

# THE 'OUTSOURCING OFFSHORE' CONUNDRUM: AN IP PERSPECTIVE

Outsourcing is a simple concept, based on the principles of comparative advantage and division of labor. Outsourcing **abroad** or **offshore**, however, is relatively complex, with significant political overtones linked to the issue of job losses. The interaction of different national business environments in such transnational relationships is a multi-layered process in which diverging legal, economic and social concerns arise. Outsourcing offshore has become a popular corporate strategy to increase profitability, and with it many jobs have moved from developed to developing countries.



Specialists in creating offshore outsourcing alliances stress the savings, which lead to lower costs while maintaining high quality. This is due to a combination of factors, such as high levels of education and skills appropriate to the tasks outsourced. Opponents emphasize the loss of jobs and opportunities for workers who are likely to face persistent unemployment thereafter. Newspapers and magazines in many countries increasingly feature articles highlighting the apprehension and insecurity over outsourcing offshore felt by workers in many sectors.

The issues raised are legitimate. Nonetheless, outsourcing offshore remains a valid business strategy at a time when information technology and the globalization phenomenon are bringing about a rapid integration of economies.

This article will focus on the role of knowledge sharing in offshore outsourcing relationships and the crucial link to intellectual property (IP) in enabling and facilitating it. The nature and critical importance of intellectual property differs in every sector of industry and business. Nonetheless, every type of IP asset – trade secrets, trademarks, industrial designs, patents, copyright and related rights, etc – may be involved at the different levels of outsourcing relationships. However, each type of IP asset is generally governed by its own distinct national law, which varies from one country to another, adding further complexity to managing IP assets in outsourcing relationships, especially if there are many partners in different countries. These issues will become increasingly important to enterprises as the practice of offshore outsourcing continues to grow.

## Trends in outsourcing

Outsourcing is generally defined as a means of "... marrying efficiency with innovation, which requires managers to consider the following: cycle time and cost reduction, leveraging scale and scope, reduction of resources, partners as role models for change, and reduction of

---

*"People are realizing that outsourcing is a genuine business innovation. It's a smarter way of delivering value by leveraging workforces all over the world. Today, fine, this is predominantly in India. But it could be in any part of the world."*

Mr. Nandan Nilekani, CEO of Infosys, the second largest Indian information technology software outsourcing provider<sup>1</sup>.

---

risk."<sup>2</sup> Outsourcing refers to an enterprise making an arm's length alliance with one or more entities or enterprises to perform carefully selected operations and day-to-day business processes that were previously done in-house.

Outsourcing arrangements in the manufacturing sector – for example in the apparel, automotive, textile and steel industries – have a long history. The practice, called **contract manufacturing or subcontracting**, was and still is used to reduce overall costs. Over the last decade, the introduction of information and communications technologies (ICTs) has considerably improved the ability to control outsourced activities or processes, whether in one or more distant locations, making outsourcing offshore a more attractive option for many other sectors. ICTs have also improved overall logistics, by allowing for reliable transport to destinations – "just in time" delivery – thus also reducing inventory costs for companies. As many enterprises using subcontractors in this way were

>>>

<sup>1</sup> "An Outsourcing Provider Sets His Sights on Global Giants" by David Kirkpatrick of Fortune Magazine, [www.fortune.com](http://www.fortune.com).

<sup>2</sup> "The Collaboration Continuum" by Prahalad, C.K. and Ramaswamy, Venkatram (November 2001).

able to improve their overall competitiveness, they moved on to outsourcing service-related functions. "*Out-servicing*" started with information technology-based tasks, and has evolved to what is known as '*business processing outsourcing*'.

Thus, the two main types of offshore outsourcing that are now on the rise can be grouped under:

- ▶ **Technology services**, which includes information technologies (applications hosting, telecommunications (voice and data), logistics, etc.); electronics (semiconductor chips; high-value microprocessors); electronic commerce, etc; and
- ▶ **Business processing outsourcing**, which deals with differentiated activities, such as finance and accounting, procurement and supply, customer contact (customer relations management), human resources, security, etc.

Many other functions, such as drug and product development in the pharmaceutical and biotechnology industries, especially clinical trials and legal services, are being outsourced offshore. For example, several law firms in the United States of America are outsourcing patent application drafting and prosecution to contractors overseas.<sup>3</sup>



### Value-chain and levels in outsourcing

Outsourcing can be used at any level of the value chain. At the lowest level, labor-intensive unskilled tasks are outsourced to low-wage countries. At the next level, the production or manufacture of a component, or the whole product or service, is outsourced. At the top level, technology development is outsourced, including some or all of the associated research and development (R&D) tasks. Marketing functions may also be partly (for example, market research) or almost wholly (for example, distribution and sales), outsourced.

### Protection of IP

Outsourcing requires the sharing of a wide array of proprietary knowledge. Effective management of this sharing of knowledge requires that both parties properly administer their IP while keeping their overall business objectives in view. The benefits of sharing IP assets must outweigh the multiple risks encountered in outsourcing, including the risks linked to the shared IP assets. Such risks include challenges in monitoring and/or dealing effectively with various types of breaches of contract clauses, theft or misappropriation of trade secrets, misuse or loss of other types of IP rights (resulting in partial loss of control of business), poor or inconsistent quality of goods and services (that may affect the reputation or brand image), enforcement of IP rights, parallel imports and grey-market issues.

#### Basic level of outsourcing relationships

**Low-wage human capital:** Focus is on labor-intensive tasks, which require unskilled, low-wage labor, then moves on to tasks requiring educated and skilled low-wage labor.

#### Second level of outsourcing relationships

**Manufacture of commodity products:** Focus on standardized (and often labor-intensive) production systems for standardized or mature (limited value-addition) products, often reaping economies of scale.

#### Third level of outsourcing relationships

**Outsourcing Development of Technology:** Focus on highly skilled science and engineering/technical personnel employed in state-of-the-art R&D setups in lower-wage countries.

<sup>3</sup> "Outsourcing Reaches Corporate Counsel" by Jennifer Fried, The Recorder: (08-25-04): "The Andrew Corp., an Orland, Ill., manufacturer of telecom infrastructure equipment, has cut back on its use of American outside counsel by sending some of its patent application work to Balwin Shelston, a law firm in Wellington, New Zealand."

Therefore, an *intellectual property due diligence enquiry* should be undertaken before finalizing any outsourcing plan to safeguard an enterprise's IP, while determining which functions be kept in-house or outsourced. It will include a range of essential issues, as listed in **Box 1**.

After having identified the areas of critical importance to its business, the enterprise can begin the process of finding and selecting one or more partners. It is essential first to assess the economic and political environment of a potential partner's location (country), as well as to consider and understand the country's institutions and legal framework. However, it is important to realize that

there are no 'bullet-proof vests' for the protection of IP.

In many countries trade secrets are inadequately – or not at all – protected by a specific national law; therefore, a primary concern when outsourcing is the potential partner's ability to safeguard confidential information of commercial value against accidental, inadvertent or willful misappropriation, misuse, sabotage, loss or theft.<sup>5</sup> If the partner cannot be trusted to protect trade secrets, then the risks of outsourcing offshore may outweigh its benefits. Hence, it is crucial to review *the integrated security and/or IP protection program* of the potential outsourcing partner. It is advisable

---

*“Executives were unanimous in saying they are very, very careful about what they offshore and what they don't,” said Rick White, head of U.S. industry group TechNet. “They tend to send things overseas that don't compromise their intellectual property, for obvious business reasons. You would never offshore unless you were sure you were going to get the same kind of quality as you would get elsewhere – and even then, you wouldn't do it if you weren't sure you could protect your intellectual property.”<sup>4</sup>*

---

to carry out a proper investigation to overcome or mitigate the risks of accidental or willful loss or misappropriation of trade secrets.

#### **Box 1. IP due diligence enquiry (Non-exhaustive list)**

- ▶ **Identify and document IP:** trade secrets, trademark(s), patent(s), industrial design(s), copyright and related right(s).
- ▶ Identify the **inventor, creator or author** of the IP.
- ▶ Determine **ownership rights** in the identified IP, including joint-ownership issues.
- ▶ Identify **contracts or other agreements** associated with the IP. For example technology transfer or licensing agreements; confidentiality and non-compete agreements.
- ▶ Identify **assigned or licensed** IP used by the interested enterprise(s): IP of third parties and/or by employees. Ascertain the rights granted to each party, and detect existing and potential sub-contracting issues.
- ▶ Identify existing and/or alleged breaches of contract, infringements, disclosure of confidential information and trade secrets.
- ▶ Determine **jurisdiction and enforcement:** applicable laws, enforceability; dispute resolution mechanisms (mediation, arbitration, choice of governing law, applicable jurisdiction).
- ▶ **Termination, expiration or exit clause** of arrangement: Is there an indemnity against infringement?
- ▶ Determine other IP-related responsibilities: Ongoing maintenance and upgrades to the IP; payments of transfer fees; product liability, IP insurance, etc.

#### **IP concerns in negotiating offshore outsourcing arrangements**

A firm should only start practical business negotiations if it is comfortable with potential partner's reputation, human, financial and technical resources, and compatibility of corporate culture. Negotiations should focus on the steps needed for both parties to safeguard and ensure proper use, sharing, licensing, development and improvement of the IP of both parties. It should also include discussion of any relevant IP assets of third parties.

Offshore outsourcing contractual arrangements can take several forms. However, most agreements will include the terms upon which both parties agree to commit their tangible and intangible assets for a mutually beneficial outcome. The contractor (the customer) and sub-

>>>

<sup>4</sup> “Companies determined to retain ‘secret sauce’” by Mike Ricciuti and Mike Yamamoto, *news.com.com*.

<sup>5</sup> For more information see “Trade Secrets: Policy Framework and Best Practices” and “Trade Secrets are Gold Nuggets: Protect Them” on the SMEs website at [www.wipo.int/sme](http://www.wipo.int/sme).

contracting enterprises (the vendor/service provider) may have similar financial expectations, but their IP and willingness to share parts of it may vary considerably. For example, a customer with high bargaining power may only outsource secondary IP and retain primary IP, whereas the vendor, in order to perform the requested service might have to share its primary IP.

Both parties are taking risks; so each must determine which IP assets should be kept out of the agreement, and which shared before, during and after the termination of the agreement. Vendors, no matter the country of origin, have legitimate expectations to move up the value-added chain by the transfer of technology. Hence, like the customer, they must also make every effort to assess the IP implications of outsourcing agreements. **Boxes 2 and 3** contain checklists that summarize IP issues of prime importance.

### When things go wrong: Challenges in enforcing IP rights

A realistic assessment of the challenges of enforcing IP rights is necessary before entering an offshore outsourcing relationship. The effectiveness of – and time and resources needed for – using the legal and administrative mechanisms for dispute resolution and enforcement of IP rights – for example, to deal with piracy and counterfeiting – vary a lot depending on the country and type of IP asset.

### Box 2. IP essentials for the contractor (customer)

- ▶ Account for all IP and associated know-how (whether registered or not, pending registration, or new (in-development) and fix the limits within which these IP assets are to be made available to the vendor.
- ▶ Ensure that the contract expressly deals with ownership issues relating to jointly created IP or over IP assets created by the vendor during the outsourcing relationship: Who will have ownership rights of newly-created information based on customer's IP data?
- ▶ Be aware of any limits on use of licensed third party IP: Can it be sublicensed to a vendor?
- ▶ Require vendor to take all reasonable measures to protect all IP assets, and especially any confidential information, trade secrets, know-how, etc. disclosed during the relationship.
- ▶ In ascertaining vendor's legal responsibilities in relation to outsourced function, make sure that their existing agreements, for example distribution, supply, marketing and research collaborations, do not compromise the IP assets to be shared with them: What would happen if the vendor were to sub-contract part of the outsourced function to independent contractors, consultants, etc.?
- ▶ Identify the vendor's other customers: Are they potential competitors? If so, what additional safeguards may be needed to safeguard the IP assets to be shared with the vendor?

### Box 3. IP essentials for the vendor

- ▶ Account for all IP and associated know-how (whether registered or not, pending registration, or new (in-development) and fix the limits within which these IP assets are to be made available to the relationship. Ensure that the outsourcing agreement includes provisions to protect owned (vendor's) IP and associated know-how.
- ▶ Ensure clarity of ownership or joint-ownership of IP assets created or improved during the course of the outsourcing relationship, whether based on customer's IP data or not; seek the maximum leeway to use any such jointly-owned IP assets for other or different outsourced functions with other customers.
- ▶ Set-up an integrated, well-functioning IP and security program to safeguard your own and the customer's confidential information, trade secrets and know-how. Enter confidentiality and non-compete agreements where and when appropriate.
- ▶ Put in place mechanisms to prevent inadvertent 'mixing' of proprietary trade secrets with those of the customer.
- ▶ Be aware of any limits on use of licensed third party IP: whether it can be used for the purposes of the current relationship.

A business strategy that employs outsourcing, if well-implemented by following a comprehensive and **integrated IP policy**, will mitigate IP-related risks and improve the competitiveness of the product or services offered by the enterprise. In the final analysis, success in the marketplace and profits will flow in a sustainable manner only if the ability of both customer and vendor to create and co-create value is protected and leveraged by using the tools of the IP system. This will also help to bolster the gains from cost savings, on-time delivery and quality of the product or service offered, which remain the pillars of any successful business enterprise. These arrangements require **thorough initial and periodic IP due diligence inquiries and IP audits**, given the significant nuances involved in such business relationships.



For more information on various practical aspects of the IP system of interest to business and industry, please visit the website of the SMEs Division at [www.wipo.int/sme/en/case\\_studies/index.htm](http://www.wipo.int/sme/en/case_studies/index.htm). The next article in the IP and Business series will discuss patent information.

