

The ‘Outsourcing Offshore’ Conundrum: An Intellectual Property Perspective

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*“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”.*²

Introduction

Outsourcing is a straightforward concept based on the principles of comparative advantage³ and division of labour.⁴ Outsourcing, abroad or offshore, however, is relatively complex with significant political overtones linked to the transfer of jobs. 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. 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.

Outsourcing offshore, now a popular corporate strategy, is used, to a large extent, by enterprises in developed countries to increase profitability by investing overseas in relatively ‘low-wage’ developing countries such as India, China and Brazil, to name a few. Advocates⁵ in creating offshore outsourcing alliances stress the savings as being the prime driver, which lead to lower costs while maintaining high quality.⁶ This is due to a combination of factors, such as high levels of education and skills appropriate to the tasks outsourced. A recent

¹ The opinions and views expressed in this article are solely those of the author and should not be attributed to WIPO. Any comments or suggestions pertaining to this article may be sent to donna.ghelfi@wipo.int. Many thanks to Guriqbal Singh Jaiya for his most valuable guidance and comments, and to Christopher Kalanje and Esteban Burrone for their inputs.

² Kirkpatrick, David (September 30, 2004). “[An Outsourcing Provider Sets His Sights on Global Giants](#)”, *Fortune Magazine*. Mr. Nandan Nilekani, CEO of Infosys, extolling the virtues of offshore outsourcing.

³ The theory of comparative advantage describes a countries’ specialization in the production of a good (at a lower cost (i.e. labour needed per unit of output) than another country) where it is then traded to another country. Commonly referred to the “Ricardian model”. Also please refer to Adam Smith’s idea of absolute advantage. For example, in “The Wealth of Nations,” Book IV, Section ii, 12: “If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage.” Such principles assume that this trade is beneficial to both countries.

⁴ Nathan Rosenburg, referring to Adam Smith, “... Smith’s understanding of the relationship between division of labour and invention. Adam Smith clearly recognised the existence of a hierarchy of inventions involving varying degrees of complexity, and requiring differing amounts of technical competence, analytical sophistication and creative and synthesizing intellect. Similarly, he distinguished between the ingenuity required to produce any particular invention on the one hand, and to modify it, improve it, or to apply it to new uses on the other.”

⁵ A group encompassing, for example, policy makers, economists, lawyers (IP and non), business and IT consulting firms and consultants providing professional services and advice, etc.

⁶ Or, to put it another way, the prime driver could be the need to lower costs while maintaining high quality, which would, ultimately, lead to savings.

survey by Ventoro⁷ (October 2004) found that “45% of those polled (5,231 Executives across North America and Europe) indicated their offshore strategy was a “success” with only 36% claiming their offshore strategy had failed”.⁸ Those who challenge⁹ the value of outsourcing offshore emphasize the loss of jobs and opportunities for workers who are likely to face persistent high unemployment thereafter. Newspapers and magazines in many countries increasingly feature anecdotes and articles highlighting the apprehension and insecurity felt by workers in many sectors. At the same time, many governments and academics are carrying out research on the consequences of outsourcing offshore.¹⁰ In a New York Times article, citing from an interview with Paul A. Samuelson, the Nobel Prize-winning economist and professor emeritus at the Massachusetts Institute of Technology, Steve Lohr writes, “According to Mr. Samuelson, a low-wage nation that is rapidly improving its technology, like India or China, has the potential to change the terms of trade with America in fields like call-center services or computer programming in ways that reduce per-capita income in the United States. ‘The new labor-market-clearing real wage has been lowered by this version of dynamic fair free trade’ Mr. Samuelson writes”.¹¹ (Mr. Lohr is referring to Mr. Samuelson’s article “[Why Ricardo and Mill Rebut and Confirm Arguments of Mainstream Economists Supporting Globalization](#)”, published in the *Journal of Economic Perspective* (Summer 2004)).

The debate is ongoing and 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 increasingly integrated economies and a recovery in global trade.¹² The key question in this connection is whether or not such outsourcing offshore can be sustained to encourage development also in the so-called ‘low wage’ countries.¹³

Trends in Offshore Outsourcing

Outsourcing can be generally defined as a means of “... marrying efficiency with innovation, which requires managers to consider the following: time cycle and cost reduction, leveraging scale and scope, reduction of resources, partners as role models for change, and reduction of risk”.¹⁴ It refers to an enterprise making an arm’s length alliance with one or more entities or

⁷ Ventoro, founded by senior executives from the ‘Offshore Outsourcing’ world, specializes in offshore outsourcing research, strategy, implementation and management. For further information see “[Offshore 2005 Research: Preliminary Findings and Conclusions](#)”, October 2004.

⁸ *Ibid.*, pg. 14: “Why Move Offshore? Achieve cost savings; Improve quality; Improve Time to Market; Gain Technical Skills; Forced Strategy; Cost Predictability; Penetrate Market; gain Industry Expertise.”

⁹ “Those who challenge...” refers to a varied group, including policy makers, economists, trade unions and workers (i.e. many USA manufacturers have written, in their labour contracts, that every outsourcing must be reviewed by its’ union), white collar employees, including many working in the IT sector.

¹⁰ Office of Senator Joseph I. Lieberman, Washington, D.C., United States Senate (May 11, 2004). “[Offshore Outsourcing and America’s Competitive Edge: Losing out in the High Technology R&D and Services Sectors](#)” is instructive on the long term implications and challenges (*for the USA*) on the issue of offshore outsourcing. “Paragraph. 6: International Collaborations: The rising number of international mergers, acquisitions and collaborations, and improved international protection of international property rights have also contributed to the offshore of R&D activities.” See page 19. See also pages 26 and 34.

¹¹ Lohr, Steve (September 9, 2004) “An Elder Challenges Outsourcing’s Orthodoxy”, *New York Times*. For a copy of the article please go to <http://www.globalpolicy.org/globaliz/econ/2004/0908samuelson.htm>, Global Policy Forum.

¹² For further information see [UNCTAD Trade and Development Report 2004](#).

¹³ Kumar, Pradeep B. (2004). “[Outsourcing of Services – the Case of India](#)”.

¹⁴ Prahalad, C.K. and Ramaswamy, Venkatram (November 2001). “[The Collaboration Continuum](#)”.

enterprises to perform carefully selected operations and day-to-day business processes that were previously done in-house.

The qualifying term ‘**offshoring**’ – outsourcing offshore – is used to distinguish the activities that occur when, for example, company *A* turns over responsibility, in whole or in part, of an in-house business function to company *B* whose location is outside of company *A*’s national jurisdiction, thereby making it a more complex arrangement than what it would have been if the two enterprises were in the same country. This may be considered as a form of foreign direct investment (FDI), a good thing, but not so it seems when the firm closes a plant or reduces its home-based activity and goes offshore to ‘outsource a function’ and then import product back into the domestic market. The United Nations Conference on Trade and Development (UNCTAD) World Investment Report 2004, in exploring the factors behind the global shift to outsourcing offshore, states that “FDI plays an important role in offshoring, although this is difficult to quantify owing to the lack of reliable data. In principle, FDI affects offshoring in two ways: through captive offshoring, and when specialized service providers set up foreign affiliates to serve foreign clients. While such investments can create many jobs, they typically do not generate large capital flows. Consequently, they do not account for large shares in the FDI statistics”.¹⁵

Outsourcing arrangements in the manufacturing sector – for example in the apparel, automotive, textile and steel industries – have a long history. The practice, termed contract manufacturing¹⁶ or subcontracting, was and is still used to reduce overall costs. As Henry Wan Jr. points out, traditional contract manufacturing operations (“bulky goods with standard specifications, transacted at arms’ length”) have evolved to the contract manufacturing of services;¹⁷ “Today, goods like clothing, automobiles, and electronic products not only have complex composition but also experience frequent style change. To manage the large number of parts and components of diverse origin becomes an independent activity: they must meet specifications, be ready on time, in large volumes, and at a competitive cost. Such management tasks have become the basis of a separate industry: the contract manufacturing service”.¹⁸

What then is the cause of the changing trading environment? Over the last decade, the evolution of information and communications technologies¹⁹ (ICTs) has considerably improved the ability to control outsourced activities or processes, whether in one, or more, distant national or international location(s), making outsourcing a more attractive option for

¹⁵ [UNCTAD World Investment Report 2004](#), “The Offshoring of Corporate Service Functions: The Next Global Shift?” Chapter IV, pg. 159.

¹⁶ Porter, Anne Millen (March 2000). Contract manufacturing is when an enterprise contracts “a third party to manufacture a product or components of a product to customer specifications.” See ‘[Contract Manufacturing – The virtual corporation: Where is it?](#)’, *Purchasing Magazine Online*.

¹⁷ Emphasis added.

¹⁸ Wan, Jr., Henry, “[Fragmented Trade and Manufacturing Services – Examples for a Non-convex General Equilibrium](#)”.

¹⁹ Schaaper, Martin. “[A proposal for a core list of indicators for ICT measurement](#)”. OECD, “Annex: Classifications – The OECD definition of the ICT sector: paragraph 20. In 1998 the OECD countries reached agreement on an industry-based definition of the ICT sector based on Revision 3 of the International Standard Industrial Classification (ISIC Rev. 3). The principles underlying the definition are the following: paragraph 21. For manufacturing industries, the products of a candidate industry: – Must be intended to fulfil the function of information processing and communication including transmission and display; *or* – Must use electronic processing to detect, measure and/or record physical phenomena or control a physical process. Paragraph 22. For services industries, the products of a candidate industry: – Must be intended to enable the function of information processing and communication by electronic means.”

many other sectors. ICTs have also improved overall logistics, i.e., by allowing for reliable transport to destinations – “just in time”²⁰ delivery – inventory costs for companies are reduced. As many enterprises using subcontractors in this way were 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**’ (BPO).

Thus, the two main types of offshore outsourcing that are now on the rise may 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** (BPO), 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,²¹ such as drug and product development in the pharmaceutical and biotechnology industries,²² especially clinical trials and legal services, are being outsourced offshore. Another example is of several law firms in the United States of America, which are offshoring a major part of the task of patent application drafting and prosecution.²³

The Value-chain and Levels in Outsourcing

The global commodity²⁴ chain has both a supply chain as well as a value chain. For the purposes of outsourcing, it is important to understand the distinction between the two. The

²⁰ “Just-in-time” is a management philosophy developed by Toyota in the 1950s. It is “a strategy for inventory management in which raw materials and components are delivered from the vendor or supplier immediately before they are needed in the manufacturing process.” See <http://www.investorwords.com>

²¹ For further information on offshore outsourcing functions see UNCTAD’s World Investment Report 2004. For examples of project categories, see www.smeoutsourcing.com.

²² Smock, Doug (March 19, 2003). “[Supply base consolidates moves to India, China](#)”, *Purchasing Magazine Online*. ““Chemical outsourcing boomed in the 1990s and is now estimated to US\$80-90 billion... One of the big issues in choosing a company from India or China will be respect for intellectual property rights,” commented Nailesh A. Bhatt, managing director of Proximaire Inc., a consulting and match-making firm based in Franklin Park, N.J. USA”.

²³ Fried, Jennifer (August 25, 2004). “[Outsourcing Reaches Corporate Counsel](#)”, *The Recorder*. “The Andrew Corp., an Orland, Illinois. Manufacturer of telecom infrastructure equipment, has cut back on its use of American outside counsel by sending some of its patent application work to Baldwin Shelston, a law firm in Wellington, New Zealand”.

²⁴ This brings about the notion that IT is considered a commodity. However, according to Paul Knapp “the standard dictionary definition of a commodity is simply ‘an article of commerce.’ This isn’t what proponents of the ‘IT as commodity’ theory mean though. The definition they rely on is ‘a mass-produced unspecialized product that is readily interchangeable.’ Mr. Knapp says this applies to IT products, such as hardware, but “a great many of the IT products businesses buy are not commodities in this sense. They are tailor-made for the business in question. These are the products that will give the business its IT competitive advantage. They are the ones businesses put the most value upon. The fact is that many IT systems, from email to data warehouses, are not commodity products. ... They have been specifically built for the business in question and cannot be easily transferred or swapped for other similar products. If they were made into commodities, businesses would not get the flexibility they demand. They would also not be able to leverage competitive advantage from them. So what does this non-commoditisation represent in the context of outsourcing? It means that businesses are handing over expensive, unique systems third parties. And one inherent aspect of almost all tailor-made IT systems is their high-level of complexity.” See Knapp, Paul (June 6, 2003) “[Why companies rushing to outsource their IT may be making a mistake](#)”.

supply chain is essentially concerned with the supply of raw materials, their transformation into finished products by a manufacturing process, and their distribution through a network of distributors, warehouse and retailers. The concept of the value chain is, on the other hand, extended and applied to the whole supply chain and its distribution networks. In the delivery of products *and* services, different economic actors are mobilized, and each will manage its own value chain.²⁵ This independence in the exploitation of upstream and downstream information can be considered to be one of the main reasons why outsourcing has become so popular with businesses. However, a disintegration of the vertical (supply chain) integrated factory could lead to the eventual fragmentation of ownership rights, thus making it an imperative for firms to identify the strengths and weaknesses in each identified value chain activity. On this basis, a firm should be able to create new value for itself as well as its customers through one or more outsourcing relationships. In other words, an enterprise should do in-house only those activities that it is capable of doing faster, cheaper and/or better than others; all other activities are candidates for being outsourced to others who are capable of doing such activities faster, cheaper and/or better.

Offshore outsourcing may therefore happen at any level of the value chain. At the lowest level, labor-intensive unskilled tasks are outsourced. At the next level, the production or manufacture of a component, or the whole product or service, is outsourced. At the next higher level, technology development is outsourced, including some or all of the associated research and development (R&D) tasks.

Some consider outsourcing of **marketing functions** to be the highest level of outsourcing. It may be done partly (for example, outsourcing of market research) or almost wholly (for example, distribution and sales are outsourced). In practice, there can be various permutations and combinations of the above categories.

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.

²⁵ Internet Center for Management and Business Administration. "[Outsourcing Value Chain Activities](#)".

Protecting Intellectual Property Assets and Know-how

Outsourcing requires the sharing of a wide array of proprietary knowledge. The nature and critical importance of intellectual property will differ 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 offshore 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.

Effective management of this sharing of knowledge requires that both parties properly administer their IP while keeping the overall business objectives in view. The benefits²⁶ 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. Therefore, an **intellectual property due diligence enquiry**²⁷ 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**.

IP Due Diligence Enquiry <i>(Non-exhaustive list)</i>	Box 1
<p>Identify and document IP: trade secrets, trademark(s), patent(s), industrial design(s), copyright and related right(s).</p> <p>Identify the inventor, creator or author of the IP.</p> <p>Determine ownership rights in the identified IP, including joint-ownership issues.</p> <p>Identify contracts or other agreements associated with the IP. For example technology transfer or licensing agreements; confidentiality and non-compete agreements.</p> <p>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.</p> <p>Identify existing and/or alleged breaches of contract, infringements, disclosure of confidential information and trade secrets.</p> <p>Determine jurisdiction and enforcement: applicable laws, enforceability: dispute resolution mechanisms (mediation, arbitration, choice of governing law, applicable jurisdiction).</p>	

²⁶ The assumption is that firms will benefit from outsourcing offshore based primarily on cost savings and enable them to then raise productivity by investing more in next-generation technologies; namely 'Innovation'. See Baily, Martin N., and Farrell, Diana (July 2004). "[Exploding the myths of offshoring](#)", *The McKinsey Quarterly*.

²⁷ IP due diligence: a thorough analysis and inventory of a company's key assets. It is indispensable in commercial transactions.

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.

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.

Ownership of IP

*"Ownership of intellectual property may also be a sticking point. "My predecessor signed a deal whereby the Web source code was owned by a third party," says James Burnett, IT manager at Fidelity Life Assurance Co. in Newmarket, New Zealand. "I took this back so that I could plan improved applications. Having full ownership of all the code puts me in a strong position."*²⁸

Ownership of IP is perhaps the **first of two critical concerns** in offshore outsourcing. Whether the outsourced work is expected to take place domestically or outside the enterprises' national borders, it is essential to identify, account for and clarify ownership related issues of IP assets improved or created during the relationship. More often than not, many companies overlook or pay inadequate attention to this very important aspect.

There are several approaches to sharing ownership rights over IP, which is improved or created during an outsourcing relationship. One approach would be for the customer to own all IP improved or created during the outsourcing relationship, with the vendor having the possibility of using the IP through a negotiated license agreement. Another approach would be for the vendor (developer) to own all such IP, with the customer (the party having commissioned the task) taking a license through negotiations. Yet another approach would be for both the customer and vendor to own jointly the resulting IP. Still another approach would be to apportion ownership of different IP assets, so improved or created, amongst the parties concerned, namely, amongst the vendor, customer and one or more third parties; this is done by a formal agreement based on negotiations guided by each parties' current and future business needs. All approaches are complex and must, therefore, be carefully evaluated and negotiated before entering into an agreement. The agreement must be detailed, and, amongst other things, should deal with ownership and use of the intellectual property assets both during and after the termination or end of the outsourcing relationship.

Many other questions concerning intellectual property will arise, and do not differ greatly from those that arise in collaborative contractual agreements. For example, who owns the IP created by a company's employees or independent contractors? If it is to belong to the company, then are all such IP assets properly transferred or assigned to the company? Who will own the customized features, improvements, new technology and product in outsourced

²⁸ Buxbaum, Peter. (July 29, 2002) "[Bringing IT Back Home – Consider these five questions before terminating IT outsourcing contracts](#)", *Computerworld*.

work? For example, in relation to copyrighted works, such as software, will an improvement or modification result in the creation of co-authorship and resulting joint ownership or will it be treated as an adaptation (also known as a ‘derivative’ work) which would be owned by the party that made the improvement? How does one determine whether ownership will be exclusive to one party or another or held jointly? What entitlements will each party have to exploit jointly created IP? What will happen to customer’s IP when it wants to switch vendors (i.e., transfer rights) or terminate contract? The complexities of the questions will vary depending on the type of IP owned, for example, entitlements differ between patents and copyright (i.e., moral rights). In most countries, unless provided for specifically in the relevant IP law, most of the issues raised would be decided by negotiations by the parties, based on their respective business objectives. During negotiations, as a rule of thumb, try to avoid agreeing to joint ownership of IP assets. In case it is not possible to do so, then all questions about its proper management needs to be spelt out in requisite detail in the agreement between the parties concerned.

Confidential Information and Trade Secrets

“How are companies getting around concerns about intellectual property, proprietary processes, and competitive advantages to actively work supply chain expansion and product expansion roles to the fullest? How can we protect our advantage while exploring what our suppliers and the market can offer us?” Mr. Lee responded “We should always respect confidentiality and there are definitely some proprietary processes that need to be protected. On the other hand, sometimes sharing a proprietary process can become a competitive advantage.”²⁹

The **second critical concern** in outsourcing offshore is the inadvertent, accidental or willful disclosure of confidential information and trade secrets. In many countries, trade secrets are protected by an expressed or implied contract; that is, they are either not at all, or are inadequately, protected by a specific national law for the protection of trade secrets or preventing espionage. 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. If the partner cannot be trusted to protect trade secrets, then the risks of outsourcing offshore may far outweigh its potential benefits. Hence, it is crucial to review the **integrated security and/or IP protection program** of the potential outsourcing partner.

Remember that the value of a trade secret rests in the company’s ability to keep relevant information confidential. Once a trade secret is made public, it enters the public domain. Invariably, it will be lost permanently and, in most instances, so will the competitive advantage linked to it. To accommodate this critical concern, a number of practical measures are recommended, such as those indicated in the articles on the website of the SMEs Division of World Intellectual Property Organization (WIPO).³⁰ Amongst these, consider relying on a **Non-Disclosure Agreement (NDA)** (also known as a **confidentiality agreement**) for keeping such vital business information confidential. While such agreements provide for

²⁹ Institute of Supply Management. [“Q & A with Hau Lee”](#).

³⁰ For more information see [“Trade Secrets: Policy Framework and Best Practices”](#) and [“Trade Secrets are Gold Nuggets: Protect Them”](#) on the SMEs website.

broad protection, and are a relatively low cost measure for the protection of trade secrets, these may be of limited value should litigation issues arise.³¹

To assist companies to overcome, or mitigate, the risks of accidental or willful loss or misappropriation of trade secrets, logistical controls will be needed. Security,³² especially in the electronic environment, is therefore an exigency in offshore outsourcing arrangements. Measures to prevent breaches of security, which may lead to disruptions in the supply chains, for example, are also linked to those measures for the protection of trade secrets. In addition, these may also be associated to the protection of individual privacy in the context of database protection obligations, particularly in the financial and health sectors.

Interestingly enough, the CSI-FBI Computer Crime and Security Survey 2004,³³ reports that compared with their previous surveys, “there has been a dramatic drop in reports of system penetrations, insider abuse, and theft of propriety information”. This drop corresponds to a dollar loss equal to \$11,460,000; a decline compared to the 2003 figure of \$70,195,900 (“propriety theft being the most expensive category of loss for 5 consecutive years”). The Report confirmed that trade secret theft was the greater threat to most enterprises. The sensitivity surrounding security and privacy is seen as “businesses are installing intellectual property ‘trackers’ which aim to tag or track company owned IP in order to prevent theft. This is an issue to both big companies ... as well small companies who often don’t have much more to protect than their IP.”³⁴ For example, security measures include electronic watermarking and time-stamping.

IP Concerns in Negotiating Offshore Outsourcing Arrangements

“Executives were unanimous in saying they are very, very careful about what they offshore and what they don’t,” said Rick White, head of the U.S. industry lobby group TechNet. He continued, “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.”³⁵

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. A firm should only start practical

³¹ For further information see [‘Disclosing Confidential Information’](#), SMEs website.

³² “... [N]etwork security must also take an active role since theft of a company's trade secrets is most likely to occur using digital media. ... Certain trade secrets, such as chemical formulae or industrial processes can be quickly utilized by competitors. Such information is critical to protect. The strictest security measures must be employed in software development projects that involve easily replicable trade secrets. In fact, such projects ought not to be outsourced at all. Other intellectual property is not as easily stolen. For example, a trade process such as a financial planning methodology, while it should be protected from competitors, takes a considerable time to master. Security measures for offshore projects should fit the risks to a company's intellectual property.” For more information see Ramer, Rob, [“The Security Challenges of Offshore Development”](#), The SANS (SysAdmin, Audit, Network, Security) Institute.

³³ CSI/FBI Computer Crime and Security Survey 2004; www.gocsi.com

³⁴ Fernandez, Dennis., Kemeny, David, and Bastani, Behfar (2003). [“Intellectual Property Strategies in Security and Privacy”](#), Fernandez & Associates, LLP.

³⁵ Ricciuti, Mike and Yamamoto, Mike (May 5, 2004). [“Companies determined to retain 'secret sauce'”](#). cçnet network.

business negotiations after being satisfied about a 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) during and after the relationship. It should also include any relevant IP assets of third parties.

Third party IP³⁶ raises intricate concerns in an offshore outsourcing arrangement. The important principle to remember here is for the party outsourcing work (the customer) to review the IP to be outsourced and examine all licensing agreements under which it has licensed third party IP. This step is to ascertain whether or not there are any restrictions on use, limitations on transfers or assignments, or confidentiality provisions. The customer will also have to ensure that the contracted party (the vendor) is aware of the terms of the third party license agreements when contracting for the vendor to use the IP. The same is also true for the vendor when accepting outsourced work; that is, a vendor must make sure that it has the requisite written prior permission of the relevant third party to use IP assets licensed from that third party for carrying out tasks connected with a particular outsourcing relationship.

The customer and the vendor (or 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 allow the use of secondary IP (the non-core IP³⁷) and not its primary IP (core IP) for the purpose of the outsourcing relationship, whereas the vendor, in order to perform the requested service might have to use (share) its primary IP. There are, however, enough situations in which the customer has to allow the use of its core IP also by the vendor.

Both parties are taking risks; so each must determine which IP assets should be kept out of the agreement, and which may be shared before, during and after the end or termination of the agreement. Vendors have a legitimate right to expect to move up the value-added chain by a transfer of technology. Hence, like the customer, they must also make every effort to assess the IP implications of all its outsourcing agreements. **Boxes 2 and 3** contain checklists that summarize IP issues of prime importance.

IP Essentials for the Contractor (Customer)	Box 2
<p>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.</p> <p>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?</p> <p>Be aware of any limits on use of licensed third party IP: Can it be sublicensed to a vendor?</p> <p>Require vendor to take all reasonable measures to protect all licensed IP assets, and especially any confidential information, trade secrets, know-how, etc. disclosed during the relationship.</p>	

³⁶ Raysman, Richard. And Brown, Peter (1998) “[Key Issues in Technology Outsourcing Agreements](#)”.

³⁷ Non-core IP is considered to be that which is not required for the current or future needs of the enterprises owning the IP assets.

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?

IP Essentials for the Vendor

Box 3

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 protection and security program** to safeguard your own and the vendors confidential information, trade secrets and know-how. Enter **confidentiality (non-disclosure)** and **non-compete agreements** where and when appropriate.

Put in place mechanisms to prevent inadvertent 'mixing' of proprietary trade secrets with those of the vendor.

Be aware of any limits on use of licensed third party IP: whether it can be used for the purposes of the current relationship.

Challenges to Enforcement of IP Rights

A realistic assessment of the challenges of enforcing IP rights is also necessary before entering into an outsourcing relationship. The effectiveness of – and time and resources needed for – using the legal and administrative mechanisms for dispute resolution and enforcement³⁸ of IP rights, and to deal with piracy and counterfeiting, vary a lot depending on the country and the type of IP asset involved. For example, referring to the principle of **exhaustion of IP rights**,³⁹ the legal framework in this respect varies considerably from one country to another, depending on whether the exhaustion principle is applied on a national, regional or international basis. Further, it may also vary within a country for different types of IP rights. Still further, within a country, it may also be variable for different products covered by a particular type of IP right. Therefore, it is not easy to decide, without guidance of experts, as to what recourse does the outsourcing business partner (customer) have when a

³⁸ Enforcement is further complicated by the difficulties arising from the civil law and common law jurisdictions. Other related issues concern the developments taking place to further enhance border measures.

³⁹ See the article on International Exhaustion and Parallel Importation in '[Introduction to IP and Business](#)'. WIPO SME Division.

product, protected by an intellectual property right, has been marketed and commercially exploited by an unauthorized third party. This form of transaction, usually referred to as participation in the ‘grey markets,’ is where goods flow through distribution channels other than those authorized by the manufacturer or producer. Hence any “subsequent acts of resale, rental, lending or other forms of commercial use by third parties can no longer be controlled or opposed.”

Small and Medium-sized Enterprises (SMEs) and Offshore Outsourcing⁴⁰

“For small or medium-sized firms, the IP challenge can be particularly daunting. Unlike their big corporate counterparts, the only tangible asset startups have got is their intellectual property,” says Tariq Afzal, CEO at a Silicon Valley software start-up called Streamatics. “IP forms the basis for a start-up. They guard it close to their chests and there are companies which are paranoid about it.”⁴¹

More and more companies are treating IP issues as not merely as a legal concern but as a strategic business tool. This, coupled with the benefits arising from the facilitating mechanisms made possible by the ICT environment, has made it possible for more and more SMEs to participate in and benefit from outsourcing opportunities, both as customers and as vendors. While the issues raised and discussed in this article are fully applicable to SMEs, the benefits and risks of offshore outsourcing arrangements will somewhat differ from those faced by larger enterprises. Needless to say that, as the recipients of a large portion of outsourced work, opportunities abound for SMEs. Both the SMEs and countries considered attractive for foreign outsourcing by companies must work to guarantee, not only the timeliness and quality of the outsourced work, but also the safety and protection of the IP assets of the outsourcing partner. Not having in place these fundamental features could have an impact on an SME’s gainful business opportunity. At the same time, an SME itself should not, in the rush to acquire clients, expose itself to unfair competitive practices in relation to their own IP assets or of any jointly created or improved IP assets.

For those SMEs outsourcing offshore, caution is suggested. First and foremost, it should be clear that safeguarding IP is critical for sustaining growth. For example, a NASSCOM article featuring an interview with the owner of Impetus, a firm founded in India, reports that “partnerships between SMEs to achieve size and reach of customers have not always been successful. There have been problems creating IPR, mobilizing funds, quality, and marketing, both in the domestic and overseas markets. However, SMEs offer unparalleled focus and niche specialization.”⁴² Hence, with vigilance in hand, SMEs can offer advantages over larger companies. Possessing specialized products and/or services with protected IP, outsourcing offshore becomes a matter of having a comprehensive business strategy and negotiating skills whereby IP is seen as pivotal to a successful relationship.

It would be imprudent to sum up by noting that only a holistic business approach to management of IP will enable SMEs to profitably leverage IP assets. According to Nicholas

⁴⁰ See Box IV.3., pg. 155, ‘Smaller TNCs are offshoring too’, UNCTAD WIR 2004.

⁴¹ From: “[Scattering the seeds of invention: The globalisation of R&D](#)” A white paper and survey from the Economist Intelligence Unit

⁴² “[SMEs offer unparalleled focus and niche specialization](#)’ National Association of Software and Service Companies (NASSOM).

Cravotta (2004) “success in a venture revolves a great deal around trust and relationships. In any case, counting on the law to protect your IP (intellectual property) is foolish.”⁴³ This is not to say that one should disregard the need for IP protection; rather, along with IP, SMEs must ensure that a party with whom it is entering into an agreement has all the necessary measures in place to protect outsourced IP.

Conclusion

There are several other IP issues associated with offshore outsourcing relationships that have not been touched upon in this introductory article, given their greater complexities in offshore outsourcing relationships. They include, for example, those aspects of IP related to fiscal policies, namely, the valuation of IP and tax considerations, including dispute resolution mechanisms and measures at the border (customs). These questions are important and would also have to be addressed adequately in almost every case.

In conclusion, an offshore outsourcing business strategy, if well implemented by following an **integrated and holistic 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, speed-to-market 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 and symbiotic nature of the relationship.

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⁴³ Nicholas Cravotta (September 2, 2004) speaking on the complexities of small companies outsourcing offshore and protecting their IP: “[Offshore Outsourcing: Now Boarding – A trip to China may just be the ticket to take your design to reality](#)”, *Electrical Design News* (EDN).

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