employees who have been outsourced to an external service provider keep on performing the same services for their former employer. Attention should be paid in this case to the legal provisions on lending of staff.¹⁵

i) Outsourcing and transfer of undertaking

When implementing a project of outsourcing, whereby employees will be transferred to the external service provider, it is important to first determine whether the operation qualifies as a “transfer of undertaking”, since this qualification has various consequences from an employment law point of view.

➤ Definition/concept of transfer of undertaking

Articles 127-1 and following of the Luxembourg Labour Code apply to any transfer of an undertaking, business, or part of an undertaking or business to another employer as a result of a legal transfer. By the meaning of these provisions, an undertaking is defined as a “stable economic entity” which retains its identity, i.e. “an organized grouping of resources, which has the objective of pursuing an economic activity, whether or not that activity is central or ancillary”¹⁶.

Pursuant to the case law of the European Court of Justice, in order to determine whether the conditions of a transfer of undertaking are met, all the facts and circumstances that characterize the transaction will have to be taken into account, such as for example:

- the nature of the activities and the degree of similarity of the activities exercised before or after the transfer;

¹⁴ See b) i) below.

¹⁵ See b) ii) below.

¹⁶ For specific examples for transfer of undertaking: Morel A., “Les droits des travailleurs en cas de transfert d’entreprises, d’établissement ou de partie d’entreprise ou d’établissement”, *Annales du droit luxembourgeois* 2002, pp. 323-334.

- any transfer of the buildings and other tangible assets, as the case may be;
- the value of the non tangible assets at the time of the transfer;
- the transfer of the main part of the staff, as the case may be;
- the transfer of the client portfolio, as the case may be;
- the duration of the possible interruption of the activities.

These criteria have to be considered generally (the list above is just illustrative) and the importance to be given to each such criterion varies according to the type of activity exercised. The qualification of a transaction as a transfer of undertaking will ultimately depend on the interpretation the judge will give to the factual elements of the case at hand, it being noted that the Luxembourg and the European courts tend to adopt an extensive interpretation of the concept of transfer of undertaking.

➤ **Consequences of a transfer of undertaking**

The main consequences resulting from a transfer of undertaking pursuant to the Labour Code are the automatic transfer of the employment contracts, the safeguarding of the working conditions, various information proceedings and the fact that the transfer cannot constitute a cause for dismissal.

▪ **Automatic transfer of employment contracts**

In case of transfer of undertaking, all rights and obligations resulting from the existing employment contracts of the employees working for the transferred entity at the date of the transaction are automatically transferred to the transferee.

The effect of the automatic transfer of the employment contract applies to all employees who are linked to the business unit transferred but only to those employees.

The automatic transfer of contract is a mandatory rule from which none of the parties involved (transferor, transferee and employees) may depart. Any agreement aiming at circumventing this rule will be void.¹⁷

The Labour Code provides for the joint and several liability of the transferor (outsourcer) and the transferee (service provider) for obligations towards the

¹⁷ Wantiez C., “Transferts conventionnels d’entreprise et droit du travail”, 2ème édition, 2003, Larcier, pp. 89-94.

employees resulting from the employment contracts and born before the transfer occurs.

- **Safeguarding of the working conditions**

As a consequence of the automatic transfer of the employment contracts, the new employer (service provider) is in principle obliged to maintain the employees' working conditions.

The new employer is also obliged to maintain the terms and conditions provided by the collective agreement applicable to the employees, if any, (i) until the expiration of such collective agreement or (ii) until the denunciation of the collective agreement and conclusion of a new collective agreement.

In addition, in case the employees benefit from an occupational pension scheme, the rights of the affiliated employees will be transferred to the new employer.

- **Information and consultation procedures**

Both the transferor and the transferee have to provide some information to their respective employees' representatives, if any or to the employees themselves and consult them on the envisaged reorganisation.

Information has to be provided "in reasonable time" in order to allow the representatives or the employees to exercise their right to express an opinion on the operation, and in any case before the transfer takes place.

When the former or the new employer envisages some measures towards its respective employees (notably in case of modification of the working conditions), he must negotiate these measures in reasonable time with the employee's representatives in order to reach an agreement.

Finally, the transferor (outsourcer) must notify to the transferee (service provider) in reasonable time all the rights and obligations that will be transferred to the latter. A copy of such notification must be transmitted to the Labour Inspection.

- **The transfer of undertaking is not a cause for dismissal**

Neither the former nor the new employer is allowed to dismiss an employee on the ground of the transfer of undertaking. In that event, dismissals will be considered as abusive and will entitle the employees to claim damages.

However, dismissals for individual reasons and dismissals due to economic, technical or organisational reasons independent from the transfer itself are possible, subject to compliance with the general rules concerning dismissals (notably, need for a real and serious cause of dismissal).

In this respect, Luxembourg case law has held that a dismissal made before a transfer or a merger, or with a view to a merger, is not to be considered automatically as an abusive dismissal. However, in order to be considered as justified and regular, such dismissal must be seriously motivated by the economic context of the required reorganisation.¹⁸

▪ **Employees' representatives**

As regards the consequences of a transfer of undertaking on the employees' representatives, various hypotheses have to be distinguished:

- In the case where some of the employees transferred are staff representatives, their status and function will be maintained provided that the autonomy of the economic entity transferred is preserved;
- If the autonomy of the economic entity is not preserved, the employees' representatives of the former employer will automatically become members of the staff representation already existing within the transferee, or constitute the common employees' representatives if no staff representation was existing within the transferee.

ii) Outsourcing and lending of staff¹⁹

Outsourcing usually implies that the employees who were previously working for the outsourcer internally, will continue to work for the same company but under a service agreement concluded by the latter with the new employer.

While working under this new scheme, attention should be paid by all parties to the conditions under which such services are carried out:

- as of their transfer to their new employer (service provider), the outsourced employees will have to work under the authority and supervision of the latter;
- on the contrary, if it appears that in practice the employees of the service provider are placed under the subordination of the outsourcer (client), this will constitute an illegal placing at disposal of staff.

¹⁸ CSJ 30/01/1997, Thill ./ ABN Amro bank ; TT Lux. 31/01/2000, Goller ./ Hypovereinsbank Luxembourg S.A. ; CSJ 28/02/2002, Nielssn ./ Dexia Nordic Private Bank Luxembourg S.A.

¹⁹ Fontaine, Philippe and Delforge, *op.cit.*, pp. 263-283.

Illegal placing at disposal of staff is defined as the fact for an employer to place its staff members at the disposal of a third party, who uses them and exercises upon them a part of the administrative and hierarchical authority, which is normally reserved to the employer. The placing at disposal of staff is subject to criminal penalties and civil sanctions.

In order to avoid the risk of having the relationship qualified as an illegal placing at disposal of staff, the outsourcer should therefore refrain from acting as an employer towards the outsourced employees.

This means that he should notably avoid giving precise and detailed instructions to the employees, supervising the performance of their work, managing the day to day relationship with the employees (e.g. work schedule, reporting, justification in case of absence, holidays) or sanctioning the employees if the work is not performed in a satisfactory manner. All these prerogatives have to remain with the new employer (outsourcer).

c) Corporate legal aspects

There may be corporate legal aspects to take into account, depending on the case at hand.

In a group of companies, it might be advantageous from a strategic standpoint to outsource (and offshore, as the case may be) certain activities (for instance all IT related services) of all group entities to one company. This company could be an existing one or otherwise incorporated for this specific purpose.

Under Luxembourg corporate law, no particular restrictions apply to the outsourcing of services to a specific company. However, outsourcing of services is possible to the extent, that it does not entail the transfer of the effective place of management to another country as this would engender the change of the nationality of the company. Luxembourg Company Law states that the domicile of a company is determined by the location of its principal establishment.²⁰ Unless the contrary is proven, the principal establishment (Luxembourg law does not provide for any definition of this term) of the company is deemed to be its registered office. A company that is domiciled in Luxembourg has hence Luxembourg nationality and shall be governed by Luxembourg law.

In this context, the domiciliation of companies could be considered as a form of outsourcing and the particular restrictions of the act of 31 Mai 1999 regarding the domiciliation of companies should be respected.

²⁰ Law concerning commercial companies of 15 August 1915, as modified.

In other respects, regarding the outsourcing of activities ruled by the Financial Act, for an entity that envisages becoming a PSF in the meaning of 29-1 to 29-4 of the Financial Act, in order to be able to provide regulated services to clients wishing to outsource their activity, many different corporate vehicles and structures may be taken into consideration. Such vehicle must be a Luxembourg-based company.

The corporate forms available under Luxembourg law for PFS are the *Société anonyme* (S.A.), the *Société à responsabilité limitée* (S.à r.l.), the *Société en commandite par actions* (SCA), the *Société en nom collectif* (SNC), the *Société en commandite simple* (SCS), or the *Société coopérative*.

Market practice-wise, a Support PFS generally takes one of the following corporate forms:

- the public company limited by shares (S.A.);
- the private limited company (S.à r.l.); or
- the limited corporate partnership (S.C.A.).

Moreover there are some particular requirements regarding the articles of association of the company which have to be complied with in case of the incorporation of a PFS as well as in the case where an existing company is transformed into a PFS.

The main requirement is among others that the corporate object of the company reflects the services that the support PSF will render.

Moreover, the company's capital has to amount to the capital required for the relevant PFS status.²¹

Furthermore, other requirements apply such as for example the need of the PFS to have its annual accounts audited by one or more external auditors ("*réviseur d'entreprise*").²²

²¹ See articles 20 and 29-1 to 29-4 of the Financial Act.

²² See article 22 of the Financial Act.

4. Outsourcing vs. Insourcing and cosourcing: pros and cons

a) Outsourcing

i) Pros of outsourcing

Besides the benefits referred to above,²³ such as cost savings, access to wider experience and knowledge, and so on, further positive aspects of outsourcing may be the access to a larger talent pool and a sustainable source of skills, the acceleration of the development or production of a product through the additional capability brought by the supplier, a wide range of business access to services previously only available to large corporations and an approach to risk management for some types of risks is to partner with an outsourcer who is better able to provide the mitigation.

ii) Cons of Outsourcing

As a general remark to the present section it should be noted that the cons of outsourcing referred to hereafter constitute legal, security and compliance issues that need to be addressed through the contract between the client and the suppliers as this would significantly lowers the risks for the outsourcing organization.

The outsourcing of activities and notably of IT activities may have some negative connotations. Some companies may view outsourcing as ridding themselves of a series of discrete IT “problems” that have been thorns on their sides, items such as maintaining legacy systems, outfitting users with IT equipment, fixing broken equipment, answering help desk calls, and so on.²⁴

There are mainly two main points of criticism, the impact of outsourcing on the labour market and the problems related to the quality of the rendered service by the external service provider.

- **Impacts of outsourcing on the labour market**

Regarding the impact on the labour market, one negative aspect of outsourcing (especially when combined with offshoring) is that outsourcing might damage the local labour market as it can affect both, jobs and individuals. It is difficult to dispute that outsourcing has a detrimental effect on individuals who face job disruption and employment insecurity. However, as referred to above,²⁵ there are legal protections in the European Union regulations called the Transfer of Undertakings (Protection of Employment).

²³ See section 1 b) above.

²⁴ M. D. Lutchen, *op.cit.*, page 75.

²⁵ See section 3 b) above.

It could be argued that the outsourcing of jobs (particularly offshore) exploits the lower paid workers. A contrary view is that more people are employed and benefit from paid work.

On the issue of high-skilled labour, such as computer programming, one other point of criticism could be that it is unfair to both the local and offshore programmers to outsource the work simply because the foreign pay rate is lower.

Should the outsourcing imply the transfer of employees, the staff turnover of employees who were originally transferred to the outsourcer could be a concern for many companies. The turnover could be higher under an outsourcer and key company skills may be lost with retention outside of the control of the company. The motivation of the outsourced staff could also be affected.²⁶

Moreover, outsourcing could lead to communication problems with transferred employees. For example before transfer staff have access to broadcast company e-mail informing them of new products, procedures etc. Once in the outsourcing organization the same access may not be available. Also to reduce costs, some outsource employees may not have access to e-mail, but any information which is new is delivered in team meetings.

This leads to the second field of possible cons for outsourcing of activities: the quality of services.

- **Impacts of outsourcing on the service quality**

There might be a risk, that outsourcing fails to realize the business value that the outsourcer promised to the client. The outsourcing organization depends thus on the service provider.

Although the quality of service is usually defined in the SLA, the SLA may not be to the same level as previously enjoyed. This may be due to the process of implementing proper objective measurement and reporting which is being done for the first time. It may also be lower quality through design to match the lower price. This applies even more as in most outsourcing agreements provide for an obligation of best effort (“*obligation de moyen*“) as opposed to the responsibility of achieving a definite result (“*obligation de résultat*“).²⁷

Also, the quality of the rendered service might be regarded differently as there are a number of stakeholders who are affected and there is no single view of quality. The CEO may view the lower quality acceptable to meet the business

²⁶ Fontaine, Philippe and Delforge, *op.cit.*, page 333.

²⁷ Fontaine, Philippe and Delforge, *op.cit.*, page 333.

needs at the right price. The retained management team may view quality as slipping compared to what they previously achieved. The end consumer of the service may also receive a change in service which is within agreed SLAs but is still perceived as inadequate.²⁸ The supplier may view quality in purely meeting the defined SLAs regardless of perception or ability to do better.

Offshore outsourcing for the purpose of saving cost could have a negative influence on the actual productivity of a company. Rather than investing in technology to improve productivity, companies gain non-real productivity by hiring fewer people locally and outsourcing work to less productive facilities offshore that appear to be more productive simply because the workers are paid less.

Moreover, offshoring can also fail because of cultural differences and consequential misunderstandings.

In contrast, increases in actual productivity are the result of more productive tools or methods of operating that make it possible for a worker to do more work. Non-real productivity gains are the result of shifting work to lower paid workers, often without regards to real productivity. The net result of choosing non-real over real productivity gain is that the company falls behind and obsolesces itself overtime rather than making real investments in productivity.

In addition, outsourcing could be negative from a security standpoint. Before any outsourcing, an organization is responsible for the actions of all their staff and liable for their actions. When these same people are transferred to an outsourcer they may not change desk but their legal status has changed. They are no longer directly employed or responsible to the organization. This may cause legal, security and compliance issues that need to be addressed through the contract between the client and the suppliers. This is a very complex area of outsourcing and requires a specialist third party adviser.

Fraud is a specific security issue which constitutes criminal activity whether it is by employees or the supplier staff. However, it can be disputed that the fraud is more likely to happen when outsourcers are involved, for example through credit card theft when there is scope for fraud by credit card cloning.

Finally, outsourcing has become a burning topic regarding the loss of personal data, another possible reason to be sceptic about outsourcing and if an organization decides to outsource certain of its IT activities, the necessity to choose a competent service provider.

²⁸ Quality in terms of end-user-experience is best measured through customer satisfaction questionnaires which are professionally designed to capture an unbiased view of quality. This allows quality to be tracked over time and also for corrective action to be identified and taken.

During the previous months, the international daily press reported several cases in which data has been lost.²⁹ The last scandal in this respect was the loss of data on criminals by the private firm PA Consulting, working for the UK Home Office in the framework of an outsourcing relationship. An employee of PA Consulting Group had stored data on a computer memory stick that was subsequently lost. The device contained personal details and intelligence on 33,000 serious offenders, dossiers on 10,000 “priority criminals” and the names and dates of birth of all 84,000 prisoners in England and Wales. There was also information on an unspecified number of people enlisted on drug intervention programs.³⁰ Not even one month later, data on prison officers was lost in the United Kingdom.³¹

Further to these scandals, which have preoccupied equally the press and the public, discussions have been triggered not only among the ordinary citizens, but also among the politicians worldwide on whether the currently applicable laws and obligations regarding the security of data are sufficient and/or if there adherence is sufficiently controlled.

b) Insourcing

Insourcing is, as the term implies the opposite of outsourcing. Thus insourcing (or contracting in) is often defined as the act of internalizing the management and control of a service, function or product that is outsourced or being considered to be performed outside the organization.³² Insourcing may include the delegation of operations or jobs from production within a business to an internal (but 'stand-alone') entity that specializes in that operation. Insourcing is a business decision that is often made to maintain control of critical production or competencies.

Insourcing is also given, when a company decides to take back an outsourced activity and to perform the task itself.

²⁹ For instance O’Neill S. and Ford R., “Thousands of criminal files lost in data fiasco”, article of 22 August 2008, published in The Times and on www.timesonline.co.uk; Kennedy D., “Hunt begins for missing data on prison officers”, article of 8 September 2008, published in The Times and on www.timesonline.co.uk; Finsterbusch S. “Der Verlust der Privatsphäre”, article of 23 August 2008, published in Frankfurter Allgemeine Zeitung and on www.faz.net (trade of personal data by former call center employees).

³⁰ O’Neill S. and Ford R., “Thousands of criminal files lost in data fiasco”, article of 22 August 2008, published in The Times and on www.timesonline.co.uk. See also the article “Company loses data on criminals”, published on 21 August 2008 <http://news.bbc.co.uk>.

³¹ Kennedy D., “Hunt begins for missing data on prison officers”, article of 8 September 2008, published in The Times and on www.timesonline.co.uk.

³² Acharya C., *op.cit.*

i) Pros of insourcing

The main reasons for insourcing of certain business functions, services or products are the maintenance of a better control of the function, service or product. The organization has for instance the possibility to monitor the quality of the service much easier than this would be the case if the service was outsourced.

Linked to this advantage of insourcing, the organization might be able to achieve a higher customer satisfaction as the performance of the insourced workers would be directly monitored by the organization.

Moreover, the insourcing of the service reduces the dependency of the organization on an external service provider and thus enforces the autonomy of the organization.

Insourcing may also be a tool to improve the security of confidential information of the organization. This aspect might nowadays have gained importance due to the scandals regarding the loss of personal data referred to above,³³ although loss may also result from own security policies loopholes.

Furthermore, insourcing is widely used in an area such as production to reduce tax, labour costs, transportation, etc.

Specialized manpower may work in the organization without being part of the organization,³⁴ and the employees may consider that their job is more secure and consequently perform better.

ii) Cons of insourcing

Insourcing might require the hiring of contractual workforce or equipment which implies additional costs and less flexibility for the organization. More precisely, it might require spending more time, effort and manpower as well as operating and training costs.

The insourcing organization might not have the same experience and infrastructure of the same quality as the service provider.

Insourcing can lead to less flexible timings or shifts and less expandability.

³³ See above 4 a) ii).

³⁴ Achraya C., *op.cit.*

The insourcing organization might not have the same market knowledge, efficiency and productivity as the specialized service provider.

Insourcing might imply higher business risks that could be shared under certain conditions if the function, service or product was outsourced.

c) Cosourcing

The term Cosourcing (also referred to as multisourcing, rightsourcing or as selective sourcing) is given where a business function is performed by both internal staff and external resources, such as consultants or outsourcing vendors, with specialized knowledge of the business function.

Cosourcing usually refers to a strategy that treats a given function - such as IT - as a portfolio of activities, some of which should be outsourced and others of which should be performed by internal staff, i.e. insourced.³⁵ Cosourcing seamlessly blends internally and externally delivered services and might help to cut costs or gain efficiencies, to maximize growth, agility, and bottom-line results. This approach moves away from the idea that the whole of a function should be viewed as a commodity, easily handed over to a service provider.

Cosourcing implies a multitude of possibilities and solutions for the client organization to obtain the customized solution for itself. The positive aspects of outsourcing and insourcing may be combined in a way which will achieve optimum results for the outsourcing organization.

5. Conclusion

Outsourcing of activities is an option that should be considered as an organization may benefit from it. However, it is important to take into account the particular situation of the organization and to establish a contractual framework that provides for both, security and flexibility.

In other respects, it should be noted that the Luxembourg market offers interesting opportunities notably for organizations of the financial and insurance sector that wish to outsource certain activities, due to the possibilities to transfer certain services to support PFS. On the other hand, for service providers aiming at offering services to organizations from all sectors, the application for a PFS status can offer numerous opportunities.

September 2008

³⁵ Achraya C., "Outsourcing vs. Insourcing, – An Industry perspective by Radical Euro Services S.A.", presented at the AmCham ComIT event dated 25 September 2008 (available on www.amcham.lu).

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