

# Business & Technology Sourcing

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## About Our Practice

Mayer Brown's Business & Technology Sourcing (BTS) practice is one of the global industry leaders for Business Process and IT Outsourcing as ranked by Chambers & Partners, The Legal500 and the International Association of Outsourcing Professionals (IAOP). With more than 30 dedicated lawyers—many having previous experience with leading outsourcing providers and technology companies—the practice has advised on nearly 300 transactions worldwide with a total value of more than \$100 billion.

## Editors' Note

This issue of the Mayer Brown *Business & Technology Sourcing Review* represents our first issue dedicated to a specific topic—the role of Asia in global sourcing. This focus reflects our recognition of the fundamental role Asia has come to play in outsourcing and service transactions globally. This recognition of the ascendant role of Asia in the global services market has led Mayer Brown to formally expand its internationally recognized Business & Technology Sourcing (BTS) practice to Asia with the recent relocation of partner Geoffrey L. Master to Hong Kong (see press release pages 45 and 46 within).

The Asian component in both outsourcing transactions and shared services arrangements has been steadily and dramatically growing over the past decade—to the point that it is the exceptional transaction that does not contain an Asian component of delivery. Every expectation is that this trend will only accelerate, as the dramatic success of India over the past decade in building its services industry into a global powerhouse has become a *de facto*, if not express, source of inspiration and focus of emulation by virtually all countries focused on economic development.

In this issue, we are focusing specifically on China and India, representing in many respects both the potential and the aspirations of Asia. For this, we have pulled together updates of articles previously published in the *Review* as well as articles entirely new to the *Review*. We hope that our clients and friends enjoy this issue of the *Review* and we look forward to our continuing participation in the development of the sourcing industry, including its increasingly global capabilities. ♦



# Going to China

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The phrase “going to China” is increasingly heard among companies looking for value and quality in their sourcing of products and services—and with good reason. Today, China’s manufacturers supply a significant and growing share of the world’s products. In addition, China is pursuing an aggressive and coherent national plan designed to help it become a leading global provider of services.

Since it opened its doors to the world 30 years ago, China has been driving policies of economic development that will enable it to create a middle-class society of reasonable means. This transformation constitutes an undertaking of historic proportions. Initially, China focused its economic development on manufacturing, and the country’s success has been dramatic. Increasingly, however, the People’s Republic has concentrated its manufacturing capabilities on higher-end products and processes, including pharmaceuticals and electronics and other technologies.

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China’s market for the sourcing of products and services is dynamic and evolving.

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Despite its remarkable success to date, however, China needs substantially more economic development. It must also deal with significant undesired

impacts of its staggering growth.

Notably, the PRC needs to address a rapidly urbanizing<sup>1</sup> population and the negative environmental issues associated with its current manufacturing industries, including heavy industrial pollution and high energy consumption in low-end manufacturing.

In the face of these needs and of associated domestic and international pressures, the Chinese government has developed its current “Harmonious Society” (和谐社会) socioeconomic goal of advancing economic growth that promotes better societal balance. As part of its effort to encourage balance, China is now making a very concerted effort to grow its services industry, seeking to leverage its successes as the world’s manufacturer to become the world’s services provider as well.

China’s market for the sourcing of products and services is dynamic and evolving. Prospective buyers of Chinese products and services must carefully analyze the market to assess which products and services can be viably sourced from China and to determine the appropriate manner for arranging such sourcing. Approached properly for a growing number of products and services, however, China ranks as one of the world’s most attractive sourcing markets, and indications strongly suggest that this trend will continue, if not accelerate.

Fortunately, prospective buyers of China's products and services can draw on lessons learned from many years of sourcing experience—their own and others'. Different sourcing environments inevitably present diverse and unique challenges. But the long-term accumulation of customers' collective experience can be effectively leveraged, enabling potential buyers to approach China sourcing with significantly heightened confidence and capability. With foresight and careful planning, well-prepared customers can take advantage of current Chinese sourcing opportunities, grow and evolve their business relations in China as further opportunities develop and simultaneously mitigate their exposure to the risks inherent in such outsourcings.

### The China Sourcing Environment

China's government has embraced the notion that developing services capabilities offers significant economic benefits consistent with its Harmonious Society objectives. The need to promote its services industry is all the more urgent for China because portions of its current manufacturing base will almost certainly be eliminated by the nation's transition to an acceptable, ecologically responsible production environment. The result has been a trend away from the PRC's traditional dominant manufacturing focus, evidenced by a steady reduction of officially sanctioned trade incentives over the past five years and by an increasing emphasis on higher-end production and processes, including services.

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The government has further adopted incentives—including tax incentives and liberalized work-out systems—to promote the development of services companies.

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With a clear eye toward India's success in its outsourcing services industry, the Chinese government has designated a number of cities as "Outsourcing Services Base Cities,"<sup>2</sup> where it is concentrating infrastructure developments and incentives. The government has further adopted incentives—including tax incentives and liberalized work-out systems—to promote the development of services companies. These and similar efforts reflect China's drive to encourage multinational companies to shift offshore outsourcing services to the

PRC. In addition, the Chinese government is working to promote the development of large and mid-size service outsourcing enterprises, with a particular focus on software and technology-related service providers. A number of China's regional and municipal governments, moreover, have acted independently to implement programs that will stimulate service-industry development in their areas in an effort to promote the Harmonious Society objectives.

### Contracting Challenges

Contract issues represent a particular challenge facing any buyer interested in sourcing from China. Significant sourcing relationships, especially those involving services, are typically dependent on complex contractual arrangements. In the context of these agreements, buyers must have reasonable confidence that their contractual rights are effective and enforceable. Impediments to contract execution or enforceability will inevitably limit the extent to which any buyer will perceive sourcing opportunities as viable, regardless of the supplier's actual capabilities.

A supportive contractual environment depends upon two factors: (1) a level of supplier contracting capability that is sufficient to enable buyers and suppliers to negotiate and execute acceptable contracts; and (2) a legal infrastructure that affords reasonably efficient and predictable contractual enforcement. In today's China, both these factors constitute works-in-progress. During the past 10 to 15 years, China's adoption of laws supporting commercial transactions has been dramatic. In fact, by many estimations China now possesses a reasonably adequate base of commercial law. The real challenge facing China in this area, however, stems from its still-evolving ability to effectively enforce its laws.

The challenges associated with contracting in China are greater in services transactions than in product-sourcing transactions. Generally, service contracts are more complex than product contracts. In many ways, this distinction reflects the practical differences between services and products, including the typically more interactive relationship between buyer and supplier involved in the provision and receipt of services. Thus, as China works to build its sourcing capabilities, the measures it implements to increase its contracting capacity will be of critical importance.

And as effective legal mechanisms for contract enforcement are developed, the scope of products and services seen as viable candidates for sourcing from China will almost certainly increase. In turn, the contracting capability of Chinese suppliers to support a broader range of sourcing transactions will undoubtedly grow as opportunities for such development emerge.

## Other Challenges and Strengths of China Sourcing

Other challenges to sourcing from China exist that may impact whether or how a particular sourcing is undertaken. For example, do Chinese suppliers possess the level of English language skills necessary to conduct particular business activities with foreign customers? Concerns over intellectual property (IP) protection, the ability of Chinese suppliers to meet requirements of regulatory compliance and arrangements for effective dispute resolution also represent major challenges facing China's dynamic sourcing industry today.

The level of English language skills within the People's Republic is frequently cited as a challenge to international businesses that are considering China-based sourcing engagements. Despite the worldwide prevalence of Chinese as a spoken language (by some accounts, it is the world's most widely spoken language), English continues to be the primary language of international business.

Although a number of the services initially targeted by the Chinese government for development (for example, software services that involve common programming languages) are not wholly dependent on broad English language capabilities, English language skills within supplier organizations have a direct bearing on buyer perceptions regarding the scope and nature of sourcings that can be effectively delivered by Chinese providers.

Significant efforts are underway to increase English language capabilities within China. In 2001, for example, English language study beginning in Grade 3 became compulsory throughout the country, and larger cities such as Beijing and Shanghai have introduced English at Grade 1. Through such efforts, the significance of this issue is likely to diminish over time. In fact, some have estimated that within a few

years, there may actually be more English language speakers in China than in India.

Protection of intellectual property is another concern among China's prospective sourcing customers. Despite China's adoption of laws generally consistent with international standards of IP protection, enforcement of these rights remains a significant problem. A variety of best practices can be helpful in protecting intellectual property, including careful due diligence in human resource and business partner selection and thoughtful design, implementation and enforcement of IP compliance programs. Further, practical protections that are based in the design and control of production and performance processes may ensure effective IP protection by preventing critical intellectual property from being accessed or copied in high-risk environments. Such an approach often requires that key activities be compartmentalized or that selected parts or processes be sourced to different suppliers. In some cases, effective risk management may demand that specific parts or processes be delivered by the buyer's home organization. In cases where such arrangements are not feasible or where critical IP must necessarily be accessed or copied, the customer may determine that certain products or services will not currently be suitable for sourcing from China.

Among prospective buyers considering sourcing from China, regulatory compliance is another key area of concern. US buyers, for example, must address compliance issues associated with US export control laws, the Foreign Corrupt Practices Act and Sarbanes-Oxley obligations that might be influenced by sourcing arrangements.

Regulatory compliance, like IP protection, can be promoted through effective processes of human resource and business partner selection and through well designed and implemented compliance programs. But certain activities may simply be inappropriate for sourcing due to the regulatory risks they present. Further, care must be taken to ensure that the sourcing contract is designed to provide the flexibility necessary to address changes in applicable regulatory requirements.

Effective dispute resolution is another concern for companies that are considering sourcing from China. This issue is especially pronounced in view of the previously noted challenges associated with contract



interpretation and enforcement in China. International sourcing arrangements frequently provide for a governing law other than China's and for a dispute-resolution process that does not depend upon China's developing legal infrastructure.<sup>3</sup>

Contractual choice-of-law provisions are generally recognized in China where one contracting party is foreign, although a number of important issues remain subject to local Chinese law. These include certain issues concerning intellectual property ownership, labor laws, land ownership, insolvency and enforcement of foreign judgments or awards.

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Ultimately, the success or failure of any product or service sourcing from China depends largely on the quality and capability of the supplier, as well as the other business consultants and partners involved in the China activities.

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Foreign companies sourcing from China frequently prefer that, when efforts to negotiate disputes between contracting parties have failed, issues be resolved through arbitration conducted outside of China under an international alternative to arbitration in China. Such arrangements must be clearly defined in the sourcing contract. The actual enforcement of arbitral awards in China, however, presents significant challenges of its own, and these must be carefully considered in any sourcing evaluation and structure.

### Sourcing Market Considerations in China

Two additional factors regarding sourcing from China present specific challenges to potential sourcing buyers: (1) China's fragmented service provider market; and (2) the difficulties involved in performing effective due diligence on Chinese service providers and other business partners in China.

China's nascent services industry is extremely fragmented and lacks a well-defined group of leading service providers. The government's efforts to encourage growth in the services industry have been focused largely on general development in the country's various designated base cities and have lacked a concerted emphasis on defining and promoting specific service capabilities. As a result, the services market in China is diffused and is characterized by local and regional

competition that has likely impeded the development of distinct Chinese service practices or brands. While today's China delivers a growing choice of service offerings, it has not developed a coherent pattern of practice or capability.

Ultimately, the success or failure of any product or service sourcing from China depends largely on the quality and capability of the supplier, as well as the other business consultants and partners involved in the China activities. Effective due diligence performed on Chinese parties tends to present significant challenges stemming from a variety of factors, including market fragmentation and language and cultural issues. It is very important, however, for a would-be purchaser to obtain clear understanding and adequate comfort regarding the capabilities and ethical standards of the Chinese parties with which it will deal. Effective due diligence in China often requires substantial patience, effort and expense, but its importance cannot be overestimated.

### Strategies and Vehicles for Initiating Sourcing from China

China's liberalized investment rules generally allow a foreign buyer seeking to source products or services to select from a wide range of sourcing models. These models include classic third-party outsourcing arrangements in which the buyer contracts with the supplier; sourcing through joint ventures; and even sourcing through wholly owned (foreign) enterprises.

In China, as elsewhere, customers are challenged to adopt and structure the sourcing model that best meets the needs of the particular transaction. The selection process should drive to identify the most appropriate model for the particular transaction mix, based on buyer, supplier and sourcing objective. Fortunately, buyers seeking to source from China can select from among most of the strategies that have historically been used in offshore sourcing.

A buyer may initiate a China sourcing by using any one of several classic entry strategies or by combining elements of several strategies. Typical sourcing entry strategies may involve:

- Utilizing pilot programs to become familiar with and to confirm the viability of the sourcing (i.e., "testing the water"), although this approach



may risk insufficient commitment on the part of one or more of the sourcing parties and may thus set the stage for failure.

- Providing an extended transition period to allow for confirmation of successful assumption of responsibility and performance by the supplier, although this approach, like the pilot program, may risk insufficient commitment, making any change-management needs associated with the sourcing more difficult to fulfill.
- Utilizing relatively short-term contracts with extension rights to allow for flexibility in substituting solutions, although this approach may be less attractive to suppliers and may nonetheless create long-term dependence on the part of the buyer, despite the shorter term.
- Limiting offshore direct reliance and exposure by utilizing a US or other home-country supplier in conjunction with Chinese capabilities, although this strategy necessarily reduces potential savings opportunities and increases risks of successful service integration.

Again, lessons learned from prior sourcing experience can and should be applied in evaluating and approaching the dynamic and evolving Chinese sourcing market.

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Despite the current challenges inherent in sourcing from China, the potential benefits are compelling.

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### Expectations for China Sourcing

Despite the current challenges inherent in sourcing from China, the potential benefits are compelling. As China further addresses areas of concern to international buyers, these benefits should increase as the risks decrease.

The economic stakes for China are high and the commitment to success of the government and growing ranks of suppliers is strong. Consequently, there is every reason to expect that China will remain vitally interested in developing and maintaining an economic and legal environment that will enable international buyers to source from China with increasing confidence and enthusiasm. ♦

<sup>1</sup> Urbanization is generally recognized both as a product of economic development and as a prerequisite for broad-based economic development. China's rate of urbanization remains significantly lower than the rates seen in other developed countries. Today, China's leadership is promoting aggressive national policies aimed at encouraging very rapid urbanization.

<sup>2</sup> On February 2, 2009, the PRC's State Council directed its Ministry of Commerce to promote the development of services outsourcing in 20 pilot cities (up from 11 in 2007). The 20 pilot cities designated as Outsourcing Services Base Cities include Beijing, Changsha, Chengdu, Chongqing, Dalian, Daqing, Guangzhou, Hangzhou, Harbin, Hefei, Jinan, Nanchang, Nanjing, Shenzhen, Shanghai, Suzhou, Tianjin, Wuhan, Wuxi and Xi'an.

<sup>3</sup> Important considerations regarding the enforceability of governing law and dispute resolution contract provisions are addressed in the article "Effective Enforcement of Contract Rights in Chinese Sourcing Contracts" in this publication.

# Human Resources and Personnel Issues in Chinese Sourcing Transactions

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Over the last 30 years, China has become one of the world's leading manufacturing powers. While labor conditions in manufacturing have raised some significant issues of international social concern, buyers of Chinese-sourced products for the most part have had relatively little occasion to focus on basic human resources and personnel issues associated with their suppliers' employees.<sup>1</sup> More recently, China has become intent on becoming a leading global provider of services.<sup>2</sup> As China seeks to attract international businesses to source services from China, human resources and personnel issues associated with supplier employees will take on a new immediacy for buyers of Chinese services.

Human resources and personnel issues are inherently significant in any services sourcing transaction. Their importance is driven by the obvious fact that the output of a services outsourcing is largely comprised of the performance of services by the supplier's employees. Whether a sourcing of services from China is undertaken through a captive (i.e., owned affiliate) entity or through a contractual outsourcing arrangement, buyers of Chinese services are directly and immediately impacted by employment and labor laws and practices in China. This impact includes the ability to enforce and exercise certain rights expected by buyers of services, as well

as risks associated with exercising such rights, including the risk of attracting liability as an employer.

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Human resources and personnel issues are inherently significant in any services sourcing transaction.

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This article provides a general overview of employment laws in the People's Republic of China, with a focus on how these laws impact the sourcing of services from China. For purposes of discussion, the article will utilize a hypothetical outsourcing transaction between a customer that is a Chinese entity and a supplier that is also a Chinese entity. Specifically, this discussion will utilize a classic outsourcing formulation in which the customer actually transfers responsibility for a scope of its operations (the "Services"), such as information technology or business process, previously performed by its employees in its facilities in China, to the Chinese supplier that, in turn, takes over responsibility for the Services and continues their performance, at least in part, at the customer's Chinese facilities.

Many foreign buyers of Chinese services will not face all of the issues arising in this hypothetical transaction. This is particularly true regarding issues associated with the customer's incumbent employees outside China

who are performing the services being transferred to the supplier (this may raise questions under the local law of such employees' location but not China). Nonetheless, using such a hypothetical Chinese customer for this discussion will allow for a broader review of the issues under Chinese law and practice.<sup>3</sup>

## Overview of PRC Employment Law

The past 10 to 15 years have seen dramatic developments in Chinese employment law. The foundations for labor and employment laws in China are (1) the Labor Law that was enacted on January 1, 1995, and (2) the Labor Contract Law that came into force on January 1, 2008. The Labor Law focuses on general rights of employees, such as employment promotion and training, collective contracts, work hours, wages, social security and benefits, and occupational safety and health. The Labor Contract Law concentrates on the more specific aspects of the contractual arrangement associated with the engagement of an individual as the employee of an employer. These laws are generally applicable to any employment relationship established in China.<sup>4</sup>

## General

A few important threshold considerations associated with employment contracts in China should be noted.

### REQUIREMENT OF WRITING

An employer is obligated to enter into a written labor contract with any employee within one month from the date of commencement of employment. Failure to do so results in the employer being required to pay to the employee twice the amount of the agreed remuneration as salary.<sup>5</sup> This obligation most likely continues through the period of continued failure to enter into a written contract.

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An employer cannot terminate an employee without cause, irrespective of what the labor contract provides, making the term—especially an indefinite term—highly significant.

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### EMPLOYMENT TERM

The term of employment has important implications with respect to termination of employment. An employer and employee can agree on the employment

term, which may be definite (i.e., for a defined period), indefinite or piecemeal (i.e., dependent on the completion of assigned work). It is important to note that an indefinite term is deemed to exist in any of the following circumstances:

- The employee has been employed under an oral contract that has subsisted for one year or more following the January 1, 2008, effective date of the Labor Contract Law.
- The employer and employee have entered into a fixed-term labor contract twice successively, and the parties intend to renew such contract upon its expiration (unless the employee has requested a fixed term).
- The employee has worked for an employer continuously for ten years or more (unless the employee has requested a fixed term).<sup>6</sup>

Further, if the employer fails to sign a written indefinite term labor contract with the employee when the term is or becomes indefinite, the employer becomes obligated to pay twice the amount of salary otherwise payable from the date the employment term became indefinite.<sup>7</sup> As noted below, an employer cannot terminate an employee without cause, irrespective of what the labor contract provides, making the term—especially an indefinite term—highly significant.

### RIGHTS OF TERMINATION OF EMPLOYMENT

**Termination by Employee** — An employee has the unilateral right to terminate his or her labor contract without reason, subject only to 30 days' advance written notice. This notice period is reduced to three days during any probationary period stipulated in the labor contract (which can be up to six months in the case of indefinite term or greater than three-year term labor contracts). No prior notice is required if the employer has breached the law or labor contract (for example, if the employer has failed to pay wages or social insurance contributions in a timely manner).

**Termination by Employer** — An employer has no unilateral right to terminate its employees. Termination of employment by an employer can legally occur only in two broad circumstances. First, in the case of definite or piecemeal term employment, termination can occur when employment in fact ends with the natural expiration of the employment contract

(that is, expiration or completion, as the case may be). However, premature termination of employment can occur only in the following limited situations:

- employee fault<sup>8</sup>;
- the employee suffers from a disease or from non-work-related injuries and is unable to perform his/her original job or any other job arranged by the employer after the medical treatment period;
- the employee is incapable of performing the job assigned, and remains incapable after being provided with the relevant training or being assigned to another position; and
- the labor contract is no longer executable due to “material changes in the objective conditions” existing at the time the contract was originally entered into, and both parties fail to agree on any variation to the original contract.

Even in cases of permissible termination (other than those based on employee fault), a 30-day prior written notice (or relevant payment in lieu of such notice) is required, and severance is payable upon the termination of employment, unless the termination is for employee fault.<sup>9</sup> These limited employer termination rights highlight the significance of indefinite term employment.

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Over the life of an outsourcing transaction, various events or activities impacting the supplier’s employees occur that carry significant implications under Chinese law.

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#### REINSTATEMENT FOR WRONGFUL TERMINATION

If an employer wrongly dismisses an employee, the employee is entitled to reinstatement to his or her job position. If the employee does not request reinstatement, or if the contract is no longer capable of being performed, the employer is obligated to pay twice the severance otherwise payable to the employee as damages.

#### OTHER LABOR STANDARDS AND ENTITLEMENTS

China’s employment statutes encompass laws establishing various labor standards and employee entitlements, especially at local levels. These may include statutory benefits for employees such as minimum wages, maximum work hours, right to overtime payments,

public holidays, statutory leave and social insurance. Local standards are subject to variation.

#### Specific HR and Personnel Considerations for Outsourcing Transactions

Over the life of an outsourcing transaction, various events or activities impacting the supplier’s employees occur that carry significant implications under Chinese law. Although some of these events or activities can occur at multiple times over the course of an outsourcing, their incidence is often associated with a particular phase of the outsourcing. These phases notably include the inception or beginning of the transaction (sometimes referred to as the transition), the period of ongoing performance (sometimes referred to as steady-state), and the termination or end-phase of the outsourcing. The following discussion identifies some of the more significant activities or events associated with these phases and describes their probable treatment under Chinese employment law.

#### Transition Phase: Transfer of Customer Employees to Supplier

A first-generation services outsourcing involves the transfer of Services performance from customer employees (each an “Incumbent Employee”) to supplier employees (each a “Supplier Employee”).<sup>10</sup> In some cases (i.e., those in which Incumbent Employees transition to the supplier), these Incumbent Employees and Supplier Employees are the same individuals. Typically, the customer and the supplier will have relatively well-developed objectives regarding what should occur with respect to Incumbent Employees.

Of course, each Incumbent Employee also will have legitimate interests (and in some cases, concerns) about the impact of the outsourcing on his or her job. From a transition end-game perspective, an Incumbent Employee will either become a Supplier Employee or not and, if not, the Incumbent Employee will either remain an employee of the customer or not. Getting to the actual result is impacted by, and in some cases is driven by, the actions of the parties in the context and through the application of employment law.

Even in mature outsourcing markets in which all parties are familiar with outsourcing transactions,

labor issues are often significant during the transition phase, and the human resources teams of both the customer and the supplier are integral transaction participants. It should not be surprising then that given the relatively recent adoption of the applicable employment laws in China, as well as the general immaturity of the nation's service outsourcing market, there is uncertainty regarding exactly how some of the activities and events of the transition phase will be treated.<sup>11</sup> Fortunately, customers and suppliers can draw on lessons learned from many years of sourcing experience in other environments, although application of China's employment laws will undoubtedly produce some unique aspects for Chinese outsourcings.

Ideally, the outsourcing agreement should expressly define the extent to which the supplier is obligated to make (or is prevented from making) offers of employment to Incumbent Employees. Sophisticated suppliers have developed significant experience in recruiting and hiring employees from customers, and in many cases a large portion of supplier personnel consists of employees successfully transitioned from customers. Notwithstanding such defined objectives, however, this is an area in which employment law plays a particularly significant role in defining the respective responsibilities of the customer and the supplier.

For purposes of this discussion, two potential scenarios involving an Incumbent Employee during the transition phase will be analyzed:

- **Scenario One — “Released Employee”**

The customer does not want to retain the Incumbent Employee but also does not want the Incumbent Employee to become a Supplier Employee (that is, does not want the Incumbent Employee to continue performing the Services). This scenario frequently arises from an accommodation of the supplier's interest that the Incumbent Employee does not become a Supplier Employee (as when the supplier has sufficient employees to provide the Services without the Incumbent Employee).

- **Scenario Two — “Resistant Employee”**

Where the customer wants the Incumbent Employee to become a Supplier Employee (and presumably to continue performing the Services) but the Incumbent Employee does not want to become an employee of the supplier and seeks to remain an employee of the customer.

## Scenario One: Released Employee

In this scenario, the customer's objective is termination of the Incumbent Employee. Absent fortuitous timing under an employment contract of definite or piecemeal duration that coincides with the outsourcing, the most likely permissible ground for the customer's termination of the Incumbent Employee would be “material change in objective conditions” described above.

To meet this acceptable criterion, the customer would argue that the objective conditions for the Incumbent Employee's employment (namely, the operational mode whereby the customer was performing its own services through its own employees, including the Incumbent Employee) have undergone a material change by virtue of the outsourcing. It is impossible, then, to sustain the original employment contract because the Services are no longer performed by the customer. The Incumbent Employee would probably not succeed in a claim for reinstatement of employment with the customer. But he or she would be entitled to the notice and severance payments described above.

Significantly, it is possible that the Incumbent Employee may seek to maintain that he or she should be entitled to employment with the supplier; that is, that he or she should become a Supplier Employee, despite the objective of the customer (and presumably the supplier) to the contrary. Such an argument would likely be based upon Article 34 of the Labor Contract Law, which provides that:

*In case of any merger, spin-off, or like circumstances of the employer, the original labor contract shall remain valid and shall continue to be performed by the employing entity which succeeds to the rights and obligations under such contract.*

Under Article 34, the Released Employee might argue that his or her employment has transferred to the supplier because the outsourcing transaction constituted a “merger, spin-off, or like circumstance of the employer.” In fact, such treatment would not be dissimilar to the treatment of customer employees under European laws implementing the Acquired Rights Directive.<sup>12</sup>

The counter argument of the supplier (as the party against whom the Incumbent Employee would most likely make such a claim) would be simply that an outsourcing transaction is not a “merger, spin-off,



or like circumstance of the buyer,” but is merely a change of business operational mode. The outsourcing, then, is not a transaction to which Article 34 protections apply.

The ultimate treatment described in this scenario remains uncertain because the law is new and untested. Consequently, its operation is somewhat unpredictable. Similar periods of uncertainty existed under European laws, however, and the scenario illustrates an area in which the customer and the supplier may draw on the experiences of customers and suppliers in other, equally uncertain situations to identify and allocate associated risks.

### Scenario Two: Resistant Employee

In Scenario Two, the customer (and presumably the supplier) desires that the Incumbent Employee transfer his or her employment to the supplier, but the Incumbent Employee seeks to remain a customer employee. Depending on the context and its specific circumstances, the customer and the supplier may benefit from application of Article 34 to this transaction, as described above. Regardless of the application of Article 34, however, the Incumbent Employee cannot be required to remain a Supplier Employee and would be entitled to terminate his or her employment, subject only to required written notice of termination.

If Article 34 were applicable so that the employment contract transfers to the supplier, the Incumbent Employee would risk losing severance payments if he or she voluntarily resigned.<sup>13</sup> Such risk would likely encourage the Incumbent Employee to continue performance under the supplier, even if only temporarily.

The Incumbent Employee’s objective of remaining an employee of the customer would almost certainly be unsustainable. To succeed in such an effort, the Incumbent Employee would need to successfully characterize the outsourcing transaction (and the associated transfer of employment to the supplier) as an illegal variation or breach of the original employment contract. Such an argument would seem wholly inconsistent with the very existence of the “material change in objective conditions” ground for termination. Particularly where an entire customer function is outsourced so that no job remains for the

Incumbent Employee, it would seem highly unlikely that any arbitrator or judge applying Chinese law would uphold such a contention. This would appear even less likely when (as in this scenario) the “same” job is available to the Incumbent Employee with the supplier.

### CRITICAL SERVICE PROVIDER PERSONNEL

It is common practice in outsourcing transactions where Incumbent Employees have become Supplier Employees that the supplier is contractually committed to retain a core group of identified Incumbent Employees for a designated period. Customers often require such commitments from suppliers as a means of reducing overall transaction risk by seeking to ensure that the supplier has benefit of employees with known experience and knowledge of the customer and Services, especially during the Services initiation period. In this context, typical minimum retention periods range from 12 to 18 months, beyond which the retention obligation expires and further retention of such Supplier Employee is within the discretion of the supplier, subject to applicable employment laws.

One important aspect of such minimum retention obligations is that the retention commitment runs from the supplier to the customer, and not to the employee. Such arrangements would seem entirely consistent with Chinese employment law.

### SERVICE PERIOD CREDIT

Certain employee benefits under Chinese employment law are affected by the length of an individual’s employment.<sup>14</sup> Thus, in the case of an Incumbent Employee becoming a Supplier Employee, it can be important whether such Incumbent Employee is credited with the period of his or her prior employment with the customer. In this area, credit often will be given under authority of an Implementation Rule of China’s State Council, providing as follows:

Where an employee has been arranged by an employer, otherwise than for the personal reason of such employee, to work for a new employer, his/her service period with the original employer shall be added in the calculation of his/her past service period with the new employer....<sup>15</sup>

This crediting rule could be significant with respect to an employee’s entitlement to an indefinite term labor contract for continuous service of 10 years or more.

Attaining an indefinite term contract through such a 10-year period of continuous service, whether through actual years worked for the supplier or with credit given for prior years as a customer employee, would preclude the supplier from terminating, without statutory cause, such Incumbent Employee.

Often the personnel provisions of outsourcing agreements expressly define circumstances for which Incumbent Employees hired by the supplier should be given credit for years of service with the customer. While the necessity for and functionality of such a provision is lessened with the interpretative ruling, best practice and clarity would support clear documentation in any event.

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Often the personnel provisions of outsourcing agreements expressly define circumstances for which Incumbent Employees hired by the supplier should be given credit for years of service with the customer.

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#### TERMS OF EMPLOYMENT WITH THE SUPPLIER

Although not entirely clear, in circumstances where Article 34 applies to effect the transfer of an Incumbent Employee's employment to the supplier, the terms of employment with the supplier will most likely be those of the pre-existing labor contract with the customer. Even if otherwise desired, suppliers seeking to hire and maintain Incumbent Employees would be hard-pressed to reduce salary and other employment terms, risking the possibility that Incumbent Employees might seek to resist (or terminate) employment with the supplier.

#### INDEMNITIES

It is typical in outsourcing agreements that the customer and the supplier allocate responsibility between themselves for employee-related liabilities (for example, responsibility for payment of wages and social insurance contributions during the period of employment with the respective party). Often this allocation is effected through indemnities for the various liabilities from the party that is allocated responsibility.

It is also likely that during periods of uncertainty regarding the treatment of Incumbent Employees under Chinese law (notably, for example, with respect

to applicability of Article 34), the parties will provide for an allocation of the uncertainty risk between them through the use of tailored indemnities. This is another area in which customers and suppliers can draw on many years of prior experience of (other) customers and suppliers in mature outsourcing jurisdictions.

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It is typical in outsourcing agreements that the customer and the supplier allocate responsibility between themselves for employee-related liabilities

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### Steady-State Phase

#### RIGHTS HELD BY CUSTOMER

During the steady-state phase of an outsourcing, continuing employee-related issues may give rise to employment law considerations. Among these are a number of customer rights frequently contained in outsourcing agreements that require or direct certain conduct by, or treatment of, Supplier Employees, including:

- the right to require the supplier to replace an individual Supplier Employee in the performance of Services if the customer deems such replacement to be in the customer's best interest;
- the requirement that Supplier Employees comply with customer rules and practice requirements (for example, code of conduct or customer site rules such as substance abuse policies); and
- the right to give input on Supplier Employee compensation (for example, through satisfaction survey input and the like).

Another set of rights involve "flow-down" rights that the supplier is obligated to make directly enforceable against Supplier Employees by the customer. These may include:

- Obligations respecting confidentiality of customer information accessed or created by Supplier Employees where the customer may feel that contractual responsibility of the supplier alone is not sufficient.
- Restrictions on the performance of services for competitors of the customer.<sup>16</sup>

Outsourcing agreements frequently also contain a provision stipulating that the supplier is responsible



for the acts of Supplier Employees, even if those acts constitute negligence, willful misconduct and/or fraud. Such a clear specification can be important to customers where (as may be the case under Chinese law) the supplier may have the ability to claim that wrongful actions of the Supplier Employee are outside the scope of the supplier's responsibility.

Major outsourcing agreements often contain a number of reciprocal obligations and rights related to supplier and customer employees. One of the most significant of these is the prohibition against hiring employees of the other, unless expressly permitted (including as exceptions the activities associated with the transition of employees to the supplier at contract inception, and rights of the customer to seek to employ Supplier Employees at the termination or expiration of the outsourcing).

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As is true of the outsourcing's earlier phases, certain labor issues or considerations arise relative to activities occurring or undertaken during the termination phase.

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The ultimate enforceability of these provisions is not clear under Chinese law. This is especially true of provisions that can be viewed as restricting the individual employee's ability to work. In China, as in most jurisdictions, contractual restrictions on employment are not viewed favorably. To the extent that these limitations are applicable between the supplier and the customer (rather than individual employees), they are more likely to be enforceable. Future developments in China's law will certainly help to clarify these issues.

#### DISCLAIMER OF CO-EMPLOYMENT

Customers in outsourcing transactions must take care to minimize or eliminate the risk of being considered an employer (most likely, a co-employer) of Supplier Employees. This risk typically arises in connection with the customer possessing (and exercising) rights over Supplier Employees performing the Services, including rights such as those described above.

This risk is sometimes exacerbated by the fact that, for some Supplier Employees, day-to-day work activities may have changed relatively little from when they were Incumbent Employees. In such circumstances, the

risk is that employer status may arise. As a result, the Customer may be found to take on employer responsibilities and liabilities such as responsibility for wages or underpaid social insurance contributions.

Outsourcing agreements typically expressly disclaim co-employer status on the part of the customer. But because claims of this nature would most likely be made by individual Supplier Employees who are not party to the outsourcing agreement, such a disclaimer may have limited impact on an employment-related claim by the Supplier Employee. Consequently, outsourcing agreements typically include a supplier indemnity for the benefit of the customer against any such Supplier Employee claims. When the customer perceives this to be an especially significant issue, it may act to mitigate its risk by accepting reduced rights directly related to Supplier Employees under the outsourcing agreement.

#### TERMINATION PHASE

The final phase of an outsourcing transaction is termination or expiration. As is true of the outsourcing's earlier phases, certain labor issues or considerations arise relative to activities occurring or undertaken during the termination phase or in connection with the rights possessed and exercised by the parties during this period.

A key concern during the termination phase is the potential follow-on applicability of Article 34 to the re-sourcing or in-sourcing of the Services. Such treatment would presumably be similar to that applicable in the outsourcing's initial transition phase, with the possibility of successor employer responsibility passing to the successor provider of the services (whether another supplier or the customer itself). This is another area in which the customer and the supplier may draw on the experience of outsourcing in jurisdictions with laws promulgated under the Acquired Rights Directive and similar laws. Until Chinese employment law in this area is settled, it is likely that outsourcing the customer and the supplier will seek to allocate such risks between themselves through appropriate customer and supplier indemnities contained in the outsourcing agreement.

Even without applicability of Article 34, an important right often required by the customer in outsourcing

agreements is the express right to hire (or allow its successor supplier to hire) Supplier Employees engaged in the performance of the Services at the end of the outsourcing engagement's term. Frequently, the customer seeks to include within this right Supplier Employees who performed Services within the final year under the agreement in order to avoid the risk of the supplier evading the obligation by assigning its most desirable employees away from the customer account.

Such a clear customer right may be unnecessary if no-hire provisions are ultimately found to be unenforceable in China. But best practice on the customer's part would typically call for a clear right of this nature to be included in the outsourcing agreement.

## Conclusion

China is experiencing dramatically swift change and development, including in its laws and its commercial practices. Dynamic growth in these areas is very much evident within the nation's services outsourcing industry. Employment law is a critical area for all service outsourcings, and it will be important for customers and suppliers of Chinese services to carefully evaluate their undertakings in light of continuing developments in the law and practice.

As legal change in China continues and accelerates, parties to Chinese service outsourcings should consider how similar issues in other jurisdictions have been addressed over the years. Much can be learned from collective experience, and particularly from experience gained during periods of development and clarification in applicable laws.

It is reassuring to note that the outsourcing business model has developed and been proven over many years in many differing legal environments, including through periods of substantial uncertainty about the treatment of a variety of issues, including specifically human resources and personnel issues. As a validated, time-tested paradigm, experience with outsourcing from such contexts can provide powerful guidance that can be applied to the benefit of customers and suppliers of Chinese services. Given the model's effective application over time, coupled with the leverage of experience and the focused support of Chinese leadership, the law and commercial practice

in China should continue to evolve in ways that increasingly support the successful sourcing of services on a global scale. ♦

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<sup>1</sup> Excluding concerns associated with important issues such as child labor and working conditions that are beyond the scope of this article.

<sup>2</sup> See *"Going to China"* in this publication.

<sup>3</sup> It should be noted that this hypothetical transaction would include the case of a foreign-owned captive entity in China transferring its operations to a Supplier. Such a scenario will likely become increasingly common as the Chinese services sector matures.

<sup>4</sup> In addition, local regulations and rules issued by provincial, municipal and other lower-level authorities are only applicable in the relevant local regions. These laws involve a variety of matters, including minimum wages, calculation of wages, application of special work-hour systems and social security contributions.

<sup>5</sup> Articles 10 and 82 of the Labor Contract Law.

<sup>6</sup> Article 14 of the Labor Contract Law.

<sup>7</sup> Article 82 of the Labor Contract Law.

<sup>8</sup> Employee fault for this purpose includes:

- The employee is proved not to fulfill the requirements of recruitment during the probation period.
- The employee seriously violates the labor discipline or the work rules and regulations of the employer.
- The employee is in serious breach of his/her duties or engages in misconduct that has caused material loss to the employer.
- The employee has entered into an employment relationship with another employer which materially affects the completion of his/her tasks with the (first) employer (and the employee refuses to rectify the situation after the matter is brought to his/her attention by the first employer).
- The employee enters into the labor contract by means of fraud, threat, force or exploitation.
- The employee is prosecuted for criminal liability.

<sup>9</sup> Severance in connection with employment termination is provided for under Article 47 of the Labor Contract Law and the relevant local labor contract regulations and generally involves a payment of one month's salary for each year of continuous employment with the employer.

- <sup>10</sup> In the case of a successor outsourcing (sometimes referred to as a re-sourcing) or a repatriation of the services to the Customer (sometimes referred to as an in-sourcing), the Incumbent Employee would be the employee of the incumbent Supplier. Such transactions occur with relative frequency in mature outsourcing markets, and the applicable considerations should be generally consistent with an initial outsourcing.
- <sup>11</sup> See *“Going to China,”* in this publication.
- <sup>12</sup> That is, the implementing legislation of member states under the Council of European Communities Directive 77/187 of 14 February 1977 (the “Acquired Rights Directive”).
- <sup>13</sup> Under Article 46 of the Labor Contract Law, an employee is not entitled to severance in the case of voluntary resignation.
- <sup>14</sup> Employment benefits impacted by length of employment include, for example, annual leave and severance entitlements.
- <sup>15</sup> Rule 10 of the PRC Labor Contract Law Implementation Rules by and effective from September 18, 2008.
- <sup>16</sup> The Supplier may enter into confidentiality and non-compete covenants with a Supplier Employee restricting him or her from providing Services to competitors of the Customer during the term of employment. However, if such restriction is to be effective even after the termination of employment between the Supplier and the Supplier Employee, such non-compete period cannot exceed two years following such termination, and the Supplier is obligated to pay compensation to the Supplier Employee within such post-employment restrictive period.

# Intellectual Property Law in the People's Republic of China: An Update

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Intellectual property (IP) frequently plays an important role in outsourcing transactions. For example, either the supplier or the buyer—or both—may bring intellectual property to an outsourcing. Intellectual property, moreover, may be developed through or in connection with an outsourcing by either or both parties acting individually or jointly. Arrangements defining the appropriate uses of and protections for such IP are often among the most important considerations in the outsourcing agreement between supplier and buyer.

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A sound understanding of China's rapidly evolving IP laws is an essential element of doing business in the People's Republic.

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Common forms of intellectual property in the People's Republic of China include trademarks, patents (inventions, utility models and designs), copyright, confidential know-how and technology. Despite relatively recent enactments in China, the country's intellectual property laws encompass the full array of subjects and areas expected in modern IP regimes. And like other countries' IP regimes, China's laws are constantly evolving.

The legal basis for intellectual property protection in today's China—including

laws, regulations, judicial opinions and administrative measures—ranges from broad civil law principles to specific, detailed rules covering matters such as integrated circuits and new plant varieties. China's IP protection laws have developed rapidly and significantly, and one is challenged to keep abreast of this high-speed legal change. Within the past few months, for example, China's third amended patent law has come into effect. Over the same brief period, China's trademark law has undergone major consultations designed to address potential and emerging issues, and these developments are sure to result in wide-ranging impacts.

A sound understanding of China's rapidly evolving IP laws is an essential element of doing business in the People's Republic. Knowledge of the changing legal framework governing intellectual property in the PRC enables businesses to leverage the benefits of IP and to mitigate its concomitant risk. Consequently, it is fundamentally important to the effective structuring and management of successful outsourcing arrangements vis-à-vis Chinese suppliers. This article aims to highlight some recent key developments in China's IP law and to give readers a sense of the nation's intellectual property regime and its continuing development.

## Trademarks

In April 2009, the Supreme People's Court of China issued an important

opinion addressing certain issues related to the adjudication of intellectual property disputes. The opinion, which is applicable at all court levels in China, contains precise judicial guidelines to courts on how they should approach various trademark and unfair competition issues. The Court's guidelines are intended to promote ideals expressed in the National Intellectual Property Strategy announced in 2008.

They include:

- Courts need not award damages or account for profits relative to a mark that is registered but not put into actual use (for example, intended for extorting infringement compensation), although injunctions may still be granted against unauthorised use.
  - Trade names or their abbreviations that have attained certain market reputation and public recognition through actual trade use are afforded protection against unfair competition.
  - An enterprise name that is properly obtained overseas cannot be defended if its use within the People's Republic amounts to trademark infringement and/or unfair competition under Chinese law.
- The circumstances under which a court may or may not decide if a mark is “well-known” are defined. For instance, the court may determine if a mark is well-known in a trademark infringement or unfair competition claim that involves the mark's identity or similarity relative to an enterprise name. On the other hand, if a trademark infringement or an unfair competition claim fails for want of some other statutory criteria, the court may not make a determination.
  - Factors to be taken into account when considering whether a trademark is well-known in China include the mark's fame and history of use, the market share of goods bearing the mark, past recognitions, and the extent and geographical scope of associated advertising activities. Supporting evidence in the form of industry rankings, market surveys, valuation reports and the like are recognized as appropriate considerations by the court.
  - The Court found that “confusion” relative to trademark infringement occurs when the public may not recognize that products bearing a well-known trademark and a mark under complaint come from the same source. Similarly, confusion exists when the public may not understand that a license, association or other like agreement has been arranged between respective traders.

Well-known trademarks represent a category of trademarks that is afforded wider protection under Chinese law. At present, foreign marks or brand names not registered as trademarks in the PRC can receive protection under the nation's trademarks laws only if they qualify as well-known trademarks within China. Given the importance and power of well-known trademarks, this is an area in which the Chinese government is striving for consistency in administrative and judicial practice and for a strengthening of protections.

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Well-known trademarks represent a category of trademarks that is afforded wider protection under Chinese law.

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As part of these continuing efforts, the Supreme People's Court of China issued a judicial opinion in May 2009 offering guidance on a number of questions concerning well-known trademarks:



## Patent

On 1 October 2009, the revised patent law of China came into effect. This law has resulted in significant changes to China's patent system, from the preliminary stage of patent application to enforcement of patents in the courts. Some key changes in the new law are:

### HIGHER STANDARD OF NOVELTY

In an application for an invention patent or utility model under the old patent law, prior use of the invention outside China (except for disclosure in a publication) did not defeat the novelty of the invention. China's revised patent law removes this territorial limit and lifts the standard of novelty by stipulating that the applied-for patent must not belong to the state of the art known to the public inside or outside China before the application date.



## FOREIGN PATENT APPLICATIONS

Under prior law, foreign companies wishing to apply for and maintain patents in China were required to engage patent representatives from among a limited class of agents designated by the State Council. The revised patent law allows all patent agents in China to handle foreign-related patent applications. Consequently, foreign applicants can now choose from a significantly larger pool of patent agents to handle their patent matters in China.

## FIRST-FILING REQUIREMENT

Under the old law, Chinese entities (including individuals) wishing to apply for foreign patents for their inventions developed in China were required to make their first patent application filing in China. The revised patent law removes this first-filing-in-China requirement. At the same time, however, the revised law imposes a new measure requiring that all local and foreign entities wishing to apply for foreign patents for inventions or utility models completed in China must first apply to the State Patent Office for a “confidentiality scrutiny.” If this process is not followed, the subject invention or utility model will not be granted a Chinese patent.

## STATUTORY DAMAGES

The new law codifies and increases the range of statutory damages applicable in certain infringement situations. For example, where the rightful owner’s loss or the infringer’s illicit profit is difficult to quantify, the court may take into account factors such as the type of patent and the nature of infringement, and it may award damages ranging from RMB 10,000 to RMB 1,000,000. Under previous law, the cap on damages in such situations was RMB 500,000.

## Technology import and export

In China, the import and export of technology is subject to a control regime that is principally set out in the Regulations of the Administration of Technology Import and Export. It is important to note that these regulations do not simply govern technology businesses. Rather, the term “technology import and export” is defined very broadly to encompass any kind of patent (or patent application right) assignment or license, confidential know-how, transfer

or technology training. Consequently, a large number of transactions in all categories of business have become subject to control.

Under this regime, certain categories of technology are prohibited from import and/or export entirely, while others require prior approval by the Chinese government. From time to time, China publishes a catalogue of prohibited and restricted categories of technology. Violation of these restrictions may attract criminal sanctions.

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Certain categories of technology are prohibited from import and/or export entirely, while others require prior approval by the Chinese government.

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Technologies that do not fall into prohibited or restricted categories are free for import and export, provided that the relevant contract is properly recorded with the Chinese commerce authorities. In February 2009, the Ministry of Commerce revised its recordal requirements by stipulating a 60-day recordal period for technology import and export contracts after their effective dates. Although the penalty for non-observance is not defined, outsourcing parties must recognize and comply with this requirement, as it represents the basis for handling tax and remittance matters arising out of any import or export activity.

## Trade secrets

Trade secrets are protected in China under the Anti-Unfair Competition Law. To qualify as trade secrets, data must constitute technical or business information that is:

- Not known to the public
- Of practical use and capable of bringing economic benefits to the owner
- Subject to confidentiality measures adopted by the owner

These criteria are defined and clarified in administrative regulations and, increasingly, in judicial interpretations. A significant judicial interpretation was issued by the Supreme People’s Court in 2007 to provide important guidance on fundamental concepts such as “public domain” and “confidentiality measures.”

For example, the category of data that is “not known to the public” is interpreted as information not commonly known to, or easily obtained by, relevant members in the trade. The Court’s interpretation provides several examples of what constitutes public information, including information that is common knowledge or industrial practice in the relevant sector; information that can be easily obtained without any charge; and information that solely concerns a product’s size or structure and that is readily discernible by the relevant public.

Relative to “confidentiality measures,” courts will consider a number of factors, including the nature of the information, the intention of the information owner, and the form of measure(s) adopted. A number of circumstances in which confidentiality measures will be found to have been taken by the information owner are also described. These include the affixing of a confidentiality label on the device that stores the information, the use of a confidential code, and the execution of confidentiality agreements.

The law, however, does not provide blanket protection for trade secrets, and it contains some extremely important limitations. One such limitation provides that obtaining trade secrets through reverse engineering of publicly available products will not constitute infringement.

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These developments represent only a recent few of the dynamic and far-reaching changes in China’s intellectual property laws. The impact that these laws can have in outsourcing strategies must not be overlooked. Awareness of the relevant legal issues provides any company with powerful tools in formulating and negotiating successful outsourcing arrangements. ♦



# Effective Enforcement of Contract Rights in Chinese Sourcing Contracts

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Effective enforcement of contract rights is on virtually every customer's short list of concerns when considering sourcing goods or services from providers in China. As China builds on its position as a manufacturing powerhouse and drives to become a global player in the services industry, its ability to assure customers that they can effectively enforce contract rights in Chinese sourcing agreements stands as a key challenge to its success.<sup>1</sup>

In considering the issue of contractual enforcement, focus often tends toward dispute resolution mechanisms that can be utilized either to compel performance in the face of actual or threatened nonperformance or to address damages or other remedies for failed performance. Emphasis tends to be placed on traditional means of dispute resolution, including mediation, arbitration, litigation and injunctive relief, and on satisfaction of awards and judgments. While the availability and effectiveness of such dispute resolution forms a critical component of contract enforcement, however, actual dispute resolution alone is far too narrow a focus for evaluating the effectiveness of contract enforcement.

Effective contract enforcement should be viewed on a broader systematic basis, as part of the overall contractual arrangement and its context. This perspective encompasses the contract's legal environment, including the availability of traditional dispute-

resolution mechanisms, but also includes contract-specific considerations, such as the structure of performance established under the contract. Further, it must take into account extra-contractual considerations, such as the broader relationship between the parties and the market visibility and reputation of the provider.

This article identifies some of the important issues facing customers as they assess effective enforcement of sourcing contracts with Chinese providers. The objective of this discussion is to assist prospective customers in evaluating the viability of sourcing arrangements with Chinese providers.

## Inventory of Considerations— Acceptance of Relatively Few Absolutes

When a customer evaluates the viability of a sourcing opportunity, it inevitably balances the criticality of specific contract compliance with the reality of actual contractual performance. In jurisdictions with reasonable predictability and assurance of contract enforcement, the evaluation can often be relatively straightforward, although it is never completely without risk. An assessment conducted in this context is ultimately aimed at determining whether a particular product or service sourcing arrangement meets the customer's acceptable risk profile. An analysis of

this nature is a challenge in any market environment, but particularly so in the rapidly evolving market of Chinese providers.

Enforcement mechanisms available for a sourcing contract can be divided into two major groupings. The first relates to the structural and operational factors established both by contract and by extra-contractual environmental considerations. These factors focus primarily on operational safeguards and mechanisms that provide practical protections in order to assure performance and, to a lesser extent, on actual enforcement.

The second category comprises more conventional enforcement mechanisms. In China, as in any commercial jurisdiction, these mechanisms include all of the traditional dispute-resolution devices (such as alternative dispute resolution and litigation) and related considerations (such as choice of law, procedures and forum). It is with this second category of enforcement mechanisms that China offers particular challenges, graphically illustrated by the fact that it has only recently formally embraced the concept of rule-of-law.

China is seeking to create a business-friendly environment characterized by predictable legal enforcement of contract rights. The People's Republic has made significant strides in its development of a national business atmosphere in which contract enforcement is reliable and consistent with international commercial standards and practices. Nonetheless, the establishment of effective, predictable enforcement mechanisms represents a relatively new endeavor in the PRC.

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China is seeking to create a business-friendly environment characterized by predictable legal enforcement of contract rights.

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Businesses operating in today's China, then, may be less certain that contractual agreements will be supported by effective legal enforcement as compared, for example, to national jurisdictions with long histories of commercial practice. This reality means that the first grouping of enforcement mechanisms described above—emphasizing contract structures and operational arrangements—has heightened significance for sourcings from China.

## Contract Structure and Operational Arrangements to Avoid Disputes

Some of the most effective contract enforcement techniques in sourcing transactions have been dispute avoidance strategies that are embodied in the scope, structure and operation of the sourcing relationship. Savvy buyers of products and services have long worked to scope and structure their sourcing arrangements to avoid or minimize the likelihood of disputes and to eliminate high-risk situations because no matter how sophisticated and established the dispute resolution environment, actual dispute resolution activities are ultimately distracting, costly and non-productive.

Proactive approaches and arrangements designed to avoid problems in the first place generally provide a superior alternative to dispute resolution strategies. These may include:

- payment schedules tied to actual delivery and acceptance by the buyer;
- strategic scoping of the sourcing agreement to ensure that the customer retains control of the overall production/performance process (e.g., limit sourcing to discrete components or phases or utilize multi-supplier arrangements);
- careful due diligence in supplier selection and monitoring (e.g., to ensure that the supplier is motivated to preserve and protect its reputation and the integrity of its operation);
- effective customer-side audit and other quality controls, including inspection and reporting; and
- effective and legitimate utilization of business incentives (e.g., retention or expansion of business).

Proactive dispute-avoidance measures, developed and tested over time as regular good practice in any sourcing transaction, are readily applicable. They take on added importance when sourcing in China, where the options and mechanisms of dispute resolution may be less developed and certain.

## Dispute Resolution Considerations in China

Despite best efforts to scope, structure and operate sourcing relationships to avoid the need for active dispute resolution mechanisms, buyer-supplier disputes requiring formalized resolution processes can and do happen. In the case of Chinese providers, all of the basic dispute resolution options are available

in the PRC. In some cases, however, these options present unique requirements and considerations.

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In sourcing arrangements with Chinese providers, there is a marked preference to resolve disputes through alternative dispute resolution efforts, rather than through litigation.

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Effective dispute-resolution strategies, ranging from structured issue escalation within the contracting parties to mediation and even arbitration, are available in China and are typically well-suited to address issues with Chinese suppliers. Prospective sourcing customers should be aware that from a cultural perspective, informal dispute resolution tends to be more consistent with important elements of Chinese culture and tradition, including Confucian ethics and the characteristic desire for harmony.

Consequently, in sourcing arrangements with Chinese providers, there is a marked preference to resolve disputes through alternative dispute resolution efforts, rather than through litigation. In fact, public litigation has historically carried a connotation of criminal proceedings in China and may be viewed as humiliating to the parties involved.

Cultural realities and other considerations explain why larger sourcing arrangements with Chinese suppliers very often include well-structured but informal dispute-escalation procedures. For example, parties may be contractually obligated to address and escalate issues within their respective management groups in order to avoid or resolve disputes without litigation. Other, more formal mediation arrangements that are legally supportable while still maintaining sensitivity to Chinese cultural and social norms may also be incorporated into sourcing contracts.

Nonetheless, resort to formal dispute resolution proceedings may be inevitable, and a buyer sourcing from a Chinese supplier must account for this possibility. In this regard, both litigation and arbitration are available methods of dispute resolution with Chinese suppliers but each carries important considerations and qualifications.

Subject to certain important limitations, a sourcing contract between a Chinese provider and a foreign customer may provide that the law of a national jurisdiction other than China will govern the contract and that any disputes under the contract will be resolved through proceedings conducted outside China. In this regard, however, two important limitations must be noted:

- despite a contract's generally valid choice of law, some issues remain subject to Chinese law. These include certain issues concerning intellectual property ownership, labor laws, land ownership, insolvency and enforcement of foreign judgments or awards; and
- courts in China are far more likely to enforce a foreign arbitral award than to uphold the judgment of a foreign court.<sup>2</sup>

### Litigation in China

Since 1979, China has had a judicial system that will hear and resolve commercial disputes. However, beyond the standard concerns of litigation in even more established judicial environments, including inefficiency, cost and time, commercial litigation in China raises a number of significant concerns—many related to the lack of a litigation tradition for resolving commercial disputes and relative infancy of its judicial system.

For a variety of reasons, including concerns with the still-developing judiciary, arbitration is becoming the predominant formal mechanism for resolution of contract disputes in China. As part of its sweeping enactment of commercial laws over the past 20 years, China enacted a comprehensive arbitration law in 1994 that, in tandem with numerous opinions issued by the Supreme People's Court, has helped to meet international arbitration law standards in terms both of scope and content.<sup>3</sup>

Practically speaking, three types of arbitration are recognized in China: domestic arbitration, foreign-related arbitration and foreign arbitration. The first two categories of arbitration describe proceedings that are conducted and enforced in China under Chinese laws. The latter category refers to arbitration conducted outside China but enforceable within the country under the New York Convention. The following table describes these distinctions:

	Domestic Arbitration	Foreign-related Arbitration	Foreign Arbitration
Non-Domestic Disputes		✓	✓
Conducted by a Chinese Arbitration Institution	✓	✓	
Conducted by a Foreign Arbitration Institution			✓
Enforceability in China	✓	✓	✓
Applicable Legislation or Convention	Arbitration Law and Civil Procedure Law	Arbitration Law and Civil Procedure Law	New York Convention

For arbitrations taking place in China, procedures that are categorized as “foreign-related” can offer the participating parties broader options, and the designation can be an important consideration.

A dispute meeting one of several specific elements can be recognized as “foreign-related” by Chinese courts. These elements include:<sup>4</sup>

- one or both parties in the dispute are foreign persons or are organizations that are domiciled in a foreign country;
- the subject matter of the dispute is located in a foreign country; and
- the facts that establish, change or terminate the contract between the parties occur outside China.

A potentially significant qualification with respect to the dispute characterization issue is the fact that, for this determination, both foreign-invested enterprises (FIEs) and wholly foreign-owned enterprises (WFOEs) are considered Chinese persons because they are Chinese-formed entities. While it is not a prerequisite that a local entity be formed and utilized in sourcing transactions by foreign customers, one or another of these structures is often used as a vehicle for various local operational reasons.

Sourcing transactions in which such Chinese-formed entities are common include shared services captive structures. In such cases, use of an FIE or WFOE structure increases the likelihood that a foreign buyer

may find its contractual obligations with Chinese providers governed by Chinese law. As a result, any disputes may be characterized as “domestic.”<sup>5</sup>

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There is far less certainty regarding judicial enforcement in the case of Chinese domestic arbitrations, a consideration that may effectively defeat the entire objective of arbitration.

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The consequence of this domestic characterization can be significant. For example, in both a recognized foreign-related arbitration and a foreign arbitration, the court’s ability to deny enforcement is far narrower than in a domestic arbitration. In contrast, the People’s Court may deny enforcement of a domestic arbitral award if it finds insufficient evidence to enforce, or if it determines that the law (which would necessarily be Chinese law) has been erroneously applied. Neither of these defenses would be available to deny enforcement in a foreign-related arbitration or in a foreign arbitration. Accordingly, there is far less certainty regarding judicial enforcement in the case of Chinese domestic arbitrations, a consideration that may effectively defeat the entire objective of arbitration.

One of the main commissions for conducting foreign-related arbitrations in China is the China International Economic Trade Arbitration Commission (CIETAC), a state-sponsored organization that was formed in 1956.

Despite significant modernization of its procedures in recent years, CIETAC proceedings continue to be viewed with some concern by the international business community. These concerns include issues regarding transparency of arbitrator compensation and even the possibility of improper influence and pressure being brought on the arbitrators.

To the extent that a dispute results in an award or judgment, a range of issues arises relative to the enforceability of that award or judgment against a Chinese supplier, irrespective of the forum proceeding or governing law applied. Applications for enforcement of arbitral awards are made to local intermediate Chinese courts. The basis of nonenforcement of otherwise enforceable foreign-related and foreign arbitral awards, however, is limited to procedural violations such as:

- lack of jurisdiction of the arbitration proceeding;
- lack of a valid arbitration agreement; and
- discrepancies in the proceeding, such as the improper appointment of an arbitrator or lack of appropriate notice to a party.

Finally, the most common reason for ultimate nonenforcement of arbitral awards (domestic and foreign-related) is one that is not limited to China: lack of assets. Such a situation may involve actual bankruptcy or insolvency. Often, however, it includes cases in which the plaintiff or court simply cannot locate assets.

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As China works to increase its role as a global supplier of products and services, the legal system and practice necessary to ensure efficient and predictable dispute resolution will certainly develop.

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## Conclusion

Enforcement of contract rights is a critical consideration in any commercial transaction. As China works to increase its role as a global supplier of products and services, the legal system and practice

necessary to ensure efficient and predictable dispute resolution will certainly develop. With this legal evolution, there should come increasingly favorable international perceptions of China's viability as a sourcing environment, and the scale and quantity of sourcing transactions involving Chinese can steadily—and sharply—increase.

In the meantime, companies looking to source from Chinese providers must carefully consider the scope and structure of their contractual arrangements. They must also carefully assess the effectiveness of their arrangements to both avoid and address disputes with sourcing providers. With diligent consideration and planning, however, companies can approach the Chinese market with a level of confidence that will enable them to take advantage of the many and growing opportunities in what is, and promises to remain, one of the most dynamic markets in the world. ♦

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<sup>1</sup> See *“Going to China”* in this publication.

<sup>2</sup> The PRC is a signatory to the New York Convention, and its courts are therefore obliged to recognize and enforce arbitral awards of other signatory countries, including the United States. On the other hand, the United States and a number of other countries have not signed treaties on recognition and enforcement of foreign judgments. Consequently, Chinese courts have no similar obligation to enforce court judgments of those countries.

<sup>3</sup> Beyond issues associated with the infancy of China's judicial system and the inexperience of its judges, principal concerns include the means of judicial appointment and compensation and the overall level of judicial qualification in many parts of the country.

<sup>4</sup> These elements were adopted by the Supreme People's Court in defining “foreign-related civil litigation” in a 1992 opinion. No such specific guidance has been given for “foreign-related” arbitration, leaving the matter less certain. Further, under Article 20(7) of the Consultation Draft of the Provisions for Handling of Foreign and Foreign-related Arbitration Cases by the People's Court (31 Dec 2003), there appears to be a likelihood that an agreement between parties for arbitration outside of China may be found void if there is no “foreign element.”

<sup>5</sup> Article 126 of Contract Law of the People's Republic of China.



# Thinking Outside the BPO: Knowledge Process Outsourcing to India

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A new form of global outsourcing to India, known as “knowledge process outsourcing,” or KPO, is following on the heels of the remarkably successful Indian market for information technology outsourcing (ITO) and business process outsourcing (BPO). Like ITO and BPO, knowledge process outsourcing allows client companies to realize substantial cost reductions by offshoring domestic business functions to lower-cost foreign venues. KPO differs, however, in terms of its potentially value-adding proposition: effectively structured and implemented, it can help companies gain strategic advantage over competitors by virtue of the types of offshored processes and functions it incorporates.

Knowledge process outsourcing offers its clients a very real possibility of significant benefit. But it also raises a number of key issues and risks that must be carefully evaluated when considering a KPO transaction in India. KPO involves the offshore outsourcing of knowledge-driven or “high-end” processes that require specialized domain expertise. Examples of these processes include research and development (R&D), insurance underwriting and risk assessment, financial analysis, data mining, investment research, statistical analysis, tax preparation, engineering and design, animation, graphics simulation, medical services, clinical trials, legal services and more.

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[KPO] raises a number of key issues and risks that must be carefully evaluated when considering a KPO transaction in India.

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The ITO and BPO market sectors create cost savings by leveraging economies of scale and rules-based process expertise. In contrast, KPO accesses the global talent pool to carry out processes that demand specialized analytical and technical skills, as well as the exercise of informed judgment and decision-making. The strategic driver for KPO is to add value by providing high-quality business expertise and superior productivity through improved time to market, in addition to realizing the traditional cost reductions through arbitrage of labor markets that have made ITO and BPO so successful.

There are vast first-mover benefits to US and European participants in KPO. But meaningful challenges exist that must be addressed and navigated knowledgeably in order to achieve and maximize the strategic incentives offered by the KPO model.

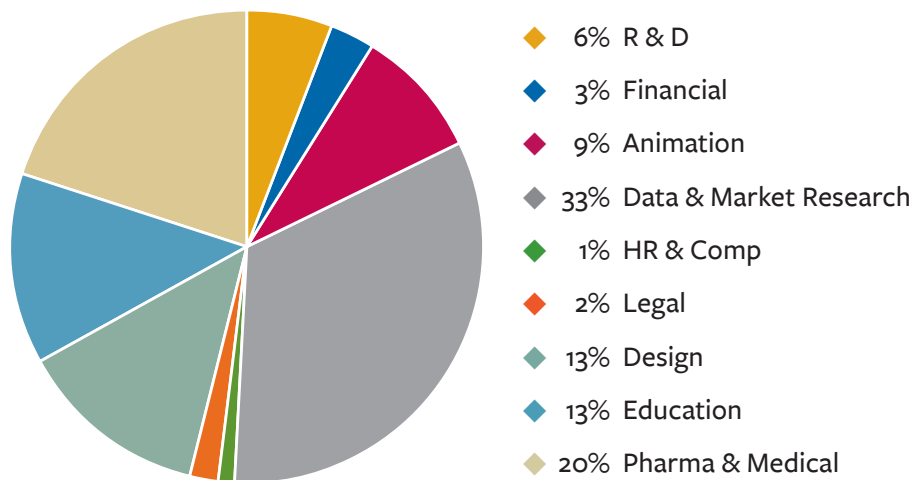
Potential KPO customers must overcome the natural and understandable hesitation to relinquish control over the outsourced processes. These processes and their associated data are often critical, and companies have legitimate

concerns about data security, intellectual property protection, quality assurance, regulatory compliance and cost, to name just a few.

By definition, moreover, KPO involves an investment by the customer in the host country's educated workforce and a dependence on that workforce that far exceeds BPO and ITO. In addition, KPO customers are far more dependent on the stability and predictability of the host country's underlying political and social structures. As a result, a deeper understanding of the host country's business, regulatory and legal framework becomes imperative.

## Attraction of India's "Knowledge Class" for KPO and First-Mover Advantage

A successfully implemented KPO can deliver truly enormous rewards. The global KPO market is poised to grow by more than 45 percent annually—to \$17 billion in 2010.<sup>1</sup> India is emerging as the global KPO leader and is expected to capture over 70 percent of the market share going forward. The major KPO domains expected to grow in India over the next five years and their respective estimated value pie distribution are reflected in the chart below.<sup>2</sup>



India has a large reservoir of English-speaking, knowledge-based professionals who are available at extremely competitive salaries. The nation also offers a rapidly evolving legal and regulatory environment that is based on a western model and that is increasingly friendly to foreign investment.<sup>3</sup>

ITO and BPO are almost exclusively cost-based; they benefit from a virtually unlimited, relatively quickly trainable labor pool in developing countries such as India and China. In contrast, KPO depends on a more limited—albeit currently vast—supply of highly skilled, educated workers. These workers, over time, will certainly demand more economically rewarding compensation packages as competition for their skills increases.<sup>4</sup>

Successful KPO participants, accordingly, should not only leverage existing resources but should also consider investing and visibly participating in education and training systems to assure a predictable future supply of highly skilled workers and to develop first-mover brand recognition in Indian society.<sup>5</sup> Many companies, such as Microsoft, GE and American Express, are already acting to do so. Because of this market timing consideration inherent in tapping into India's increasingly developing worker base, first mover considerations are therefore not insignificant with respect to KPO strategy.



The future prospects for KPO in India are immense because KPO is applicable to multiple-industry sectors in which India's highly skilled workers and technically educated professionals have developed specialized expertise. These sectors include (but are not limited to) finance, pharmaceuticals, healthcare, biotechnology, insurance, electronics, software, aerospace, automotive, textiles, industrial machinery, entertainment, media and publishing, education, law and engineering.

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Many US businesses have already made successful forays into the KPO domain in India to leverage India's knowledge class. Among them are leading American corporations such as GE, IBM, Microsoft, HP, Intel, Oracle, Cisco, Texas Instruments, Sun Microsystems, Philips, Motorola, JP Morgan, Citigroup, McKinsey, Goldman Sachs, Reuters, Morgan Stanley, United Airlines, Ford, General Motors and Caterpillar. Many of these businesses are projected to expand their KPO operations in India, and it is likely that a host of new entrants will join them in seeking to leverage India's growing KPO sector.

Two examples of KPO in India—the pharmaceutical and financial services sectors—are worth noting. In the pharmaceutical industry, global producers such as AstraZeneca, GlaxoSmithKline, Pfizer, Novartis and Eli Lilly have moved portions of their clinical drug testing operations to India in an effort to leverage the nation's vast and diverse population and its pool of highly skilled, relatively low-cost scientists. This strategy can significantly accelerate the trial time and time to market for new drugs, and it offers potential savings of 40 percent to 60 percent compared to US costs. India's vibrant local pharmaceutical sector and its recently amended patent laws granting patent protection to drugs and chemical products, coupled with its history of process protection, have also attracted global pharmaceutical companies to offshore R&D to India.<sup>6</sup>

India's attractiveness as an offshore destination for clinical research is further enhanced by investment

incentive policies ranging from tax holidays to duty exemptions and by its acceptance of the International Conference on Harmonization Guidelines for Good Clinical Practices. With the cost of bringing new drugs to market continuing to escalate in the United States (current estimates approach US\$1 billion per product), the possibility of halving the cost of clinical trials and drug discovery by moving those processes offshore cannot be ignored.<sup>7</sup> Increasing pressure on pharmaceutical companies to improve productivity and profitability without sacrificing quality to sustain competitive advantage makes KPO a compelling strategic route.

Similarly, KPO initiatives within the financial services sector have seen tremendous growth in India as global financial institutions such as JP Morgan, Citigroup, Prudential, Goldman Sachs and ABN AMRO continue offshoring high-end work, either through delivery by affiliated legal entities in India or by unaffiliated, pure-play third-party vendors. Most of these businesses originally outsourced IT-enabled common finance and accounting processes that were transactional in nature, such as accounts payable, accounts receivable and payroll. But many have gradually migrated to offshoring high-end financial processes, such as equity research, business intelligence, credit risk analysis and insurance claims processing.

### KPO Delivery

When it comes to the KPO delivery model, one size does not fit all. Currently, three key KPO delivery models exist. These include:

- offshoring through affiliated legal entities in India, which can be thought of as “captive KPO”;
- contracting with unaffiliated third-party vendors, or what can be called “third-party KPO”; and
- partnering with local entities to share control of local operations used for delivery of KPO services, or “joint venture KPO.”

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When it comes to the KPO delivery model, one size does not fit all.

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Each model has its own advantages and risks, and each should be evaluated carefully in order to identify

and assess the relative pros and cons for a particular KPO strategy. Businesses should adopt different delivery models for different situations, taking into account variables such as the nature and scope of the activities to be offshored, previous offshoring experience, concerns about security and control of intellectual property (IP), risk tolerance, tax considerations and budgetary constraints.

For example, third party KPO can be more quickly implemented and often can offer greater flexibility in access to talent, scalability and cost structure. But it also yields to the third party more control over day-to-day operations and the handling of sensitive data and IP, and it creates more reliance on the foreign host country's legal regime and the timely enforcement of contracts.

In comparison, a captive KPO model usually requires more time to implement and provides less flexibility to ramp up or down quickly. However, it ensures substantially more customer control over management of the offshore operations and the company's sensitive data and IP and less dependence on foreign enforcement of contract rights. A KPO customer should consider adopting the captive KPO strategy if the outsourcing's scope involves a substantial transfer to India of critical proprietary technology, IP or data and if the enterprise cost of possibly losing control over some meaningful component of those assets is high.

In India, KPO initially took hold in captive centers through the establishment of local subsidiaries, and estimates suggest that over 50 percent of offshore business in India is currently captive KPO. But as the Indian KPO market matures and the business, legal and regulatory environment there continues to advance and stabilize, customers can be expected to increasingly leverage third party KPO in light of that model's advantages relative to flexibility, scalability and range of expertise.

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The substantial benefits that KPO in India offers must be seen as “hand in hand” with the unique and heightened risks inherent in the transfer of customer-owned knowledge to India.

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Regardless of the delivery model, KPO invariably requires the customer to disclose and share knowledge-intensive processes with the offshore provider. This knowledge may take the form of proprietary technology, software, chemical entities, specifications, product designs, business processes, methodologies, drug formulations or other sensitive data. Accordingly, the substantial benefits that KPO in India offers must be seen as “hand in hand” with the unique and heightened risks inherent in the transfer of customer-owned knowledge to India. These risks must be carefully considered upfront, and they must be diligently mitigated to realize the full benefit of KPO to India.

## Conclusion

KPO to India can yield enormous cost savings and increased efficiencies to the customer. It can also leverage India's vast knowledge class to perform high-end skill- and judgment-based services and functions. But the potential KPO customer must be aware that KPO presents a number of risks—particularly with regard to controlling intellectual property and protecting sensitive data—that must be considered and addressed. These risks can be managed, however, through appropriate due diligence, planning and a well-crafted KPO contract that properly identifies and addresses the risks and that provides real and practical protections and enforcement mechanisms. ♦

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<sup>1</sup> Study conducted by Evalueserve in 2004.

<sup>2</sup> *Knowledge Process Outsourcing (KPO)—An Emerging Opportunity*, Kelly Services White Paper, July 2006.

<sup>3</sup> India produces 441,000 technical graduates, nearly 2.3 million other graduates and more than 300,000 postgraduates every year. A Survey of Business in India in *The Economist*, June 3, 2006.

<sup>4</sup> A Deutsche Bank research report published in October 2005 reports that wages for skilled workers in India are rising on an average by 12-15% per year.

<sup>5</sup> The National Association of Software and Service Companies (NASSCOM) predicts that the Indian IT sector faces a shortfall of 500,000 professionals by 2010 that threatens India's dominance of global offshore IT services. *Financial Times*, July 20, 2006.

<sup>6</sup> The Patents (Amendment) Act, 2005.

<sup>7</sup> A Survey of Business in India, *The Economist*, June 3, 2006.

# Offshoring to India: Are Your Trade Secrets and Confidential Information Adequately Protected?

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Despite growing competition from emerging markets around the world, India continues to be the number one destination for outsourcing services involving information technology and business processes (IT/BPO services). In recent years, moreover, a new model of global sourcing known as “knowledge process offshoring” (KPO) has taken hold, and India has quickly become the global leader of KPO services.

KPO involves the offshore outsourcing of knowledge-driven or “high-end” processes that require specialized domain expertise. Today, Indian suppliers of KPO successfully deliver outsourced processes across a growing spectrum of sophisticated disciplines, including research and development (R&D), insurance underwriting and risk assessment, financial analysis, data mining, investment research, statistical analysis, tax preparation, engineering and design, animation, graphics simulation, medical services, clinical trials, legal services and more.

As offshoring of services to India moves up the value chain from IT/BPO to KPO, the protection of intellectual property (IP)—including any trade secrets or confidential information that may be transferred to or created in India in the context of a KPO sourcing—becomes an ever more critical concern for the offshoring customer. IP concerns must be knowledgeably addressed to

maximize the benefits and strategic incentives that the offshoring model can deliver without losing control of valuable customer IP. This article identifies key issues that any offshoring customer should carefully assess in order to mitigate the risks associated with offshoring trade secrets and other confidential information to India.

When offshoring a high-end process or functionality to India, knowledge (such as source code, formulae, designs, specifications or experimental data) that is transferred offshore is often confidential in nature and is generally not suitable for local registrations in the form of patents. Therefore, before initiating an offshoring process, a US customer must seriously consider how it can best protect this information to maintain its competitive advantage. A primary concern for a US customer should be the Indian service provider’s ability and willingness to safeguard customer-owned trade secrets and other commercially valuable confidential information against misappropriation, misuse, unauthorized disclosure, sabotage or theft.

## India’s Existing Legal Framework for Trade Secrets

In the United States, trade secrets are afforded statutory protection at both federal and state levels, with meaningful civil and criminal remedies to counter

misappropriation. Penalties for misappropriation can, and often do, include significant compensatory and punitive damages, injunctive relief and attorneys' fees. This is not the case in India, however. Indian law provides no statutory or other legal protection of trade secrets. This non-legal environment presents numerous challenges concerning trade secret protection and enforcement, and it can jeopardize a US customer's IP unless the customer carefully employs certain contractual mechanisms that are enforceable in India.

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In the Indian legal context, parties must rely primarily on contracts to protect trade secrets. Indian law recognizes the common law tort of "breach of confidence" irrespective of the existence of a contract. But the tort's utility is limited in an offshore sourcing context because the duty of confidence at issue can be enforced only against a party that is either a fiduciary to the US customer or is in an employer-employee relationship with the complaining party. Also, the duty arguably extends only to the unauthorized disclosure of confidential information to a third party and does not prevent the recipient's own "misappropriation" of the information.

### Perils of Subcontracting

Consider a hypothetical situation involving an Indian service provider that has engaged a subcontractor in India to perform the offshored services for a US customer. If the Indian subcontractor discloses or misappropriates the US customer's trade secrets or confidential information, the customer has neither a breach-of-confidence claim against the subcontractor nor a breach-of-contract claim, except in the unlikely event that the US customer has contracted directly with the subcontractor.

The contract between the US customer and the Indian service provider might well hold the provider liable for damages caused by the subcontractor's inappropriate disclosure. But that cause of action still does not

directly address or foreclose the subcontractor's past and possibly future misconduct. Essentially, then, the US customer is left without a direct remedy against the Indian subcontractor and without an immediate legal means to effectively stop the disclosure.

### Employee Misconduct

Concern for third-party subcontractor misconduct unfortunately exists with respect to the misconduct of employees and ex-employees of the Indian service provider. Surveys reveal that a majority of data-misconduct situations originate with employees or ex-employees of a service provider. Recently reported instances involving the theft of trade secrets belonging to western companies offshoring to India illustrate the gaps in Indian law that expose IP in offshore transactions to real vulnerability.

In 2002, for example, a former employee of Geometric Software Solutions Ltd., an Indian software vendor, attempted to sell proprietary source code owned by SolidWorks, a US client of Geometric, to the client's competitors. The former Geometric employee was caught red-handed in a sting operation, but he could not be effectively prosecuted in India because the source code was considered a trade secret. Indian law did not recognize "misappropriation" of trade secrets, and the US client did not have any contractual arrangements with the former employee with which it could directly enforce its rights.

A similar situation arose in 2004, relative to an employee at an India-based software development center of Jolly Technologies, a US customer. The employee misappropriated portions of the company's IP by allegedly uploading files that contained source code for a key product to her personal Yahoo! e-mail account. The theft was detected in time to prevent the employee from distributing the stolen code. But once again, due to gaps in India's IP law, the US customer could not successfully prosecute the employee.

These and other cases have drawn close scrutiny and have served as a wake-up call to the global sourcing community and the Indian outsourcing industry. Indian providers have aggressively lobbied their government to strengthen the nation's IP regime and thus to demonstrate to the world's investor community that India is acting to protect foreign IP.



The risks associated with subcontractor and employee misconduct relative to IP in India are very real. It is critical, therefore, for US customers to be aware of this enforcement gap and to address it in their operative contracts with Indian service providers. Customers must also work to carefully scrutinize relevant contracts between Indian service providers and their subcontractors.

## Effective Strategies to Safeguard Trade Secrets and Confidential Information Offshored to India

### DRAFTING COMPREHENSIVE CONFIDENTIALITY AND IP OWNERSHIP AGREEMENTS THAT ARE ENFORCEABLE IN INDIA

Trade secrets and confidential information must be protected with well-constructed contractual arrangements between a US customer and its Indian service provider. It is imperative, too, that any contractual relationship between the service provider and its subcontractors includes an express right of enforcement by the US customer against the subcontractors.

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Confidentiality and non-competition covenants are enforceable under Indian law and offer a vital line of defense in the US customer's effort to protect trade secrets and confidential information in India.

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Contract provisions should clearly and effectively prohibit the wrongful disclosure and misappropriation of trade secrets and proprietary data by the service provider and its subcontractors. In addition, the contract should expressly acknowledge the US customer's right to enforce violation of these provisions for damages and of the customer's right to seek to enjoin such wrongful acts locally.

Confidentiality and non-competition covenants are enforceable under Indian law and offer a vital line of defense in the US customer's effort to protect trade secrets and confidential information in India. A US customer must insist upon unambiguous provisions in the operative contract requiring the Indian service provider to ensure specific performance standards. These standards should explicitly oblige the provider to:

- maintain the customer's trade secrets and confidential information in strict confidence, not only during the term of the contract but also after its termination;
- permit controlled access on a "need-to-know" basis only, including the customer's right to enforce such obligations directly against service provider personnel having access to the customer's information; and
- accept contractual responsibility and liability for any breach of confidentiality obligation or misuse of such information by itself, its subcontractors, employees or former employees.

A well-designed operative contract should enable the customer to immediately terminate the agreement in the event of a service provider's failure to comply with its contractual confidentiality obligations. In addition, it should result in uncapped financial consequences to the service provider.

### PERFORMING DUE DILIGENCE TO AVOID CHAIN-OF-TITLE ISSUES AND TO ENSURE PASS-THROUGH NON-DISCLOSURE OBLIGATIONS

Because prevention is better than cure, a US customer should conduct comprehensive due diligence regarding the Indian service provider's track record of maintaining data security. Prior to entering into a final contractual arrangement, the customer should perform due diligence as thoroughly as possible to make sure that the Indian service provider has written agreements in place with its employees and consultants that address IP ownership and non-disclosure obligations. These agreements should be closely scrutinized to ensure they sufficiently protect the US customer's rights and interests and are valid and enforceable under Indian law.

To the extent practicable, and depending on the nature and sensitivity of customer IP involved in the project, a US customer should consider entering into non-disclosure and IP ownership agreements directly with the provider employees and consultants who will be assigned to the project. In that way, confidentiality and IP ownership obligations should remain in force even after the employee or consultant is no longer employed or engaged by the Indian service provider. In addition, the US customer will have contractual privity with such

employees and consultants, and it will have legal standing to sue in India (and, presumably, in other venues) in the event of a breach of their obligations.

#### IMPOSING NON-COMPETE RESTRICTIONS THAT ARE ENFORCEABLE IN INDIA

The operative contract should also include non-competition covenants that restrict the Indian service provider from using competitive technology or personnel in connection with the customer's competitors. The US customer must bear in mind, however, that India has stringent laws against overly restrictive trade practices. The enforceability of a non-compete covenant, then, is subject to a case-by-case determination, and any particular terms cannot in every case be assumed to be enforceable.

The Indian Contract Act provides that a non-compete agreement will not be enforced to the extent that it restrains a person from exercising a lawful profession, trade or business. Judicial precedent under Indian law indicates, however, that an Indian court will enforce a restrictive covenant if it meets what is known as a "reasonableness" test. For example, a restrictive covenant imposed during the period of the subject's employment is more likely to be upheld than is a covenant operating after the termination of employment.

In *Niranjan Shankar Golikari v. The Century Spinning & Manufacturing Co. Ltd.*, the Supreme Court of India upheld a restrictive clause in an employment contract that imposed constraints on the employee not to reveal or misuse during the period of the employment any trade secrets that the employee learned while employed. Similarly, Indian courts tend to apply a stricter level of scrutiny to non-competition provisions in contracts for the provision of services than to contracts solely for the sale of a business or to franchise agreements that restrain the franchisee from dealing with competing goods. This tendency on the part of the courts makes the drafting of non-compete provisions in offshoring contracts a critical and sensitive task.

#### ENFORCING PROPER CHECKS AND BALANCES ON SUBCONTRACTING

Subcontracting by the Indian service provider can dramatically increase the customer's IP risk profile. Therefore, proper checks and balances should be

placed on the provider's ability to subcontract any portion of the offshored services.

To the extent possible, the US customer should require that subcontractors enter into contractual commitments that are directly enforceable by the US customer. At the very least, the US customer should insist upon contractual controls that:

- require prior approval rights with respect to all subcontractors and that retain the customer's right to review the terms of all subcontracts;
- require flow-down of certain mandatory provisions to safeguard the US customer's rights and interests, such as data privacy, IP ownership and assignment provisions and confidentiality obligations;
- enable performance of thorough due diligence with respect to subcontractors;
- require the Indian service provider to be contractually responsible for subcontracted functions; and
- maximize, to the extent practicable, the customer's chances in India of being positioned legally to enforce contractual protections regarding data privacy, confidentiality and IP ownership directly against the subcontractor.

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Subcontracting by the Indian service provider can dramatically increase the customer's IP risk profile.

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#### IMPLEMENTING EFFECTIVE INFORMATION GOVERNANCE MEASURES

The US customer should perform a thorough, engagement-specific risk assessment prior to sending any sensitive information offshore. The customer should also develop and implement effective information-governance strategies and internal security measures to control the access, availability and dissemination of trade secrets and confidential information in India. Key measures should include:

- requiring meaningful background checks to be performed on employees and consultants engaged by the Indian service provider and assigned to the US customer's account;
- permitting controlled access on a need-to-know basis;

- managing attrition and turnover rates of employees;
- briefing employees on security measures and conducting exit interviews of ex-employees to remind them of continuing confidentiality obligations;
- performing routine audits to verify a service provider's compliance; and
- to the extent possible, marking hard copy documents and electronic data with "confidential" or "proprietary" legends prior to their circulation.

Given that most security breaches result from internal employee misconduct, the US customer should require its Indian service provider to implement sound personnel security controls. These measures should be implemented via a three-pronged approach of employee screening, rigorous training and robust disciplinary processes.

#### ASSESSING NEED FOR LOCAL PATENT REGISTRATIONS IN INDIA

Before embarking on an offshoring transaction involving India, a US customer should determine whether to protect IP that might be shared or created in India through trade secrets or by obtaining a local Indian patent. In this context, a fundamental question is whether to seek local patent protection for any invention that is either patentable or already patented outside India and that will become available in India as a result of the outsourcing engagement. Similarly, the customer must determine if local patent protection should be sought for any project-related innovations originating in India and if subsequent global filings should be initiated for any India-originated innovations.

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By applying a well-considered patent strategy upfront, a US customer can minimize both infringement risk and the risk of potential loss of any global patent rights in light of differing standards of patentability worldwide. To a large extent, the customer's patent strategy will be driven by the nature of the offshoring project and by the degree of critical IP involved. For example, in a KPO in India involving research and development of chemical entities, it may be worthwhile

to obtain local patent protection for the chemical entities. Similarly, in a KPO involving the manufacture of drugs in India, the customer may wish to obtain local patent protection for the drug formulations in order to prevent local generic companies from copying the drug.

A key benefit of patent protection is that it provides the patent owner with a bundle of strong statutory rights. These rights may be enforced against any third party in India to stop unauthorized use of the patented technology, regardless of the existence of any contractual or fiduciary relationship.

Furthermore, independent development of a patented technology, unlike a trade secret or a copyright, is not a defense to a claim of infringement. While not usually a significant risk, a US customer in India should generally be aware that Indian patent laws empower the government to grant a "compulsory license" to a private party or a government agency under certain circumstances.

India's patent laws also provide for broad "research and experimental use" exceptions. Customers should be aware that under these exceptions, a third party's experimental use of a patent, even for commercial purposes and without the patent owner's consent, does not constitute infringement in India.

Finally, a US customer must keep in mind that computer programs and business methods continue to be *per se* not patentable in India. Consequently, they must be protected as trade secrets through appropriate contractual protections.

#### OTHER IP CONSIDERATIONS

As a practical way to manage IP risk, the US customer should conduct and implement best risk-management practices prior to initiating any KPO arrangement in India. At a minimum, the customer should:

- perform detailed, upfront due diligence of the Indian service provider to evaluate the entity's track record for protecting IP;
- be extremely selective about the IP that is to be offshored and avoid where possible offshoring critical technology;
- maintain core components of the offshored IP in the United States; and
- require frequent disclosure of work-in-progress and



periodic receipt of incremental project deliverables during the course of the initiative, in order to avoid being denied access to such technology in the event of a dispute or bankruptcy.

To further mitigate risk, a customer may adopt a “distributed R&D model” by dividing R&D responsibility among multiple supplier entities and, if appropriate, across multiple jurisdictions. The customer should note, however, that distributed R&D can be expensive, since additional capital and resources will be required to manage and integrate results from the various participating entities.

#### EXPLORING MECHANISMS TO MITIGATE ENFORCEMENT RISKS IN INDIA

The enforcement of the US customer’s rights and remedies is always a vital concern, and those concerns can be exacerbated when dealing with an Indian service provider. This is particularly true if the provider has few or no meaningful assets in the United States against which a judgment could be executed.

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*Jurisdiction and enforcement provisions in the operative contract should be thoughtfully crafted to provide the US customer with adequate, flexible rights and remedies consistent with the nature of the business or knowledge process and the underlying customer IP being offshored to India.*

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If the Indian service provider has meaningful assets located in the United States, and if a US plaintiff successfully obtains a judgment in a court of competent jurisdiction, the judgment can be enforced against those US assets with relative ease. If a dispute with an Indian service provider is adjudicated in the United States, however, but the provider’s primary assets are located in India rather than in the United States, the customer must seek redress within the Indian legal system to obtain and enforce a judgment against the provider’s India-based assets.

Efforts to enforce a foreign judgment in India can be arduous, time-consuming, expensive and unpredictable. If an Indian provider has few meaningful US assets, then it may be advisable for the US customer to institute an initial claim against the provider in India, rather than in the United States.

This may obviate the customer’s need to re-litigate the claim in India as a means of enforcing a US judgment against the provider’s Indian assets.

This approach may be especially true if the US plaintiff is seeking injunctive relief and if time is of the essence. Jurisdiction and enforcement provisions in the operative contract should be thoughtfully crafted to provide the US customer with adequate, flexible rights and remedies consistent with the nature of the business or knowledge process and the underlying customer IP being offshored to India.

The US customer should perform early due diligence to identify the physical location of the Indian service provider’s assets. This initial effort will enable the customer to assess its potential ability to enforce rights and remedies with respect to an Indian service provider. It will help the customer determine the extent of the Indian provider’s US presence and, correspondingly, to evaluate local provider assets that will be available for the satisfaction of judgments.

To further mitigate enforcement risks, the US customer should explore alternative measures, such as insurance, performance bonding, letters of credit or guarantees from the Indian service provider and its financially responsible affiliates. In addition, the customer should ensure that it retains flexible, rules-based termination rights.

To best mitigate the risk of an Indian service provider seeking refuge in an Indian court and being mired in prolonged litigation and subject to unfamiliar procedures, private arbitration is the preferred means of dispute resolution in an offshore sourcing transaction involving India.

#### CONSIDERING ALTERNATIVE DISPUTE RESOLUTION MECHANISMS TO MAINTAIN CONFIDENTIALITY

In India, litigation concerning breach of trade secret protection clauses can lead to open disclosure and consequential loss of the trade secrets at issue if the legal proceedings are not closed. For this and other reasons, the operative contract should require that all disputes relating to the US customer’s trade secrets and confidential information be subject to confidential mediation or arbitration, rather than to litigation. The contract should also specify that these dispute-resolution measures will, if possible,

be conducted in a non-Indian venue and that all IP and information involved in the proceeding will be treated confidentially. The relative ease of enforcing foreign and India-based arbitral awards in India provides an additional compelling reason for adopting arbitration as the formal dispute resolution mechanism in India.

#### DETERMINING THE APPROPRIATE OFFSHORE DELIVERY MODEL

A potential US customer may consider adopting a “captive” offshoring model involving offshoring through affiliated legal entities in India. Implementation of a captive model may be especially appropriate if the business would experience significant adverse impact and cost as a result of losing control over IP that would be transferred to, or created in, India.

It is not surprising that a high percentage of captive offshoring transactions in India are in IP-intensive sectors such as advanced software, high-tech electronics and pharmaceuticals. Establishing a captive in India will provide the US customer with more control over day-to-day operations and IP.

A customer must balance that benefit, however, against the increased capital outlays and expense

inherent in captive models. In addition, a majority of the critical legal issues discussed in this article are as relevant to captives as they are to other outsourcing structures. The need to carefully evaluate and address these issues will be equally critical regardless of the offshore delivery model elected by the customer.

#### Conclusion

In summary, offshoring to India cannot only yield significant cost savings and increased efficiencies but also leverage India’s vast knowledge class to perform “high-end” KPO services and functions. However, because of the potential risks to a customer’s IP that may be transferred to or created in India, a US customer contemplating an offshoring project in India must carefully assess India’s IP legal framework vis-à-vis the business or knowledge process that will be offshored, and accordingly determine the necessary and available safeguards to protect its IP, including trade secrets and confidential information. These safeguards may include statutory and common law protections, but carefully crafted and robust contractual provisions combined with practical and enforceable mechanisms to minimize IP-related risk are mission-critical and should be an integral component of any offshoring project in India. ♦

# Outsourcing Contracts with Indian Suppliers: What to Expect When Enforcing US Customers' Rights and Remedies in India

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In any offshore outsourcing transaction, the enforcement of the US customer's rights and remedies is always a vital concern. Those concerns can be exacerbated when dealing with an Indian supplier with few or no meaningful assets in the United States against which any judgment or arbitral award could be executed.

If the Indian supplier has meaningful assets located in the United States, and if a US plaintiff-customer successfully obtains a judgment against the supplier in a US court, the judgment can be readily enforced against those US assets. Significant issues arise, however, when the Indian supplier's primary assets are located in India, rather than in the United States. In that event, and even if a dispute with the supplier has been successfully adjudicated in a US court, the US plaintiff must still seek redress within the Indian legal system to obtain and enforce a judgment against the Indian supplier's India-based assets.

Therefore, a US customer should understand upfront the Indian supplier's corporate structure, including the location of assets within the supplier's corporate family, and structure the dispute resolution provisions to maximize the possibility of recovery against the Indian supplier's assets in the event of a dispute.

If the Indian supplier has assets in multiple jurisdictions outside the US,

the US customer should seek recovery against the Indian supplier's assets in a jurisdiction that will be most effective vis-à-vis the customer's suit. For example, if the Indian supplier has assets in both the UK and India, it may be prudent for the US customer to seek enforcement of a US judgment against the Indian supplier's UK-based assets. This is because the enforcement of US judgments by UK courts is relatively routine.

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Under Indian law, a US judgment is not directly enforceable in India.

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Whenever possible, the US customer should also consider additional mechanisms beyond the operative contract in order to guarantee performance and payment from the Indian supplier. Such protections might include, for example, parent or affiliate guarantees, letters of credit, payment escrow accounts, product liens and security interests and insurance, as applicable.

## Enforcing US Judgments in India

Under Indian law, a US judgment is not directly enforceable in India. Rather, it can only be enforced by filing a fresh lawsuit in an Indian court based on the US judgment, which will be treated as a component of the plaintiff's evidence against the Indian defendant. It should be noted that such a lawsuit can

require years before any relief is actually awarded by the Indian court. Furthermore, the US judgment will not be enforceable in India if the Indian court determines that:

- The judgment was not issued by a court of competent jurisdiction.
- The judgment was not issued on the merits of the case.
- The judgment appears to be founded on an incorrect view of international law or a failure to recognize Indian law if such law is deemed applicable.
- Principles of natural justice were ignored by the US court.
- The judgment was obtained by fraud.
- The judgment sustained a claim founded on a violation of any law in force in India.

Only when a judgment is obtained from the Indian court in this proceeding may the US customer seek to attach the Indian supplier's assets in India. This restriction also applies to any injunctive relief issued by a US court that will need to be enforced against a defendant in India.

The enforcement process is much more simplified and streamlined with respect to certain countries designated as "reciprocating territories" by the Indian government. Foreign judgments passed by courts of these "reciprocating territories" can be directly enforced in India by filing execution proceedings, and they are deemed to be decrees of the Indian courts for enforcement purposes, thereby considerably speeding the process. India's designated reciprocating territories include the UK, Singapore, Hong Kong, Malaysia, Canada and New Zealand, to name a few. The United States is not considered by India to be a reciprocating territory.

Efforts to enforce a foreign judgment in India can be arduous, time-consuming, expensive and unpredictable. Consequently, US customers of Indian outsourcers should incorporate effective jurisdiction and enforcement provisions in the operative outsourcing contract. This will help to ensure that the US customer is protected by adequate, flexible rights and remedies that are appropriate to the nature and scope of the services outsourced to the Indian supplier. Particular

care must be taken to safeguard any intellectual property (IP) or other sensitive or proprietary data that may necessarily be transferred to the Indian supplier in the course of the outsourced engagement.

## Enforcing Governing Law and Forum Selection Provisions

Indian courts recognize private international law principles and will generally enforce choice-of-law clauses agreed upon by the parties, except under very limited circumstances. Exceptions to this general rule are made if, for example, the chosen governing law would violate public policy in India in some way. Thus, in the operative outsourcing contract between an Indian supplier and a US customer, the customer must always unambiguously require a particular state's law as the governing law of the contract.

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*A US customer should be cognizant of the effect that Indian laws might have on the contract terms agreed upon by parties to an outsourcing arrangement.*

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A US customer should be aware, however, that Indian courts may nonetheless apply Indian law to adjudicate disputes in certain fields, including disputes involving IP, real property, labor issues and insolvency, for example, regardless of the governing law stipulated in the contract, thereby limiting the practical realization of the contract's intended protections should the Indian supplier seek protection in an Indian court. Therefore, a US customer should be cognizant of the effect that Indian laws might have on the contract terms agreed upon by parties to an outsourcing arrangement.

Indian courts also generally recognize forum selection clauses, including clauses that require the parties to litigate disputes in a foreign jurisdiction. To avoid becoming embroiled in litigation in Indian courts, a US customer should require that the parties adjudicate any dispute arising from the licensing or technology transfer transaction exclusively in a US jurisdiction or a "neutral," non-Indian jurisdiction.

To be enforceable in India, exclusive foreign venue provisions should be carefully crafted in accordance with Indian law requirements and should include express waivers. One exception to an exclusive venue provision that may be beneficial to a US customer

would be to retain the customer's right to seek injunctive relief in a local court in India under appropriate circumstances, such as to stop an Indian party from the unauthorized use or disclosure of the US customer's IP in India.

It is important to note that enforcement of venue selection clauses are not without limitation in Indian courts. If an outsourcing contract contains an exclusive non-India venue provision but the Indian supplier seeks protection in an Indian court, that court may elect, at its discretion, not to enforce the venue provision. Instead, the court may act to adjudicate the lawsuit in India if it determines that justice will be better served.

For example, a US customer could find itself involuntarily in an Indian court if the Indian supplier, notwithstanding the agreement to submit to foreign jurisdiction, initiates an action in an Indian court or seeks an "anti-suit" injunction against the proceedings initiated by the US customer in a foreign court. In such a situation, the Indian court could decide to assume jurisdiction or could stay the action, depending on the circumstances of the case.

### Arbitration Preferred over Litigation

Among US and other international customers of Indian outsourcers, private arbitration is the preferred means of dispute resolution in commercial transactions involving India. Arbitration enables customers to mitigate the risks of an Indian supplier seeking refuge in an Indian court, of becoming mired in prolonged litigation, and of being subjected to unfamiliar adjudication procedures. Other factors, such as the confidentiality of arbitral proceedings and the relative ease of enforcing both foreign- and India-based arbitral awards in India, provide additional compelling reasons for adopting arbitration as the formal dispute resolution mechanism in India.

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India is a signatory to the 1958 United Nations Convention on the Recognition and Enforcement of Foreign Awards, commonly referred to as the "New York Convention." The agreement makes a foreign arbitral award rendered in a "convention" country far

easier to enforce in India than are comparable court judgments. However, a foreign arbitral award may be challenged or refused enforcement in India on certain limited grounds. These include:

- Incapacity on the part of any parties to the contract
- Invalidity of the arbitration agreement under the law governing the dispute
- Lack of due process afforded to either party
- An award that is beyond the arbitration clause's scope
- Matter that is not subject to resolution by arbitration under India's laws
- A situation in which enforcement would be contrary to public policy in India.

If an Indian court is satisfied that the foreign arbitral award is enforceable pursuant to India's Arbitration Act, it is deemed to be a decree of that court and is readily enforceable in India.

In an outsourcing transaction, therefore, the operative contract should unequivocally specify that all disputes relating to the transaction must be arbitrated. In addition, the contract should stipulate that the arbitration is to be conducted in the United States or (although less preferable) in recognized neutral, non-India venues, such as Paris, London or Singapore. The US customer should consider whether to preserve the right to seek injunctive relief in India depending on the circumstances specific to the transaction.

On January 10, 2008, the Supreme Court of India issued an important decision in *Venture Global Engineering v. Satyam Computer Services, Ltd.*, 2008 (1) CTC 348, regarding the enforcement in India of foreign arbitration awards. The Court's decision paves the way to challenge foreign arbitral awards in an Indian court based on broad public policy grounds and has important implications for any US customer that may find itself involved in an arbitration proceeding against a supplier located in India.

Specifically, the Supreme Court upheld a challenge in India to a foreign arbitration award on the grounds that the relief contained in the award violated certain Indian statutes and was, therefore, contrary to Indian public policy pursuant to Part I of India's Arbitration and Conciliation Act of 1996 (the "Arbitration Act"). As a result of the *Venture Global* decision, new risks exist with respect to the impact of Part I of India's



Arbitration Act on contract parties' rights and expectations in agreements that involve India and that contain arbitration clauses.

The Supreme Court's decision did recognize, however, the right of contract parties to exclude the application, in whole or in part, of Part I of the Arbitration Act in their contracts. Accordingly, new risks arising from the Court's decision may be mitigated through diligent analysis of Indian law concerning the rights and interests involved in a particular transaction, and through carefully drafted provisions in the underlying contract that expressly address issues raised by the Court's holding.

### Unpredictable Consequences of Indian Supplier Bankruptcy

In India, as in the United States and many other jurisdictions, a supplier's bankruptcy can have a catastrophic effect on the customer and can significantly impact the enforceability of the operative outsourcing contract. A party's bankruptcy can significantly alter the relationship of the parties by operation of law to effectuate the purpose of bankruptcy laws (i.e., to maximize the value of the debtor's estate).

The outcome of bankruptcy proceedings in India can be unpredictable and can pose severe risk to a US customer. If the Indian supplier becomes a debtor in bankruptcy, the status of the outsourcing contract, including any IP or proprietary technology that may have been licensed, assigned or otherwise transferred to or from the Indian debtor in bankruptcy, becomes a significant issue. Questions raised in this context include:

- Can a US customer unilaterally terminate the outsourcing contract and all underlying licenses to customer IP or proprietary technology when the Indian supplier files for bankruptcy in India?
- If not, what rights and duties will the Indian debtor-supplier continue to have with respect to the outsourcing contract and to any US customer's IP?
- Can the Indian debtor-supplier unilaterally terminate the outsourcing contract or otherwise cut off the US customer's access to the supplier's IP that might be critical for the US customer's operations?

- What legal recourse is available to a non-debtor contract party in India?

These are important considerations from a US customer's perspective that must be carefully analyzed and addressed beforehand in an effort to mitigate the unpredictable consequences of an Indian supplier's bankruptcy.

A US customer should be aware that India's bankruptcy laws are antiquated, complex and inefficient compared to US bankruptcy law. For example, India's bankruptcy laws do not provide any specific guidance like that found in Section 365 of the US Bankruptcy Code relative to the respective legal obligations and rights of licensors and licensees of IP in bankruptcy. Lack of available protections or predictability for non-debtor contract parties under Indian bankruptcy laws, therefore, can potentially create real vulnerabilities for the US customer.

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A US customer should be aware that India's bankruptcy laws are antiquated, complex and inefficient compared to US bankruptcy law.

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The unanticipated consequences of an Indian counterparty's bankruptcy may be avoided if the US customer is able to promptly terminate the operative outsourcing contract pre-bankruptcy. Of course, timely termination is usually feasible only if the US customer remains vigilant toward the Indian supplier's performance and financial health on a routine basis.

When drafting the outsourcing contract, care should be taken to include effective mechanisms that will provide the US customer with early warnings of supplier difficulty. Appropriate, applicable tools such as performance benchmarks, periodic financial reporting and "no material adverse change" certification requirements, as well as escrow arrangements and security interests in critical licensed IP, should be thoughtfully incorporated into the contract. In addition, payment terms, licenses and any ongoing obligations of the parties under the operative contract should be structured to minimize the impact of the Indian counterparty's bankruptcy on the US customer's interests.

## Enforceability of Third Party Beneficiary Rights

India, unlike the United States, does not explicitly recognize any established “third party beneficiary” law. Typically, such laws entitle a third party to enforce contract terms in agreements to which it is not a party but that are expressed or implied for that party’s benefit. In that context, a third party beneficiary is an intended—not just an incidental—beneficiary of a contract.

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Currently, Indian legal practice entitles only contracting parties to enforce rights, and hence to recover damages, under the contract.

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There is no statute in India that expressly permits or prohibits an intended third party beneficiary from enforcing such a contract. The general rule under Indian law to date, however, is that no right under a contract may be enforced by a person who is not a party to the contract unless certain established exceptions apply. In other words, Indian courts have adopted a rather strict interpretation of the doctrine of privity of contract based on English common law.

Currently, Indian legal practice entitles only contracting parties to enforce rights, and hence to recover damages, under the contract. Indian courts have acknowledged certain exceptions to the privity doctrine based on the principles of equity, but these exceptions are very limited and narrow in scope.

India’s strict application of the privity doctrine can potentially create a significant enforcement gap from a US customer’s perspective. To illustrate this point, consider a research and development (R&D) services outsourcing contract between a US company (“US Co”) and an Indian supplier, pursuant to which the supplier will provide services to US Co and US Co’s affiliate (“US Affiliate”), and the supplier’s indemnities will extend to both US Co and US Affiliate receiving the services under the outsourcing contract. In this

hypothetical situation, US Affiliate would be deemed an intended third party beneficiary under the contract.

If US Affiliate were to voluntarily or involuntarily engage in an Indian legal proceeding to independently enforce a supplier indemnity for the affiliate’s benefit, it could well be deemed not to have legal standing or sufficient rights or interests to sue under the contract. For the same reasons relative to standing, rights in interest, actual damages and so forth, US Co’s ability to enforce the contractual supplier indemnity for the benefit of US Affiliate would be equally questionable in an Indian forum.

It is therefore prudent to determine upfront the intended third party beneficiaries and, where feasible, to structure the contractual relationship in a manner that will adequately equip such beneficiaries with direct enforcement rights in India. Alternatively, the operative outsourcing contract can be assigned to a third party beneficiary, in which case the assignee beneficiary will be able to directly enforce the contract.

## Conclusion

While outsourcing to India can be a powerful means of streamlining IT and business functions that can yield substantial cost savings, increased efficiencies and improved service quality, it also demands more complex and robust risk assessment and management because of the unique and heightened risks inherent in cross-border outsourcing arrangements and the potential challenges of enforcing rights and remedies in foreign jurisdictions with different legal systems. These risks and challenges can be successfully managed, however, with thorough due diligence, objective supplier selection and the careful assessment and treatment of the issues discussed above in an outsourcing contract that memorializes all underlying business terms and provides effective real and practical protections and enforcement mechanisms to a US customer. ♦

# Is Legal Process Outsourcing Right for Your Company?

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Many corporate legal departments and law firms in the United States are experimenting with legal process outsourcing (LPO) as a means of reducing costs and increasing efficiencies while maintaining acceptable quality of service (QoS). The momentum behind the current popularity of LPO is, in part, a reaction to steadily increasing US legal costs and to the negative economic impact of the faltering global economy.

Global LPO growth potential may directly correlate with the overall size and projected growth of the legal services market in the United States. According to the US Census Bureau, our domestic legal services industry generated US \$236 billion in revenue in 2006 and is expected to grow steadily at a rate of more than six percent per year for the next decade. This sizeable market offers a highly lucrative environment for LPO to take hold.

To meet the growing demand for LPO, numerous providers have entered the marketplace, offering alternative service and promoting a distinct trend toward the outsourcing of certain legal tasks and procedures. As a result, the LPO model that, only a few years ago, was viewed with substantial skepticism and that raised questions of its own legality is now widely perceived as a feasible alternative means of addressing companies' legal needs.

That said, the framework required to properly regulate the LPO industry and to address the legal and ethical issues it is sure to raise is in a nascent—but rapidly evolving—stage. The US legal community has yet to take a definitive stance toward the viability of the LPO model. But the LPO industry appears eager to embrace some form of self-regulation as a means of fully establishing itself.

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In the context of an LPO initiative, a client company selectively delegates certain legal functions and services that are traditionally performed in the United States to an LPO provider based in an offshore location such as India. The provider offers the client a skilled or trainable workforce at costs that are significantly lower than those demanded by US counterparts. The basic value proposition of the LPO, then, holds that outsourced legal work will be performed offshore by trained, qualified and locally licensed lawyers and paralegal staff at a fraction of the cost of having the same work performed by US-based legal professionals.

Services subject to LPO agreements can range from tasks such as legal coding and legal transcription to more involved projects involving legal research, litigation support, document review, contract drafting and management, legal publishing and intellectual property-related services such as patent application preparation. In addition to significant cost considerations, LPO arrangements may also enhance home-base productivity by freeing a client legal department or law firm to focus on strategic, value-adding legal work and to take advantage of time zone differences in offshore locations, thus enabling 24x7 operations.

The ability of an LPO arrangement to provide real benefit to a client company depends substantially on two central factors: (1) a sober assessment of the client's legal needs and requirements; and (2) a realistic determination of whether the relevant legal services and tasks can be outsourced without sacrificing important qualitative considerations. Quality degradation, after all, will inevitably be counterproductive, resulting in the added cost of home-base "re-do" and elevating client risk.

A comprehensive and meticulously performed initial assessment of the pros and cons of LPO—basically, a diligent LPO "gating analysis"—will do much to determine if and under what conditions a company may successfully deploy the LPO model to meet its legal needs consistent with its overall strategic business goals and objectives. Some of the fundamental questions that should be addressed in the course of a thoughtful LPO gating analysis include:

- What are the legal needs, services and requirements that may be suitable for an LPO?
- What—if any—dependencies will make a complete handoff of the legal tasks and services unfeasible or impossible?
- Are the services needed on a recurring basis (e.g., patent application preparation), a non-recurring basis (e.g., unique litigation involving facts peculiar to a large contract) or an intermittently recurring basis (e.g., periodic product liability claims or certain due diligence tasks associated with transactions or filings)?
- Do the services at issue relate to core or non-core business functionalities?

- Does the customer assume additional risk related to the source of need for the legal services by engaging in an LPO? If so, how much risk is generated, and is it acceptable?
- How important is cost savings vis-à-vis QoS? How do the prospective outsourced services support or fit with the client's overall strategic business goals and objectives?

As part of the LPO gating analysis, potential LPO clients must carefully assess the generally applicable risks, ramifications and ethical concerns that are inherent in offshoring legal work and that accompany—and may outweigh—the benefits of LPO. Some key risks and ethical considerations peculiar to an LPO arrangement include:

- risk of unauthorized disclosure of confidential information;
- liability concerns related to the unauthorized practice of law;
- unintended or inadvertent waiver of the attorney-client privilege, including assessment of if and when the privilege will apply;
- possible lack of robust procedures to identify and resolve conflicts of interest;
- recognition, when applicable, of the need for client consent;
- fee-sharing arrangements and client disclosure; and
- compliance with export control laws with respect to offshoring information regarding US-originated inventions for patent drafting services.

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Most LPO demand in the United States currently involves low-value, labor-intensive legal services, such as legal transcription, document conversion, legal coding and indexing and legal data entry.

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Most LPO demand in the United States currently involves low-value, labor-intensive legal services, such as legal transcription, document conversion, legal coding and indexing and legal data entry. For the most part, these services are supplied by India-based LPO providers. As the LPO industry matures, however, the nature of outsourced legal work is expected to ascend the value chain.

Researchers at ValueNotes, for example, estimate that in 2006, India's LPO industry generated US \$146 million in revenue. They project industry revenue to grow to US \$640 million by 2010, at which time LPO firms in India are expected to employ over 32,000 India-based professionals. Another research company, Evalueserve, is more conservative in its LPO projections; but the fact that LPO is likely to become a sizable mainstay in the US legal services market is increasingly difficult to question.

India's emerging prominence in LPO is not surprising, given the nation's remarkable success as a global supplier of information technology outsourcing (ITO) and business process outsourcing (BPO). More recently, many US companies have engaged in what are known as knowledge process outsourcing (KPO) transactions, which leverage India's vast pool of highly skilled, well-educated workers to perform knowledge-driven or "high end" processes that require specialized domain expertise. Legal process outsourcing is actually a specialized form of KPO.

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India's professional labor pool shows no sign of shrinking. Approximately 80,000 new Indian lawyers graduate each year from law schools.

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Its enormous reservoir of well-qualified, English-speaking lawyers and paralegals helps to explain why India is a strikingly successful source of LPO. From a cost—as well as a quality—perspective, Indian legal professionals are extremely competitive. Typically, for example, they command salaries that are 80 percent to 90 percent less than those of their US counterparts. And India's professional labor pool shows no sign of shrinking. Approximately 80,000 new Indian lawyers graduate each year from law schools. These graduates are particularly well-suited to service US-based legal needs because, like the United States and the United Kingdom, India's legal

system follows the common law model. The nation's rapidly modernizing legal and regulatory environment, too, is based on the US/UK model of jurisprudence.

Currently, LPO demand in India is primarily met by two service delivery models. These models include captive centers operated by US corporations and law firms (such as those established by GE, Cisco, Oracle, DuPont and Bickel & Brewer); and third-party LPO firms that provide legal services to US corporations and law firms (for example, niche firms such as Pangea3, Qusilex and Lexadigm that only provide legal services, and multi-service firms such as Infosys and WNS that provide legal services in addition to other BPO offerings). Variations of these models will emerge as the Indian LPO industry matures and evolves to better service its customers.

Each of the two LPO models has specific advantages and risks that must be evaluated relative to a particular LPO strategy. LPO customers should be prepared to adopt different delivery models, taking into account numerous variables such as the nature and scope of the activities to be offshored; previous offshoring experience; a qualitative due-diligence review of potential providers' work; issues regarding security and control of confidential or privileged information; risk tolerance; and tax considerations and budgetary constraints.

Clearly, LPO can present a viable alternative to companies seeking to reduce their legal costs. Successful LPO implementation, however, demands thorough consideration and careful accounting of the engagement's circumstances and needs. A company considering an LPO must objectively evaluate the potential initiative's unique gating issues, especially those relating to its specific value proposition, the generally applicable risks of any LPO, the offshore location and the provider involved, and the type of LPO model best suited to the customer's needs. ♦



## JSM Expands Business & Technology Sourcing Practice in Asia with Relocation of Geoffrey L. Master

9 October 2009

JSM is expanding its well-regarded Business & Technology Sourcing (BTS) practice with the arrival of partner Geoffrey L. Master (马斯杰). Formerly based in Washington, DC, Geof will lead the expansion of the firm's BTS practice in Asia.

According to Geof, Asia is seeing a rapid growth in outsourcing business. Geof noted "Cost pressures and the profound implications of changes in technology have led businesses to look to outsourcing as an effective means to achieve cost efficiency and process improvements and obtain access to cutting edge technologies and business processes. Within the region, there are many impressive providers offering world-class outsourcing services on a global basis. Additionally, regional enterprises are increasingly looking to outsourcing and other service arrangements to acquire the scale and capabilities to compete globally. Our BTS practice is uniquely suited to meet the demands of clients entering outsourcing arrangements."

Paul Roy, a senior partner in the BTS practice, commented, "Our BTS practice's extensive experience in international outsourcing deals positions us very well to support inbound and outbound Asia transactions, particularly when combined with JSM's

strengths in the region. Geof is particularly well-suited as our lead BTS partner in Asia both because of his past international experience with one of the world's largest service providers and, more recently, his extensive work with customers in a wide range of international outsourcing deals."

Elaine Lo, Asia Chair and senior partner of JSM, commented, "Information technology and business process outsourcing and shared services activities in Asia are thriving. Now more than ever, our global network is essential for both international and regional clients seeking on-the-ground support for sourcing transactions. Mayer Brown has been at the forefront of information technology and business process outsourcings for many years. We are delighted to see Geof coming to Asia to support this important market."

As a partner in Mayer Brown's BTS practice, Geof has broad experience in information technology and business process sourcing transactions involving global and niche outsourcing providers, offshore captives and hybrid structures. Geof has represented clients in many different industries, ranging from startup enterprises to national and global firms, as well as governmental entities. Prior to

joining Mayer Brown, he served as International General Counsel for Electronic Data Systems Corporation (EDS), a global outsourcing provider often credited with originating the modern outsourcing industry. He is recognized by Chambers & Partners and others as a leading lawyer in the outsourcing field and frequently speaks at international conferences on a wide range of sourcing issues. Geof has been praised not only for his legal judgment but also for his excellent business sense and full awareness of commercial realities. ♦

## 孖士打律师行优化律师资源 提升亚洲商务及技术采购组实力

2009 年 10 月 9 日

孖士打律师行商务及技术采购组的实力进一步增强。于商务及技术采购领域杰出的合伙人马斯杰 (Geofrey L Master) 获调往香港办事处在该组任职。马斯杰此前在 Mayer Brown 华盛顿办事处工作, 今后将负责领导及扩大亚洲商务及技术采购组的业务及实力。

马斯杰认为, 亚洲的业务及技术采购业务正进入快速增长阶段。他认为, 「成本压力和技术改变带来的深切影响促使很多企业选择外包, 从而有效益和改善业务流程以及采用先进技术及商务流程。同时, 亚洲也拥有很多优质的外包商提供世界顶级的全球外包服务。此外, 区域性企业也越趋向通过外包和其它服务安排提升营运规模和实力, 在面临着与日俱增的全球竞争下, 更具竞争力。我们的商务及技术采购组正是客户满足这些需求的最佳选择」。

商务及技术采购组高级合伙人 Paul Roy 表示, 「我们的商务及技术采购组在国际外包方面拥有独一无二的经验, 凭借孖士打在该地区的实力, 该组可对该地区的进出口交易提供高质素法律服务。马斯杰在国际采购交易方面拥有丰富的经验, 特别适合担任我所亚洲商务及技术采购负责人。他曾协助多名客户处理广泛的国际外包法律事务, 之前亦于全球最大之一家外包服务商累积了丰富的国际经验」。

孖士打律师行亚洲区董事会主席兼首席合伙人罗婉文表示, 「亚洲的信息技术及业务流程外包和共享服务活动日渐繁荣。我们具备的全球网络, 现在比以往任何时候更能为国际及区域性客户的采购交易提供实地法律支援。多年来, Mayer Brown 一直处在信息技术及业务流程外包的最前沿。我们很高兴马斯杰能来到亚洲支援这一重要市场」。

作为 Mayer Brown 商务及技术采购组合伙人, 马斯杰在涉及全球及利基外包服务商、离岸控制及混合结构的信息技术及商务流程采购交易方面, 经验丰富。马斯杰的客户遍布各行各业, 其中既有国内公司、全球性公司、政府实体, 也不乏创业企业。马斯杰在加入 Mayer Brown 之前, 曾在美国电子数据系统公司 (EDS), 一家经常开展现代外包业务的国际公司, 担任首席国际法律顾问。他获《钱伯斯与合伙人》(Chambers and Partners) 及其它评鉴机构公认为外包领域的杰出律师, 并经常在众多国际会议上就一系列采购问题发表演讲。马斯杰超强的商业意识和对商业现实透彻的认识, 与他的法律判断一样令人钦佩。◆

## Author Profiles

### GEOFFREY L. MASTER

#### *Partner*

Based in the Hong Kong office, Geof Master leads the firm's Business & Technology Sourcing practice in Asia. He has broad experience in sourcing transactions, including outsourcing and offshoring information technology and services, as well as business processes in many countries. He writes and is a frequent speaker at international conferences on issues related to outsourcing and shared services.

### ANDY S. YEO

#### *Partner*

Andy Yeo counsels major companies operating in China on a wide range of human resource issues including drafting special contract terms, termination agreements, dismissal, compensation and restrictive covenants. He is based in the Shanghai office and has worked in China for more than 13 years. He frequently speaks on employment law in China and has been endorsed as a Highly Recommended Lawyer in HR industry publications.

### KENNY K. S. WONG

#### *Partner*

Based in Hong Kong, Kenny Wong is the head of the firm's IP/IT practice in Asia. He handles the full range of contentious and commercial IP and IT work and advises clients on setting up franchised operations in Hong Kong and Mainland China. His practice includes entertainment law, where he acts for copyright-collecting societies, production companies, celebrities and artists. He serves on various professional committees, including the IP Committee of the Law Society of Hong Kong.

### EUGENE I. LOW

#### *Associate*

Eugene Low has experience in all levels of civil litigation in Hong Kong and Chinese courts and handles a wide range of contentious and non-contentious IP and IT matters. He is also an accredited mediator of the Hong Kong International Arbitration Centre. He is based in the firm's Hong Kong office.

### R. TERENCE TUNG

#### *Partner*

Terence Tung, based in our Beijing office, has extensive experience in liquidation and debt restructuring and led the GITIC liquidation case. He also has experience in various contentious matters at the level of the People's Court at various provinces and municipalities in Mainland China and the High Court of Hong Kong, including banking, commercial and contractual disputes.

### SONIA BALDIA

#### *Partner*

Based in the Washington DC office, Sonia Baldia is a partner in the firm's Business & Technology Sourcing practice and co-chair of the firm's global India practice. Sonia is admitted to practice both in the United States and India and is a registered patent attorney with the US Patent and Trademark Office and Indian Patent Office. Her practice focuses on global sourcing transactions, international IP counseling and India-related corporate matters. She has been recognized by Chambers USA as a leading lawyer in business process and information technology outsourcing.

### DANIEL A. MASUR

#### *Partner*

Dan Masur represents clients in a broad range of on-shore, near-shore, and offshore information technology and business process sourcing transactions involving global and niche outsourcing providers, offshore captives and various hybrid structures. He is based in the Washington office. Prior to joining Mayer Brown, Dan served as general counsel of an outsourcing provider. Dan is recognized as one of the leading lawyers in this field by Chambers, Legal 500 and Best Lawyers in America.

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