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# Companies Can't Outsource Competition Law – The Relevance of Competition Law to Outsourcing Transactions

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## SUMMARY

Over the past two decades, companies have increasingly made use of outsourcing. Often functions perceived as “non core” were outsourced to specialist providers, often located offshore, who then delivered the same services back to the company more cheaply. This was achieved by using cheaper labour, newer technology and by reusing infrastructure developed for other companies with similar requirements. In today's leaner times, outsourcing transactions will continue to be important given their potential cost reductions.

However, companies need to ensure compliance with European competition laws. For example, some types of outsourcing transaction may need to be notified under merger control rules, meaning that prior approval would be needed before the outsourcing can be put into effect. In other cases, contractual restrictions put in place to give the company a competitive advantage may themselves be anti-competitive and subject to challenge.

Competition law is, in the authors' views, seldom given the consideration it deserves by outsourcing practitioners. This article will endeavour to redress the balance.

## INTRODUCTION – THE DIFFERENT TYPES OF OUTSOURCING

Outsourcing and in particular offshoring has enjoyed rapid growth. Outsourcing to India alone is estimated to have grown from USD 12.9bn in 2004 to USD 40.3bn in 2008, with growth in Business Process Outsourcing (BPO), the outsourcing of back office business functions, being the most pronounced.

The common characteristic of outsourcing is that a specified “outsourcing service provider” will supply the “customer” with certain services that the latter previously performed in-house. There are a number of forms of outsourcing.

- *Alternative sourcing* involves the termination of the business activities within the customer – including laying off the employees who previously carried out those activities and the dismantling of existing infrastructure. In parallel, the outsourcing service provider begins to deliver the same services to the customer via a supply agreement. Such a transaction is akin to a normal service contract. It is not a concentration within the EC Merger Regulation (“ECMR”) as there is no transfer of assets or personnel.
- *Captive outsourcing* involves the creation of a unit or subsidiary within a company (typically in a lower cost jurisdiction) which assumes responsibility for a certain category of service. This would not need to be notified under the ECMR since internal restructurings within a single corporate group do not constitute a concentration. Article 81(1) would not apply to such an intra-group arrangement.
- *Outsourcing and Offshoring* involves the transfer of a business unit with associated assets and/or personnel from the customer to the outsourcing service provider. The assets and personnel being transferred can vary. For example, a BPO is less likely to require the transfer of assets than an IT Outsourcing. If the outsourcing provider is geographically proximate to the customer and within the EU, then the staff are likely to be automatically transferred to the provider under the Acquired Rights

Directive. If not, the staff will be made redundant and the outsourcing provider will use its own employees. In the past 18-24 months, firms such as Dendrite, SAP and Oracle have bought development teams from outsourced partners. There is also a trend for some companies to transfer their captive outsourcing operations to third party.

- Joint Venture sourcing involves an outsourcing/offshoring that is to be owned by a joint venture between outsourcing provider and the customer. The advantage for the customer is that it retains an additional degree of control over the outsourced operations and benefits from any capital appreciation of the outsourced business. This method has been used in both the public and the private sectors.
- Multisourcing involves splitting up operations into a number of different functions which get outsourced simultaneously to a number of different outsourcing providers. The client benefits by having direct access to the different contractors – this is more cost effective than hiring a single outsourcing provider who uses sub-contractors and takes a margin on the subcontractors' services. In addition to the service contract, there need to be horizontal agreements between the service providers to regulate their conduct and resolve issues that do not fall at the feet of any one of the providers.

### OUTSOURCING/OFFSHORING AND THE ECMR

Outsourcing/Offshoring is the most likely type of outsourcing to raise competition law issues given that the transfer of a team of employees or assets can constitute a concentration under the ECMR. National Competition Authorities such as the UK's OFT take a similar view, considering outsourcing situations involving the transfer of employees and assets to be relevant under UK merger control, provided that the transaction causes the enterprises in question to cease to be distinct.

In addition to satisfying the normal turnover thresholds, there are several requirements for outsourcing transactions that must be met before there is a need to file the transaction with the European Commission.

The Consolidated Jurisdictional Notice makes clear (at paragraph 25) that outsourcing will only constitute a notifiable concentration if the transferred unit can be classified as a "business with market presence". The notice explains this concept further: "This requires that the assets previously dedicated to in-house activities of the seller will enable the outsourcing service supplier to provide services not only to the outsourcing customer but also to third parties, either immediately or within a short period of time after the transfer". In the outsourcing world, this is described as a shared services platform and is a

common method for outsourcing providers to reduce costs by sharing a platform or infrastructure. Even if the assets are not used on a shared platform, if they have the "means to develop market access" within a short period of time, then the transfer could also be a concentration.

Thus there will be no concentration where the outsourcing service supplier merely acquires a right to direct its newly transferred employees and assets exclusively for the benefit of the customer. So the outsourcing of an in-house IT business, that is not placed on a shared services platform, for instance, would not need to be notified since the business being outsourced would not be supplying third parties.

### JOINT VENTURES AND THE ECMR

The Consolidated Jurisdictional Notice makes clear that setting up an outsourcing joint venture will be considered to be concentration, provided it is a "full function" joint venture, i.e. it operates on a lasting basis, performing all the functions of an independent economic entity, and is not dependent on its parents. This can be a difficult issue to judge for outsourcing transactions.

For instance, in the IBM / Fiat case (*Case Comp/M.2478*), the Commission decided that the joint venture was fully functional since it had significant capitalisation from the outset as well as having an independent management and a staff of almost 5000 employees. Crucially, whilst the joint venture entity would sell IT services to its founding companies, it would also offer services to third parties. Around 50 to 70 % of the revenues of the joint venture entity would come from merchant sales to third parties and this was seen as sufficient to fulfil the criterion. Thus, similarly to transfer outsourcing, if the joint venture entity achieves significant sales to third parties, this will increase its likelihood of being classed as full function.

### TURNOVER AND THE ECMR

To be notifiable to the European Commission under the ECMR, a concentration must have "Community Dimension," satisfying the turnover thresholds in Article 1.

In an outsourcing context, ascertaining the turnover of the business that is being outsourced can be awkward. (The turnover of the acquiring business, i.e. the outsourcing service provider, will generally be easy to ascertain.) The Consolidated Jurisdictional Notice (at paragraph 163) makes it clear that the relevant turnover should be calculated on the basis of the previous internal revenues generated by the respective employees whilst in-house. The calculation of the internal turnover of a part of the customer's business will not be easy, given that an IT department, for instance, will rarely be a distinct entity within a company and as a support group may not have real "turnover". Therefore it will often be necessary to

estimate. The Notice makes clear that if the previous internal turnover does not appear to correspond to a market valuation of the activities in question, forecast revenues may be a suitable proxy. Given that there will almost certainly be divergences between previous internal turnover of the outsourced unit whilst still based with the customer and the turnover of the same unit once part of the more efficient outsourcing service provider, this determination may not be as simple as outsourcing parties may imagine it to be.

So whether a merger is indeed notifiable under the ECMR may depend on rather subjective estimates, something which is relatively unusual under the ECMR.

### ANCILLARY RESTRAINTS

Ancillary restraints are obligations related to and necessary for the conclusion of a concentration. These can include clauses preventing the customer from competing with the business transferred – in effect preventing the customer from resuming in-house services. Other examples include agreements to guarantee the purchase of a certain quantity of services for a set period of time. Ancillary clauses are deemed to be necessary for the merger and therefore in principle can fall outside the scope of Article 81 (1). (If a merger is below the ECMR thresholds, then the EC ancillary restraints notice does not technically apply. But it remains highly persuasive because other countries' merger control rules apply a similar approach and an analysis under Article 81 may consider ancillary restrictions as being justified by the merger.)

The Commission has indicated that such agreements will only be considered to be ancillary if they are limited in time, generally meaning a duration of less than five years and in some cases less than three years. This may not be long enough in many outsourcing situations, which envisage outsourcing to be indefinite or to last for a long period. But this does not mean that such arrangements are illegal – it simply means that companies who have such agreements will need to carry out a separate analysis of the competition issues associated with the agreement under Article 81, including checking the applicability of block exemptions and the 1978 subcontracting notice and self-assessing possible individual exemption under Article 81(3).

### INFORMATION EXCHANGE

When a customer outsources services to one of its competitors, or in the case of a transfer of outsourced services from one supplier to another, or in the case of multisourcing, there are potential information exchange issues that can arise. In an outsourcing situation, suppliers and customers may in some cases need to discuss service levels, costs as well as strategies, notably in negotiations leading up to the conclusion of an outsourcing deal. Whilst some information exchange will be legitimate and necessary, other types of information exchange may be more problematic. Care may be needed.

### CONCLUSION

The above analysis has considered European law and shown that a number of elements of competition law are relevant to outsourcing. Particular care is needed with merger control since any merger filing needs to be undertaken to strict deadlines and approval of the relevant authority may be needed before outsourcing deals can be implemented. The same principles would equally apply under national competition rules both in the EU and around the world.

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