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10 Steps to Success in Outsourcing Contracts

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INTRODUCTION

Ten years ago, when I first started to work in the games industry, outsourcing wasn't just uncommon in video games development projects – it was expressly forbidden. Publishers generally stipulated in their development contracts that the developer should not outsource or subcontract any work to any other person.

Their rationale was that they, as publishers, had located the best developer for the job – so they wanted that developer to do the job, and not to pass it on to someone else.

Now, the reverse is true – instead of saying to the developer "you shall not outsource", many publishers now start by asking the developer "how will you save me money by outsourcing?"

What is "outsourcing"?

Strictly speaking, pure "outsourcing" involves the transfer of a *business function* or *process* from one company to another. For example, a company might outsource its payroll function to an accountancy firm; or outsource its customer support and call centre function to an offshore call centre specialist. Transactions of this type involve complex integration and sharing of management resources. Outsourcing in this relatively narrow sense clearly does happen in the video games industry, but is not the subject of this paper.

Instead, this paper is about outsourcing in the wider sense: where one company (the "client") engages another company (the "outsourcing company") to create something which the client has already agreed to deliver to a third party (for instance, the client's publisher) or decided to acquire for itself.

Examples include:

- a developer of a racing game engaging a different company to create 3d car models for the game;

- a developer of a first person shooter engaging a different company to create and integrate the multiplayer functionality of the game; or

- a developer of a futuristic space combat game engaging a different company to implement special effects in the game.

References to "outsourcing" in this paper are references to the types of transactions described above. These are qualitatively different from contracts with individual freelancers, contracts for middleware, and contracts with service providers including lawyers and accountants.

Why is outsourcing now considered important?

Outsourcing provides different benefits to the parties involved in video games projects.

Savings

Game publishers may favour outsourcing if it can reduce the costs of developing a game without affecting game quality. Typically, this may be achieved by taking advantage of lower costs for talent in other jurisdictions, for instance by having modular assets created abroad. However, the cost savings generated by outsourcing asset creation must always be measured against cost increases caused by managing a project in a different time zone using developers from a different linguistic and cultural background.

According to a talk on the subject at GDC 2006, the net cost savings brought by outsourcing are ultimately unlikely to exceed 15%.

Coping with fluctuating team sizes

Game developers may favour outsourcing as a practical solution to the growing problem of growing and fluctuating team sizes. Game development has now reached such a level of complexity that not only are increased numbers of individuals required to work on a game, but their increasing specialization makes it harder to transfer individuals from one task to another. It is now no longer sensible for some developers to seek to employ, on a full time contract, all of the individuals required to complete a game. In particular, it makes little sense to employ those individuals who are required for a limited period of time to carry out particular projects. It is often easier to use other established companies to carry out specific tasks (or simply to provide extra development "muscle" when needed) instead.

Increasing specialization

Outsourcing companies may favour outsourcing if it allows them to break into mainstream game development – or to retain a place in mainstream game development – as the industry becomes increasingly complex and as projects become increasingly expensive. Many new companies will find it easier to obtain work by offering specialised skills in a particular field of game creation, rather than by chasing full scale game development contracts. Equally, many established companies may find it difficult to continue to expand in line with the team sizes now required for game development. If they are already particularly skilled in one particular feature of game development, then they may profit instead from focussing purely on that feature.

Purpose of this paper

This paper is intended to describe ten important issues to consider when negotiating an outsourcing contract. It does not set out an exhaustive list of the key legal and commercial issues in outsourcing agreements. However, one or more of these ten issues is almost always present whenever an outsourcing relationship fails.

Addressing these issues properly from the outset of the relationship might therefore help to make the relationship work – or at least to save money if it fails.

Disclaimer

Finally, I must make it clear that the contents of this paper are not legal advice nor are they a substitute for legal advice. You should not rely on the contents of this paper or the accompanying lecture at GDC 2007 in order to do (or refrain from doing) any thing or taking (or not taking) any course of action. This paper necessarily includes substantial generalisations for the purposes of illustration. Always take specific legal advice before entering into any outsourcing or other contract.

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RIGHTS

Section 1 – dealing with the ownership of IP rights in the work created

Introduction

The work created by the outsourcing company under the outsourcing contract is protected by intellectual property rights. In addition, the outsourcing company will usually use or deal with the intellectual property rights owned by other organisations – including the client itself, the client's publisher, and their licensor(s) – when creating the outsourced work.

Ultimately, the outsourcing relationship doesn't exist in a vacuum – instead, it takes its place within a pre-existing structure of commercial arrangements between the client, its publisher, their licensors, distributors and licensees, and other parties. The outsourcing contract has to take this structure of commercial agreements into account.

Accordingly, the ownership of IP rights in outsourcing contracts is usually less open to negotiation between the parties than the ownership of IP rights in full game development contracts.

The client's commitments

The starting-point for the allocation of IP rights in an outsourcing contract is the client's own commitments to its other partners, particularly its publisher and any licensors. If the client has already committed to transfer all IP rights to its publisher, then the outsourcing contract has to reflect this by transferring all IP rights in the outsourced work to the client.

This will of course mean that the outsourcing company will not be able to re-use that work with other clients. As this may have a significant impact on the financial value of the deal to the outsourcing company, this is an issue which must be addressed from the outset of negotiations and factored into the contract price.

Licensing IP rights to the outsourcing company

The outsourcing company may need to use work provided by the client – such as assets created by the client or another developer for another platform version of the client's game – in order to create the outsourced work. If it does so, the outsourcing company needs to ensure that the outsourcing contract contains the following terms:

- an express *licence* from the client to the outsourcing company, permitting the outsourcing company to use the work provided by the client in order to create the outsourced work (but only for that purpose); and

- an express statement that the outsourcing company is not required to clear any third party IP rights in the work provided by the client (see the car model example in Section 9).

Invalid transfers of IP rights

The client needs to ensure that the outsourcing company is legally able to transfer the IP rights which it has agreed to transfer to the client. As noted in Section 7 below, some countries do not allow for the wide IP transfers that a client may already have agreed with its own publisher. If this is the case, the outsourcing company will simply not be legally entitled to transfer the required IP rights to the client, irrespective of the terms of the outsourcing contract.

Chain of title from staff

The client may need to show a clear "chain of title" showing all IP rights moving from each individual involved in creating the outsourced work to the client. In order to achieve this, the client will need to show how the IP moved from each individual creator to the outsourcing company. This may require it to obtain copies of the employment or contractor agreements signed by the outsourcing company's staff and contractors.

Alternatively, the client may simply require each individual staff member to transfer all IP he or she may acquire in the outsourced work directly to the client, by signing a separate IP assignment directly in favour of the client.

"Leapfrogging" IP assignments

Similarly, the client's *publisher* may require a transfer of IP directly from the outsourcing company (or even its staff) to the publisher, without passing through the client at all. Proceeding in this way will give the publisher greater confidence that it has got the relevant rights from the creators of the outsourced work. A direct transfer may also assist the publisher if it falls out with the client or if the client goes out of business. If the client has agreed to this, the client will need to ensure that the outsourcing company agrees to sign (or to ensure that its employees sign) the relevant IP transfer documentation.

Example

A publisher wishes to commission a new game in an existing and popular franchise owned by the publisher. Given the value of the franchise, the publisher is concerned to ensure that no person who works on this game might claim ownership over any of the IP rights in the game (including rights over any new game characters, new game concepts or new game worlds). Accordingly, the publisher ensures that the independent developer who creates the new game agrees:

- to assign all game IP rights it may acquire to the publisher;
- to ensure that all of the developer's staff sign a separate agreement between them and the publisher, assigning all game IP rights they may acquire directly to the publisher;
- to ensure that any outsourcing company engaged by the developer assigns all game IP rights directly to the publisher (again through a separate agreement); and
- to ensure that all individuals engaged by the outsourcing company also sign a separate agreement between them and the publisher, assigning all game IP rights they may acquire directly to the publisher.

The publisher also needs to *manage* this process carefully. In particular, it needs to require notification of all outsourcing arrangements, and to establish a system to ensure that it obtains all of the direct IP assignments required.

Timing

Even when the outsourcing company agrees to assign all IP in the outsourced work to the client, it may not wish to do so immediately. In particular, as noted below in Section 6, if the outsourcing company has any concerns about the solvency of the client, it may wish to hang on to the IP in the outsourced work until it has received all of the money due under the outsourcing contract.

Conclusion

Ownership of the IP in the outsourced work is usually determined from the outset by the client's earlier commitments to its publisher and other parties. If all IP rights are to be transferred to the client, the client needs to ensure that this is legally effective in the country in which the outsourcing company is located. In addition, the client may require the outsourcing company's own staff to assign any IP they obtain directly to the outsourcing company; and the client's own publisher (or licensor) may require similar assignments directly from the outsourcing company and its staff. Finally, even if the IP in the outsourced work is to be transferred to the client, the outsourcing company may nevertheless prefer to retain that IP until it has received all of the money due to it under the outsourcing contract.

MONEY

Section 2 – how and when does the money flow?

Introduction

To the outsourcing company, the flow of money is often the most important component of the outsourcing agreement. However, the flow of money has important implications for the progress of the project as a whole and is therefore of significant importance to the client as well.

Payment on delivery

The client will usually want to pay the outsourcing company on delivery of the outsourced work. This means that the outsourcing company bears the risk that the outsourced work takes longer (or costs more) to develop than expected. Even if this is accepted by the outsourcing company, the outsourcing company will need to ensure that payment is made before delivery if delivery is delayed by the client (as further described in Section 5).

Acceptance

In practical terms, payment on delivery requires the client to *agree* that the work has been delivered. If the work does not meet the client's requirements then the client will simply not accept that the work has been delivered at all. The outsourcing contract should set out a workable testing and acceptance procedure, including the following components:

- an agreed and workable specification (see Section 3);
- objectively measurable quality requirements (see Section 4);
- a requirement for the client to test each deliverable and provide feedback within an agreed time; and
- a positive obligation on the part of the client to accept each deliverable unless that deliverable fails to meet the agreed specification or the agreed quality requirements.

Third party approvals

A difficulty arises if the client needs to obtain the approval of one or more third parties. For instance, the client's publisher may also need to accept the outsourced work within a game milestone; or the client's publisher may have acquired a licence from a third party licensor (such as a movie studio) granting the licensor additional approval rights over all aspects of the game (including the outsourced work).

The client will normally wish to delay payment for any outsourced work until all of these other parties have approved that work. If nothing else, this can help the client force the outsourcing company to undertake (free of charge) any additional work required by these additional parties as a condition for approving that work. Clearly, the outsourcing company will usually seek to avoid any delay in acceptance or payment due to publisher or licensor feedback, for the same reason.

Ultimately, it is difficult to address the risk of a third party not approving the outsourced work, unless that party uses exactly the same approval criteria and specification as those in the outsourcing contract. If all parties in the wider game project use the same approval criteria and specification then (at least in theory) the outsourcing company should not face the risk of non-payment despite meeting the requirements of the outsourcing contract.

However, many third parties (particularly IP licensors) require substantial discretion over whether to approve deliverables or not. In those circumstances, it is difficult for the client to justify withholding payment to the outsourcing company if the client has approved the outsourced work but a licensor has subsequently disapproved it simply because it is "not good enough". The outsourcing company can legitimately argue that any additional requirements of a licensor should be treated as additional work requests by the client, and should not delay payment for the work already completed.

Royalties

Most outsourcing contracts involve the payment of fixed sums in return for the delivery of defined work. However, as outsourcing projects become more complex, both parties may wish to add a profit share element to the outsourcing contract. This can be achieved by an agreement for the client to pay a royalty to the outsourcing company on income generated by the relevant game.

This paper does not address the detail of royalty calculation and payment terms. A fuller treatment of these issues can be found in the TIGA *Template Terms for calculating royalties in the interactive entertainment industry* and its associated Handbook (available from the author or from TIGA).

If the client proposes a royalty to the outsourcing company, the outsourcing company needs to understand the potential value of that royalty. If the client receives all of its income related to the game from a single publisher, then it will usually suggest sharing that income. In order to evaluate that proposal, the outsourcing company must try to establish the likely net royalty to be paid to the client (and should bear in mind that many games never generate a net royalty at all). This requires the outsourcing company to understand the following terms of the client's contract with its publisher:

- the probable *per unit value* of the royalty to be paid to the client by its publisher (this requires an understanding of the contractual definition of "gross revenue" and the deductions made to achieve "net revenue", as well as the headline royalty rate offered);

- whether the royalty is *recouped* against any advances paid to the client by its publisher (and, if so, how the recoupment model works);

- the *dates* for payment of the royalty; and

- whether the royalty is subject to any *retention* (e.g. for returns) by the client's publisher.

All of this information is located in the client's contract with its publisher, which it may not be permitted to disclose to the outsourcing company. However, without this information, the outsourcing company simply cannot hope to understand what (if any) royalty payment may realistically be paid to the client, and therefore shared with the outsourcing company.

Conclusion

Payments to the outsourcing company are usually triggered by delivery of agreed work. The outsourcing company should ensure that it is paid within a set time period following delivery of work to an agreed specification and quality. In addition, the outsourcing company should be reluctant to agree to payment being conditional on the approval of third parties, particularly if these third parties have wider rights to disapprove the outsourced work than the client.

If the client offers a royalty to the outsourcing company, the outsourcing company will need to understand the details of how the client's own income is calculated, in order to determine the value of that proposed royalty.

SPECIFICATION

Section 3 – defining the project scope and avoiding feature creep

Introduction

The essence of an outsourcing agreement is the creation of outsourced work. The outsourcing agreement needs to describe the outsourced work in precise detail *before* the outsourcing agreement is completed and work begins. This is to the benefit of both parties: the client needs to be sure that it will obtain work which meets its requirements for the agreed price and by the agreed delivery dates; whilst the outsourcing company needs to be sure that it will be paid once it delivers the work it intends to create.

This is something of an obvious point, of course, and it applies equally to all agreements under which one party is creating assets or other work for another party. However, there are some further considerations which (whilst also relevant to other types of deals) can arise more frequently in outsourcing relationships.

Client requirements

Once again, the starting-point is the client's own contract with its publisher. The specification in that contract must necessarily define the work to be created by the outsourcing company. Even if the specification in the client's contract with its publisher is not sufficiently detailed to define the outsourced work without further description, the eventual specification for the outsourced work must always remain consistent with the specification agreed by the client and its publisher.

Additional criteria driven by the client's production processes

The outsourced work is likely to be integrated into the client's own production pipeline. This may therefore require the outsourced work to adhere to additional criteria which are solely connected to the client's own production infrastructure or processes (and have nothing to do with the quality of the outsourced work itself). For example, assets may be required in the client's proprietary file format, or need to comply with particular file name protocols established by the client.

All of these requirements need to be agreed in the specification for the outsourced work.

"Feature creep"

"Feature creep" or "scope creep" consists of uncontrolled specification changes, often occurring in small incremental steps, resulting in a project drifting away from its original focus. The consequence is invariably budget and schedule overrun.

Described in this way, feature creep is a risk to any project, not only outsourcing projects. *However, outsourcing projects are inherently more vulnerable to feature creep than certain other project types, simply because of the sheer number of parties involved in the overall game project*. These include the client's publisher and, in many cases, the client's (or its publisher's) licensor(s). They also include console manufacturers, who control game content through their own approvals process.

Example

A publisher wishes to develop a realistic soccer simulation game. It acquires various licences from famous soccer players to use their likenesses in the game. The publisher then engages a developer to create the game, and the developer engages an outsourcing company to create the 3d models of the soccer players.

The 3d models meet the specification agreed in the outsourcing contract (which referred solely to polygon count) and both the developer client and the client's publisher approve the models. However, some of the soccer players are dissatisfied with their game avatars, and ask for relatively minor changes in height, weight, facial expression and hair colour. These requests are passed down the chain to the outsourcing company, which is able to make the changes at limited cost and agrees to do so in order to preserve its relationship with its client, the developer.

These changes in turn cause other soccer players to notice that their avatars are now slightly less realistic than those of their rivals – so they too ask for additional changes. It is difficult for the outsourcing company to refuse to make these changes, having already accommodated similar requests in the past. However, the total work required in order to make these additional changes now means that the project budget has been exceeded (leading to losses to the outsourcing company) and the delivery schedule has been missed (causing the client developer to miss the milestone dates agreed with its publisher) and jeopardising the planned ship date for the game.

Feature creep tends to occur for one of two reasons:

- *an unclear specification* (making it harder for the parties to spot specification changes when they happen); or

- *weak or non-existent change control processes* (allowing the outsourcing company to agree and implement specification changes without the full budgetary and scheduling implications first being understood and then agreed with the client).

In our example above, the outsourcing company might have eliminated the problems it experienced with the soccer stars if it had:

- addressed avatar realism in the specification (by stating that avatars would adopt a uniform facial expression and would only correspond to the real players they represented in general terms); and

- adopted (and actually *used*) a change control process under which the budgetary and scheduling implications for each suggested change were agreed by the outsourcing company and the client developer before the change being made.

Ideally, the limitations of avatar realism which should have been agreed in the specification for the outsourced work should also have been specified in the client's agreement with its publisher *and in the publisher's agreement with the soccer players* – in which case the whole problem might have been averted in the first place. However, this may not always happen in practice; and it is up to both the outsourcing company and the client developer to ensure that the publisher bears the risk of additional work driven by licensor requirements. Again, they do so by ensuring that the specification is appropriately detailed and that their agreements contain adequate change control processes.

International deals

Outsourcing companies in different countries (or coming from different industrial backgrounds) may have different approaches to issues such as quality and consistency of work. If the client is used to dealing with developers in the same country and industry as the client, then the parties can often make do with a less detailed specification because the client and the outsourcing company will share common standards of production. However, if the client and the outsourcing company come from different industrial and cultural backgrounds, they may not share the same production standards – and should make up for this by agreeing an even more detailed specification.

Specification by example

If the outsourcing company has been engaged to provide a number of similar assets (e.g. a number of 3d building models) then the parties might agree that the specification should refer to one or more examples which both parties are happy with. If the outsourcing company created some example models as part of the bidding process, then these models will be available *before the outsourcing contract is signed* (an essential specification requirement, as noted above). Of course, the outsourcing company needs to be aware of this possibility when creating the example models in the first place.

Conclusion

When agreeing the specification for the outsourced work, the parties need to start with the specification which the client has agreed with its own publisher. They also need to bear in mind any additional technical requirements driven by the client's internal production processes.

In order to avoid feature creep, the parties need to agree both a clear specification and a workable change control process. The need for clarity is greater if the parties do not share the same cultural or industrial background, and therefore don't share the same production norms. Using agreed example assets can help to clarify the specification.

QUALITY

Section 4 – defining and judging "quality"

Introduction

The issue of work "quality" is connected to the issue of a clear specification addressed in Section 3. After all, the overall quality of the outsourced work might be one component of the specification. However, the issues of work specification and work quality are not always combined, if only because "quality" is often an abstract concept with little place in a technical description of video game assets. It is not uncommon for clients to *add* a requirement that the outsourced work be of a certain quality, *in addition* to the requirement that it meet the agreed specification.

Ironically, the clearer and more objective the specification, the greater the benefit to the client of specifying an quality additional criterion for the work. If the specification is clear and unambiguous, the client may have little scope to reject work if that work *technically* meets agreed specifications, even if (to the client's eyes) that work is "just not good enough". An additional requirement that the work be of "satisfactory quality" gives the client a separate, additional right to reject work which it considers unsatisfactory.

It is clearly in the interests of the outsourcing company to ensure that any additional quality requirements do not negate the benefits of a clear specification.

What is "quality"?[1]

The concept of "quality" is both relatively abstract and highly subjective – the quality of a work is in a sense "in the eye of the beholder". This is clearly a problem in a creative project with multiple parties, as each party will have its own conception of quality and those conceptions will almost certainly differ. If a client turns down a deliverable because it is of "low quality", the outsourcing company will find it difficult either to address the client's concerns (by undertaking further work) or to challenge the client's determination in a court of law.

As a result, the outsourcing company should not agree to any measurement or review criterion which is both abstract and subjective. In particular, "extreme" variants such as "highest quality", "state of the art" and "AAA quality", should be avoided at all cost.

Equally, the outsourcing company should not agree to a term requiring it to create assets of satisfactory quality "as determined by the client in its sole discretion". This would place the outsourcing company at the mercy of the client, and deprive the outsourcing company of all of the benefits of a clear specification and acceptance procedure.

[1] This question has been addressed at length in Robert M. Pirsig's work *Zen and the Art of Motorcycle Maintenance* (and nothing I can add here can do justice to that analysis).

Objectivity by reference to other works

This is not to say that references to issues such as quality should be rejected out of hand. These do have a part to play, provided that they are removed from the purely subjective and the abstract. This can be achieved by referring to existing works. For instance, a requirement that cut scenes for a game be “of no less quality” than the quality of the cut scenes in another named video game at least provides a clear reference point (the other named game) to begin with.

Clearly, the comparator work should be developed for the same platform as the outsourced work (with a similar development budget and timetable) in order for the comparison to be meaningful.

Objectivity by reference to discernible business standards

Adding a reference to existing business standards (which the parties, or a court, should in theory be able to establish) can also bring an element of objectivity to the issue of quality. For instance, the parties might agree that the outsourced work should be “of the quality to be expected of a professional game developer”. Again, it will be easier for them to agree (or for a court to determine) what this means in relation to a specific deliverable.

Early termination rights as an alternative

Section 8 addresses the possibility of the client benefiting from a right to terminate the outsourcing contract “without cause”, i.e. without having to show a breach of contract by the outsourcing company. In practice, this right can provide the client with similar protection to that afforded by the use of unclear quality criteria (while avoiding an expensive legal dispute).

Conclusion

If the client wishes to hold the outsourcing company to a minimum standard of quality, the outsourcing company should avoid agreeing to meeting a purely abstract or subjective standard. A measure of objectivity can be obtained by referring to other games or established business standards. Equally, the outsourcing company should not agree to the client being the sole arbiter of whether the outsourced work meets the agreed quality standards. Lastly, a right for the client to terminate the outsourcing contract “without cause” can bypass difficulties in defining and measuring quality altogether.

DELIVERY

Section 5 – addressing delivery risks

Introduction

The outsourcing agreement invariably includes a schedule for delivery of the outsourced work. If the outsourcing company is late in delivering any work, this will usually constitute a material breach of contract by the outsourcing company. The consequences can be severe, and can include a termination of the outsourcing contract by the client, usually combined with a lawsuit for damages.

This is understandable if the delay is caused by the outsourcing company. However, the outsourcing company should not necessarily accept liability for delay caused by the client, or by other circumstances beyond the control of the outsourcing company.

Client delay

Outsourcing companies rarely operate in a vacuum. In any outsourcing project, the outsourcing company will usually need input of one form or another from the client, or from the client's publisher or another party such as a licensor. This input might simply be a question of timely testing and feedback during the acceptance process. However, it may be much more involved than this, even requiring the delivery of substantial assets from the client to the outsourcing company.

Clearly, the outsourcing company should not be liable for any delay in delivering the outsourced work, if that delay was first caused by the client delaying an essential client input. Accordingly, the outsourcing contract should

- expressly *identify* all of the client inputs which may have an impact on the completion and delivery of the outsourced work;

- specify the *date(s)* on which those inputs are required; and

- specify that all delivery dates are subject to *automatic extension* if delivery is delayed because those inputs are not received by the outsourcing company in time.

The client may wish to ensure that the outsourcing company notifies it as soon as there is a delay which might affect the delivery schedule.

Inputs from third parties

The outsourcing project may require inputs which originate with third parties. For instance, the outsourcing company may require a style guide developed by a publisher. Equally, if the relevant game is based on a movie in development, the outsourcing company may require information relating to that movie, which may only be available from the movie studio.

If the client does not control these inputs, it may be reluctant to agree that the delivery schedule can slip if these inputs are not received in time by the outsourcing company. This will make the outsourcing company responsible for securing these inputs. Clearly, the outsourcing company should reject this unless it is able to secure these inputs independently of the client.

“Force Majeure”

Many commercial contracts include a “force majeure” clause. This absolves a party from liability for breach of contract if that breach arises due to circumstances beyond the control of that party, such as acts of war or terrorism. However, the wording of these clauses is often (arguably) wide enough to encompass delayed completion of the outsourced work due to delayed delivery of certain inputs.

Conclusion

Whilst the outsourcing company will normally be liable for delayed delivery of the outsourced work, it should ensure that it is not liable if this delay is caused by factors outside its control. This requires the parties to identify all of the inputs required by the outsourcing company, as well as the dates for delivery of these inputs, and to agree a mechanism to extend the delivery schedule if any of those dates is not met. A “force majeure” clause in the outsourcing contract may also assist the outsourcing company if it faces delays caused by factors beyond its control.

CREDIT

Section 6 – managing exposure to the other party's creditworthiness

Introduction

Almost every commercial relationship involves each party taking a risk as to the solvency of the other party. The longer the relationship lasts, the longer each party is exposed to the creditworthiness of the other.

In an outsourcing relationship, it is important to note that the client's exposure does not end when the outsourced work is complete. Instead, the exposure continues until there is no prospect of any claim against the outsourcing company (for instance, a claim under any warranty of non-infringement), which may be many years after the release of the game.

Equally, if an outsourcing company receives royalties on the sale of the game, its exposure to the client continues until there is no prospect of it ever making a claim against the client for non-payment of royalties (which may happen many years after the royalty stream ceased).

The outsourcing company needs to consider not only the solvency of its client, but also the solvency of its client's publisher. If its client's publisher is likely to experience cash flow difficulties during the project, these are likely to feed through to the client and the outsourcing company can expect to feel the impact of these difficulties as well.

Due diligence

This paper is not about financial due diligence.

However, there is simply no substitute for adequate financial due diligence. Most countries have established credit rating agencies which can produce detailed reviews of even the smallest companies. In addition, companies can usually make their own extensive enquiries into prospective partners, which will usually begin by a review of the annual accounts of the relevant company. (If there are no available accounts, then that in itself is an important warning sign).

Outsourcing contract points

The parties can use the outsourcing contract to manage their exposure the other's solvency in the following ways:

- *Payment Up Front*. The outsourcing company will normally wish to ensure that it receives enough payment up front to cover all of the costs of starting the outsourced work. This will include the costs of negotiating the outsourcing contract, together with the costs of setting up the team. These costs might also include the lost profit on any other deal that the outsourcing company has had to reject in order to free up staff to carry out the work required under the outsourcing contract.

  Clearly, the client will seek to defer (or "back-end load") payment as much as possible, for the same reasons. If the outsourcing company becomes insolvent during the project, the client's money will be much safer in its own bank account rather than in the hands of the outsourcing company's creditors.

- *Payment terms*. Although the client will usually insist on paying against delivered milestones, the longer the client can wait before paying, the more exposed the outsourcing company. 30- or 45-day payment terms clearly import more exposure to the outsourcing company than a requirement to pay within 7 days.

- *Suspension and termination rights*.

  - The outsourcing company will not usually have an automatic legal right to terminate the outsourcing contract and redeploy its staff if the client fails to pay a single invoice on time. However, a single missed payment can be a symptom of severe cash flow problems, so the outsourcing company should ensure that it has the right to suspend work immediately if has not been paid; and that it has the right to terminate the contract if non-payment continues for an agreed period after notice.

  - Equally, other breaches of contract may also indicate solvency problems. Accordingly, each party should require the right to terminate the outsourcing contract if the other fails to comply with the terms of the contract (as further described in Section 8).

  - Both parties should also require similar rights of suspension and termination if the client becomes insolvent (or "quasi-insolvent", such as seeking Chapter 11 protection).

- *IP assignments*. If the outsourcing company is *assigning* (i.e. transferring) IP to the client, then it has no control or claim over that IP (and therefore no leverage) after the assignment has occurred. Accordingly, the outsourcing company should seek to ensure that the IP in any particular deliverable is not assigned until either (i) the client has paid for that deliverable; or (ii) the client has paid all sums due under the contract. If the client has become insolvent, the outsourcing company will have a better chance of obtaining payment from the client's liquidator (or from the client's publisher) if it has retained IP in a game which is still being developed. (Of course, if the game is cancelled, then this leverage is far less effective.)

In contrast, the client will require an assignment of all IP in all of the outsourced work, effective as of the signature of the outsourcing contract, in order to protect its rights to use the relevant work should the outsourcing company go out of business.

- *IP licences*. If the outsourcing company is simply *licensing* IP to the client, then the outsourcing contract can specify that the licence can be terminated (along with the outsourcing contract as a whole) on non-payment by the client, or if the client goes out of business. However, some legal systems will not allow the outsourcing company to terminate the outsourcing contract or the client's licence rights simply because the client has become insolvent or quasi-insolvent, even if this right is specified in the contract.

<u>Insurance</u>

The outsourcing company is usually exposed to the client's creditworthiness solely to the extent of any fees due to it by the client. It is unusual, although not impossible, for the outsourcing company to have a claim against the client for more than the sums which the client agreed to pay in the outsourcing contract.

In contrast, the potential liability of the outsourcing company to the client – and therefore the extent of the client's exposure to the outsourcing company's creditworthiness – may be much greater than the value of the outsourcing contract. In particular:

- If the outsourcing company causes a delay in completion of the game, the client may be liable for the costs of that delay incurred by the client's publisher. The client's publisher may also be entitled to terminate its contract with the client, thus putting an end to the entire project. The losses borne by the client could be very substantial.

- If the outsourced work infringes the IP rights of a third party, this might result in a massive IP claim against the client. The client will seek to recover the costs of that claim against the outsourcing company. Again, these costs are likely to be many times greater than the value of the outsourcing contract.

The greater the ultimate liability, the greater the likelihood that the outsourcing company will simply not be able to pay, and will go out of business instead. This is not much consolation for the client, as it will still face massive liability in both of the scenarios listed above. The only solution is to ensure that the outsourcing company is insured against any liability under these two scenarios – in which case, the client is exposed to the creditworthiness of the insurance company instead.

Conclusion

Both parties to an outsourcing contract are taking a risk as to the creditworthiness of the other party. However, both can reduce that risk by ensuring that the terms of the outsourcing contract address the possibility of the other going out of business. This means considering exactly *when* money is to change hands. It also involves considering when IP is to transfer. Ultimately, however, the client may need to require the outsourcing company to obtain insurance in case the client needs to make a particularly large claim against the outsourcing company.

INTERNATIONAL DEALS

Section 7 – dealing with additional risks involved in international outsourcing deals

Introduction

Many outsourcing contracts are international in scope – the parties are located in different countries. Clearly, this will almost inevitably be the case if the client selects an outsourcing company on the basis of price, if the lower price is driven by the lower salaries paid in the country in which the outsourcing company is located. However, in addition to cost savings, international outsourcing deals involve additional risks to both parties.

Enforcement problems

It is often harder and more expensive to enforce a contract against a company based in a separate jurisdiction. Taking legal action abroad means instructing a new set of attorneys in the relevant country, which costs money. The process of taking legal action may simply take longer in that country. The courts of that country may apply different rules relating to contract law or IP law. They may have a natural bias towards their own nationals, or even be open to bribery or other illicit approaches which a local defendant will often find easier to carry out.

One partial solution to this problem is for a party to ensure that all of its contracts are governed by the legal system of the country in which it is situated; and that the courts of that country have exclusive jurisdiction over any dispute. This at least reduces the risk of delay in achieving judgment, or of losing the case because of the application of different legal rules. However, a judgment will still need to be *enforced* against the losing party, and this almost always requires a recourse to the legal enforcement apparatus in the country in which the losing party is situated.

Differing conceptions of IP

Different legal systems apply different rules relating to the creation and the transfer of IP. Some systems prohibit the waiver or transfer of certain types of IP (particularly so-called "moral rights" which cannot be waived or transferred in some European jurisdictions). Some systems also consider that global assignments of IP (where all possible exploitation rights – whether known or unknown – are transferred by the creator to a third party) are legally invalid. Yet others consider that transfers of IP signed *before* the relevant work is created are invalid.

Unfortunately, the outsourcing contract cannot always circumvent these problems for the client, even if the contract is expressly subject to the legal system of the country in which the client is based.

Example

A US client engages a foreign outsourcing company to create musical compositions and recordings for the client's game. The client needs to acquire all IP in those assets (in order to pass these on to the client's publisher). The client enters into an outsourcing contract which is subject to US law and over which the US courts have exclusive jurisdiction. The outsourcing contract includes a standard assignment of IP to the client.

However, the laws of the country in which the outsourcing company is located do not allow individual staff members to transfer all of their IP rights to the outsourcing company. Accordingly, the outsourcing company cannot pass those rights on to the client, despite the terms of the outsourcing contract.

The client should always seek local legal advice as to whether the IP-related provisions of the outsourcing contract are legally enforceable in the country in which the outsourcing company is situated. There is simply no substitute for taking this precaution.

Cultural issues

Western companies tend to assume that everyone is familiar with the basic principles of western IP law, particularly copyright and trade mark law. However, many countries simply do not share the cultural norms which underpin western IP law. In particular, some cultures may not consider copying or adapting existing works to be inherently "bad", or originality to be inherently "good" (two fundamental principles underlying western copyright law). Others may not afford private property (including intellectual property) the levels of protection afforded to property rights within capitalist societies. If an outsourcing company is located within a culture with profoundly different conceptions of IP law, then inadvertent IP infringement (such as selling the same asset to different clients) may occur without malice or fraud on the part of the outsourcing company.

Insolvency regimes

Different countries have evolved different rules to apply when a company becomes insolvent. Some systems are more creditor-friendly, whilst others tend to favour the debtor company at the expense of its creditors. If a party takes a big risk in relation to the credit of the other party (as further described in Section 6), then it has to be aware of the operation of insolvency regime in that other party's country. Otherwise, it might find that the contractual protections on which it relies simply do not operate in that country.

Example

An outsourcing company in country A licenses some software to a client in country B. The client becomes insolvent and applies for court protection from its creditors. The outsourcing contract contains an express term allowing the outsourcing company to terminate the outsourcing contract (and cancel all of the licences granted under the outsourcing contract) if this happens. However, the insolvency law in country B expressly forbids termination of any rights in those circumstances. As a result, the outsourcing company loses all leverage in negotiating with the court-appointed administrators of the client.

Conclusion

Many outsourcing contracts have an international dimension which imports further risks to both parties. In particular, each party must consider how the legal system of the other party might affect their understanding of IP rights and insolvency procedures. They should also consider the added costs and difficulties in obtaining and enforcing a judgment against a party based in a different country. Lastly, they should consider whether local cultural practices make inadvertent IP infringement more likely.

TERMINATION

Section 8 – agreeing an orderly divorce if the relationship isn't working

Introduction

Although the parties naturally assume that the outsourcing project will progress smoothly, they need to consider what will happen if the project does not go to plan. Early planning for this possibility can result in substantial cost savings should the project encounter unexpected problems.

Example

A client engages an outsourcing company to create localised text and audio assets for the foreign language SKUs of the client's game. After reviewing the first set of delivered assets, the client concludes that they are of not of the quality it expected. It does not think that the quality is likely to improve, and accordingly decides to appoint a different outsourcing company to complete the localization task. The outsourcing company disagrees with the client's assessment of the work and demands payment.

The only option open to the client is to terminate the outsourcing contract for material breach by the outsourcing company and to threaten legal action. This results in an open dispute between the parties, with both parties facing the possibility that the other will escalate matters to a full blown lawsuit, with neither party sure of the possible outcome.

Termination "without cause"

The most common way of dealing with the circumstances outlined above is to allow the client a right to terminate the contract "without cause", i.e. without having to show a breach of contract by the outsourcing company. The outsourcing company will usually agree to such a right, provided that it is paid enough money when the contract is terminated on this basis. In the example above, if the parties had agreed at the outset that the client could terminate the outsourcing contract at any time, "without cause", on payment of an agreed sum, then this would almost certainly have been a preferable outcome *for both parties* to the outcome described above.

Termination caused by the client's publisher

The client's contract with its publisher is likely to include a right for the publisher to terminate the game project without cause. As a result, even if the client does not obtain a general right to terminate without cause, the client should retain a right to terminate the outsourcing contract if the project as a whole is cancelled. Again, the outsourcing company will be more likely to accept this if it is paid an appropriate sum on termination.

Standard termination rights

It is generally good practice for both parties to any commercial agreement to benefit from a right to terminate that agreement either for breach of contract by the other party, or because the other party has gone out of business. In general:

- Any right to terminate for breach should only be exercisable if the breach of contract is *material* and has not been remedied within an agreed *notice period*.

- A contract right to terminate due to the insolvency of the other party may be considered invalid in certain jurisdictions (see Section 7).

Consequences of termination

The outsourcing contract should specify the consequences of any early termination. For instance, some terms of the contract (such as the parties' confidentiality obligations) should usually survive termination. In other cases, issues such as ownership of (and payment for) the work completed before termination will depend on the *reasons* why the contract was terminated. For instance, if the outsourcing contract is terminated by the client "without cause", the outsourcing company may ask for a return of all IP rights transferred to the client. However, if the outsourcing contract is terminated by the client due to a breach by the outsourcing company, the client will usually insist on retaining those IP rights.

Conclusion

The parties should consider the possibility of early or premature termination of the outsourcing project before the outsourcing contract is signed. In particular, they should consider whether to allow the client to terminate the project early because of creative or quality concerns which may be disputed by the outsourcing company.

In addition, they should agree the circumstances in which either party can terminate because the other has not performed as intended, or because the other has gone out of business.

In each such case, the parties should consider which contract terms will continue to operate after termination of the contract, and whether additional terms should come into effect on termination of the contract.

<u>IP RISKS</u>

Section 9 – allocating risks of accidental IP infringement

<u>Introduction</u>

Any project under which work is being created by one party and used by another party includes a risk of accidental IP infringement. In an outsourcing contract, there is a risk that the outsourced work infringes the IP rights of a third party.

- Infringement can occur by accident, for instance when an artist creates a logo which strongly resembles a third party's registered trade mark; or when a designer creates a character who resembles a real world celebrity.

- Separately, if the staff of an outsourcing company deliberately use the IP of a third party under the mistaken belief that they are allowed to do so (or without caring whether they are allowed to do so or not), this again will result in "accidental" infringement of that third party's IP rights.

There is also a *separate* risk that a third party makes a *claim* that the outsourced work infringes its IP rights – even if that claim ultimately fails.

Usually, the party that actually *uses* the relevant work is the first in the line of fire. If the outsourced work is contained in a game which is published by the client's publisher, then the client's publisher is the first to be sued if someone claims ownership of IP rights in the outsourced work. The client's publisher will of course go on to sue the client, who will seek to pass this liability on to the outsourcing company via the terms of the outsourcing contract.

<u>Managing the risk of accidental IP infringement</u>

The probability of accidentally infringing the IP of a third party can be substantially reduced, although never eliminated, by the party responsible for creating that IP. That party can ensure that its staff follow appropriate internal procedures whilst creating the outsourced content. It can establish a system of staff training to ensure that its staff know the rules relating to IP and what they can and cannot do with IP belonging to third parties. It can institute a system under which all outsourced work is separately scrutinized before being transferred to the client.

<u>Due diligence</u>

Clearly, the client has less control over the measures taken by the outsourcing company's staff than the outsourcing company itself.

Once again, however, there is no substitute for the client undertaking appropriate due diligence. In particular, it can enquire as to the steps (if any) taken by the outsourcing company to reduce the risk of accidental IP infringement. If the outsourcing company does not have any system or formal staff training programme in place, then this alone should be of substantial concern to the client.

If the outsourcing company has been in business a long time, then the client may infer that it has adequate systems for reducing the risk of accidental IP infringement, simply because it has survived in business for some time. (It may simply have been lucky, however).

Contract terms

Clearly, the outsourcing contract should allocate the risk of accidental infringement of IP. As noted above, between the client and the outsourcing company it is the client who will usually be first in the firing line if the outsourced work infringes the IP of a third party. As a result, the client will usually seek to transfer this risk to the outsourcing company. It usually does this by requiring the outsourcing company to *represent and warrant* that the work it creates does not infringe the IP rights of any third party.

In addition, the client will usually require the outsourcing company to bear *all* of the costs and expense caused by the accidental infringement of third party IP rights, whether foreseeable or not and including legal fees and expenses, by requiring the outsourcing company to *indemnify* the client against all costs and expenses arising from the accidental infringement of IP rights.

Lastly, the client may also require the outsourcing company to indemnify it against all costs and expenses arising out of any *claim* that the outsourced work infringes the IP rights of a third party, even if that claim ultimately turns out to be false. Of course, the outsourcing company may be reluctant to pay up in these circumstances, as it will not have been at fault in the first place.

Limiting the risks transferred to the outsourcing company

Although the outsourcing company will usually agree to accept responsibility for the work created by its staff, this should be subject to one important limitation. The outsourcing company is creating work to the order of its client. The client creates the specification for the work. This means that the client has to accept responsibility for certain aspects of the outsourced work.

Example

A client has been commissioned to create a car racing simulation game. The client commissions the 3D car models from an outsourcing company. The client asks the outsourcing company to warrant that the use of these models in the game does not infringe the IP rights of any person.

The outsourcing company should not accept such a wide-ranging warranty. Whilst it can accept liability if its staff copy the model from another game, it should not be responsible for any potential action brought by the car manufacturer which owns the IP rights in the car which is being modelled. These rights should be cleared by the client or the client's publisher, and the outsourcing company should disclaim any responsibility for undertaking such clearances.

Credit exposure

Even if the outsourcing company assumes all of the risks relating to the accidental infringement of third party IP rights, this means nothing in practice if the outsourcing company will not have the funds to cover its potential liability for such infringement. Ultimately, very few companies in the games industry can cover the full costs of a catastrophic IP claim, including extensive legal fees, statutory damages and product recalls. If the outsourcing company simply goes out of business as soon as a claim is made, then the client has no protection at all. This is dealt with in greater detail in Section 6.

Insurance

As noted in Section 6, the client may require the outsourcing company to insure against the costs of any claim the client may eventually bring against the outsourcing company which relates to the accidental infringement of third party intellectual property rights. In addition to addressing the credit exposure risk noted above, this may have the added benefit of subjecting the outsourcing company to the scrutiny of the insurance company. Insurance companies will not insure all comers; instead, they will usually only consider established, professional organisations with strong risk management procedures already in place.

Liability transfers

As further noted in Section 10, if the outsourcing company limits or excludes certain classes of liability which might arise on accidental infringement of third party IP rights, then this simply means that the costs of these classes of liability will remain with the client. This is so even if the client has sought to transfer these costs to the outsourcing company in the warranties, representations and indemnities of the outsourcing company.

Conclusion

The parties can never completely eliminate the risk that the outsourced work infringes the IP rights of a third party. Since the client will usually be first in the firing line should this occur, it will usually try to transfer this risk to the outsourcing company. It does so via the warranties, representations and indemnities of the outsourcing company. Separately, the client should undertake its own review of the outsourcing company's internal procedures for reducing the risk of accidental infringement of third party IP rights; and consider requiring the outsourcing company to insure against this risk.

LIABILITY

Section 10 – matching potential liability with expected revenues

Introduction

As noted in Section 6, the potential liability of the outsourcing company to the client may be much greater than the value of the outsourcing contract. In particular, the costs of delaying completion of the game as a whole, or of settling an IP infringement action brought by a third party, may be many times greater than the total amount payable by the client to the outsourcing company.

It is impossible for the outsourcing company to completely exclude the possibility of an expensive dispute with its client. The outsourcing company therefore needs to ensure that it takes the risk of any such dispute into account when setting its price for creating the outsourced work.

(If the outsourcing company doesn't know how to price this risk, it can simply ask an insurance company how much it would require to accept the risk in place of the outsourcing company under a "professional indemnity" or "E & O" policy. The answer will usually run into the tens of thousands of dollars.)

Exclusions of liability

The outsourcing contract can be used to reduce the potential liability of one or both parties to the other.

Firstly, the outsourcing company can *exclude* certain types of liability altogether. Typically, this includes a rejection of any responsibility for unexpected or unforeseeable damage or costs which may be suffered by the other party.

Example

The outsourcing company agrees to provide some cut scenes by an agreed date, but misses this date by one week. This in turn delays completion of the game by one week. Unknown to the outsourcing company, the client agreed with its own publisher than it would accept a 50% reduction in royalties if the game does not ship by an agreed date. The small delay caused by the outsourcing company delays completion of the game beyond that agreed date, and the client loses half of its royalties as a result. The client then claims the value of the lost royalties from the outsourcing company.

In examples such as the one above, if the outsourcing company had known about the potential extra cost of a small delay, it would either have increased its price (to compensate it for the potential additional risk) or rejected the project altogether. The outsourcing company will usually seek to exclude this type of liability altogether.

Types of loss or damage for which liability is commonly excluded include the following:

- Special
- Consequential
- Incidental
- Punitive
- Indirect
- Economic

Limitations of liability

In addition, a party can *limit* its overall liability under the outsourcing contract. Typically, it will limit that liability to either a factor of the total contract value (for example, to twice the contract value), or to a specific sum.

Matching contract value with contract risk

Limitations and exclusions of liability can co-exist in an outsourcing contract.

Excluding a party's liability for certain classes of loss or damage, and limiting its remaining liability, can help a party to keep its potential liability "under control" – i.e. to understand how bad things can get if the project fails – and to price its services accordingly.

However, shifting liability from one party to the other is essentially a "zero-sum" game. For each dollar of liability which is avoided by one party, the other party correspondingly loses that dollar and cannot recover it. Allowing the other party to limit or exclude its liability has just as much impact on the overall risk of a project as limiting or excluding one's own liability.

Conclusion

The value of an outsourcing contract to the parties is more than just a function of the money to be paid by the client and the value of the work created by the outsourcing company. The parties' total potential liability under the deal should also be taken into account when determining the value of the deal. The more liability a party can avoid, the lesser the potential costs of the deal and the greater its value.

CONCLUSION

This paper is about outsourcing contracts. However, the common thread that runs through almost all of the sections above concerns the *other contracts* (and the other parties) involved in the wider game project.

Ultimately, the outsourcing contract cannot be considered in a vacuum, without reference to these other contracts and these other parties. Core issues such as IP ownership, acceptance criteria, work specification, quality, delay and even credit risk and early termination rights are all driven in whole or in part by extraneous contractual relationships and related considerations involving the client, the client's publisher, licensors and platform holders.

While outsourcing contracts are often considered to be more straightforward than contracts for the development of a complete game, this ignores the additional complexity which inevitably arises when additional parties and additional contracts have to be taken into account. Reconciling multiple parties and their often conflicting commercial interests (and contractual rights) requires both skilful negotiation of the outsourcing contract and skilful management of the relationship once the contract has been signed.

Other Relevant Papers by the Author

If you found this paper helpful, you may be interested in the following GDC papers by the same author (who can be contacted at *vincent@sarassin.net*):

- *Ten Common Mistakes in Mobile Game Distribution Agreements (And How To Avoid Making Them)* presented at GDC Mobile 2005; and

- *Licensing Without Tears: Ten Steps to Success in Content and Brand Licensing* presented at GDC Mobile 2006; and

- *Commissioning Mobile Content: 10 Steps to Success* presented at GDC Mobile 2007.

In addition, the UK's trade association for game development companies TIGA has published a model content commissioning contract. This is available from the TIGA website at www.tiga.org.

Lastly, more information on the calculation of advances and royalties is available in the *Template Terms for calculating royalties in the interactive entertainment industry* and its associated *Handbook*, available from TIGA or from the author.

ABOUT THE AUTHOR

Vincent Scheurer graduated in law at Oxford University in 1993 and was called to the Bar in London in 1994. He started his career in interactive entertainment when he joined UK games publisher Europress as its sole in-house counsel in 1997. Following the acquisition of Europress by Hasbro Interactive in 1999, Vincent joined one of Europe's leading interactive entertainment teams at UK law firm Osborne Clarke, where he represented games industry leaders, international licensors and trade associations.

Vincent left Osborne Clarke to form Sarassin LLP in August 2004. Sarassin LLP is a London-based legal and business affairs consultancy for computer games publishers and developers and other organisations involved in the interactive entertainment industry. Sarassin specialises in advising on and negotiating the full range of commercial agreements encountered by publishers of mobile, PC, console and online games, including:

- development and publishing agreements;
- distribution agreements;
- technology acquisition agreements;
- licence agreements;
- new project finance structures;
- conversion agreements;
- option agreements;
- contract due diligence; and
- contractor agreements.

Vincent lectures regularly at interactive entertainment conferences including GDC and GDC Mobile. He is a contributor to the IGDA Contract Walk-Through and the editor of the TIGA Template Terms on royalties and related provisions for PC, console and mobile games as well as the TIGA model contract for commissioning interactive entertainment work.

Vincent is also the author of the video games section of the *Entertainment Law Handbook*, published in the UK by Law Society Publishing and available from March 2007.