

# The Hidden Risks of Outsourcing:

## Is Your IP Safe Abroad?

By Christopher L. Sorey

**T**he outsourcing debate has focused on the exportation of well-paying jobs to foreign countries. Close attention to job losses is justified when one considers that by the year 2015, the U.S. will have exported an estimated 3.3 million jobs to countries such as India, Russia, and the Philippines to the detriment of American workers.<sup>1</sup> A recent poll of U.S. corporate executives revealed that companies are ignoring the possibility of political backlash resulting from outsourcing and plan to send more jobs overseas in the coming months. Currently, only 30 percent of these companies indicated that they are moving forward in a cautious manner due to public outcry.<sup>2</sup> In previous years, outsourcing accounted for \$100 billion in revenue; projections for 2005 estimate that figure will grow to \$200 billion.<sup>3</sup> The savings generated by outsourcing cannot be ignored, but neither should the risks.

Besides the loss of jobs, intellectual property (IP) theft is another insidious threat to the American economy and its edge in the world markets. Companies looking to take advantage of the enormous savings produced in outsourcing arrangements have often ignored the risks to IP. These companies must be cautious because theft and devaluation of a company's IP have far-reaching consequences. Most companies do not adequately address the risk of exportation of intellectual property. Thus, these companies risk loss of competitive advantage and overall market share.

### Outsourcing: Why do Companies do it?

IN THE 1990'S, COMPANIES UTILIZED OUTSOURCING to gain expertise and to provide access to scarce information technology (IT) resources in a booming economic market.<sup>4</sup> Instead of starting an in-house IT division, an employer could contract with a third party to provide IT expertise. Common forms of this third party expertise included support for maintaining computer hardware and software systems, support operations, and telecommunications.<sup>5</sup> While the IT work may not have been in-house, at least it was in country.

Sending work abroad was once labeled "offshoring," and is still known by this term in some circles. Offshoring occurs when one company hires a foreign company to perform some business function. The definition of "outsourcing" has evolved to mean sending jobs and work overseas, and thus, these words have become interchangeable. As a result, when most people hear the word "outsourcing" they automatically assume it

means work going abroad.

In a world driven by profit, the cost savings aspect of outsourcing is the primary motivation for U.S. companies. For example, a company could acquire engineering services from three Indians, four Chinese, or five Russian workers for the same salary as one U.S. engineer.<sup>6</sup> However, American firms do cite other reasons for outsourcing. Companies claim that outsourcing gives their firm access to a larger skill set and cuts down on production time by freeing up domestic personnel to concentrate on more time sensitive projects.<sup>7</sup>

### An Illustration of the Risk

IN THE INFORMATION AGE, a company's edge over its competition is frequently embodied in either trade secrets or copyrighted source codes. Unfortunately, if stolen, a company is then hard pressed to regain a competitive advantage in its marketplace. A look at historical IP misappropriation best illustrates the risks involved with outsourcing.

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The year is 1876, and Alexander Graham Bell's telephone is sweeping the globe. It is the "must-have" technological advancement of its time. In Sweden, a company starts repairing the devices and, in that effort, is able to reverse engineer the product and start producing its own telephone. Ericsson, the Swedish phone company we know today, is born.<sup>8</sup> Ericsson's fortune is built on Bell's misfortune. Bell failed to file for patent protection in Sweden,<sup>9</sup> and this oversight resulted in the birth of an industrial empire. Bell was partially foreclosed from further exploitation of the Swedish market and the second comer was enriched by Bell's innovation.

A 2004 example illustrates the current dilemma. An employee at an Indian outsourcing firm was confronted by her

supervisors for suspicious activity taking place at her workstation. Allegedly, the employee was caught uploading source codes along with design documents and sending them to her Yahoo! e-mail account. When confronted, the employee excused herself from work and vanished.<sup>10</sup> Since this incident, Jolly Technologies, Inc. (“Jolly”), the American company that outsourced the work to India, has pleaded to no avail with Indian authorities to arrest the alleged thief and enforce India’s law. Likewise, Jolly has met resistance from the Indian IT industry group that represents outsourcing firms in India. Jolly also alleges that the Indian police asked for what amounted to a bribe before they would seek the criminal suspect. The situation has forced Jolly to file suit in India accusing the police of negligence, claiming that they refused to investigate the case.<sup>11</sup> This story is just the tip of the IP iceberg. Many of these crimes go undetected or unreported – just as individuals are reluctant to report crimes



where one has been duped, companies may also be reluctant to report IP theft because of the repercussions at home.

Stories such as these illustrate reasons why companies should be cautious when outsourcing IP. Source code (i.e., the uncompiled code of a computer program) is the backbone of many companies’ business. To get computers to do the wonderful things they do, the computer must be provided with instructions. The instructions are written in source code, which then translates in the form of binary object code that is readable to the computer. These codes are often times very long and intricate. In one case, a source code for a simple alarm clock was roughly

11,000 pages long. For many companies, source code is much more than propriety information. Source code is the “secret sauce,” so to speak, and once it is out of a company’s control, the company loses its competitive edge in the market. Source code and other intellectual properties are easily susceptible to theft and misappropriation when placed in the wrong hands.

As illustrated by the Jolly Technologies case, stealing source code may consist of four simple steps: (1) “Select all,” (2) “Copy,” (3) “Paste,” and (4) “Send.” The ease and speed with which one can steal source code is surprising; a company’s edge in the marketplace may be erased in a matter of seconds.

Companies that outsource should not be surprised when their IP is misappropriated, particularly when their outsourcing involves information technology. India, which is one of the leading outsourcing destinations, is a hotbed of software piracy. In fact, the International Intellectual Property Association found that Indian piracy levels for business software applications were 69 percent in 2003.<sup>12</sup> China, another outsourcing hotspot, posted a piracy level of 92 percent.<sup>13</sup> The Philippines and Russia, which are developing reputations as outsourcing destinations, had piracy levels of 60 percent and 93 percent respectively.<sup>14</sup> Nonetheless, U.S. companies continue to ship critical and sensitive work to outsourcing vendors in these countries. The piracy numbers either reflect a public disrespect for intellectual property rights or a lack of enforcement by the respective governments.

The outsourcing trend does not appear to be slowing despite political backlash in the United States. Instead, the political rhetoric on the campaign trail has drawn more attention to the benefits of outsourcing, such as the low cost and high level of expertise found in places like India.<sup>15</sup> As one expert noted “Indians are doing for information technology processes what the Japanese did to manufacturing processes in the 1970’s.”<sup>16</sup> Well-respected companies like Accenture, Unisys, and Google are planning to expand outsourcing operations in India. Apparently, the risk of IP portfolio theft is outweighed by the hope of saving a dollar.<sup>17</sup>

A 1998 study by the Brookings Institution reported that 85 percent of Standard and Poor’s 500 (S&P 500) companies’ market value consisted of intangible assets.<sup>18</sup> The bulk of these intangible assets were intellectual properties such as copyrights, patents, trademarks, and trade secrets. Federal Reserve Chairman Alan Greenspan noted “the economic product of the United States has become so predominantly conceptual”<sup>19</sup> and that “intellectual property can be stolen by an act as simple as broadcasting an idea without the permission of the originator.”<sup>20</sup> When a company’s intellectual property is misappropriated or stolen, the value of the IP assets decrease and the company’s market value decreases. This devaluation can be devastating and account for losses stretching into billions of dollars.

For instance, if 85 percent of the market value of the S&P 500 is composed of intangible assets and that number is diminished by even 1 percent, the value of U.S. corporations would be substantially deflated.<sup>21</sup>

### Protections Already in Place

AT HOME, AMERICAN COMPANIES ENJOY THE BENEFIT of a very strict IP regime. Of course, we have all heard the stories of 12 years old children nefariously circumventing copyright law with Napster and cd burners. However, when it comes to software, the U.S. has the lowest piracy rate in the world.<sup>22</sup> Software makers attribute this low rate to strict enforcement policies.<sup>23</sup> U.S. IP enjoys protection by the U.S. Patent and Trademark Office, the Copyright Office, the Customs Agency, the Justice Department, and complex internet laws. While most people are acquainted with the civil aspects of these protections, there are also criminal protections for IP theft. Both copyright law and trade secret law allow for the criminal prosecution of violators. However, IP protections outside of U.S. borders are not so broad.

What level of IP protection can American companies rely on when conducting business abroad? Although protection for both software and source-code is available under U.S. copyright laws, international protection of software is a bit trickier. Copyright protection abroad consists of a series of treaties patched together. Currently, a truly global copyright

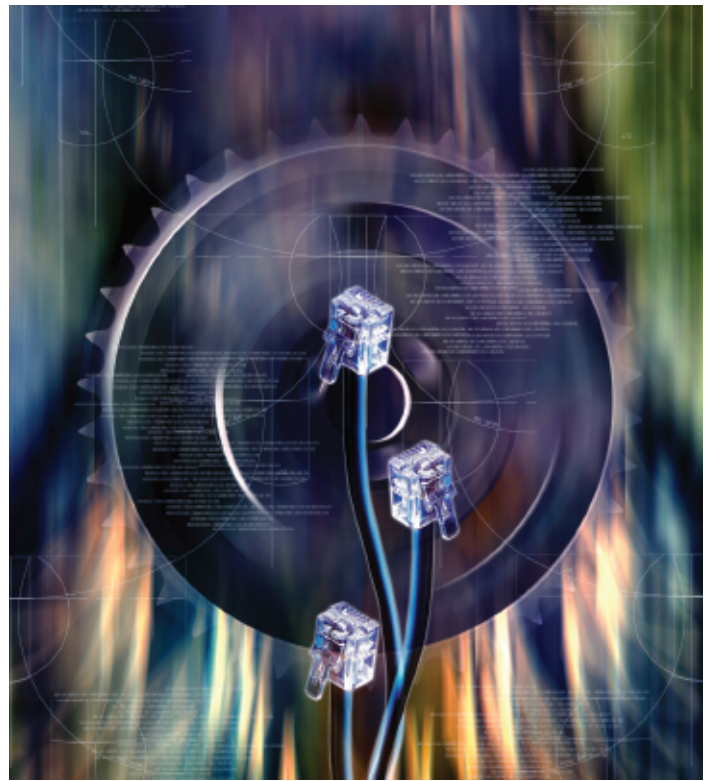
**“Although protection for both software and source-code is available under U.S. copyright laws, international protection of software is a bit trickier.”**

protection scheme does not exist. Essentially, treaties and agreements tie the copyright regimes of many countries, including the U.S., together.

The most important of these arrangements resulted from the formation of the World Trade Organization (WTO). With the birth of the WTO came the Agreement on Trade-Related Aspects of Intellectual Property, the so-called “TRIPS” Agreement. The TRIPS Agreement subjects WTO member nations to substantive copyright obligations laid-out in the earlier Berne Convention. Under TRIPS, member nations must meet minimum standards of IP protection and must comply with Articles 1 through 21 of the Berne Convention (except

Art. 6).<sup>24</sup> Specifically, all member nations are required to protect computer programs under copyright law.<sup>25</sup> The requirements laid out in TRIPS appear to provide assurances on a global scale, but some member countries’ approach to IP law enforcement remains a problem.<sup>26</sup>

The U.S. government’s frustration with many multilateral IP agreements’ enforcement has led to the creation of bilateral agreements, which attempt to provide better IP protection for American companies.<sup>27</sup> The economic interests of American companies have also prompted the U.S. government to go a step further and unilaterally monitor and sanction countries that fail to enforce IP protections.



In an attempt to protect American interests abroad, the U.S. reserves the right to monitor IP piracy and impose sanctions against countries that fail to enforce obligations arising under WTO membership and TRIPS. This monitoring and sanctioning is mandated by Congress under the Omnibus Trade and Competitiveness Act of 1988. Under 19 U.S.C. § 2216, Congress authorized the United States Trade Representative (USTR) to monitor the implementation of trade agreements between the U.S. and foreign nations.<sup>28</sup> If the USTR determines a foreign nation is not implementing or satisfactorily enforcing IP protection, then the USTR may levy sanctions against that country.<sup>29</sup> In addition, the USTR releases an annual report, the “Special 301” Annual Review that groups nations into three categories based on the nations’ respective enforcement of IP rights.<sup>30</sup>

Special 301 reports examine approximately 70 countries. Countries with the most egregious reputations for protecting IP rights are placed on the Priority Foreign Country's list.<sup>31</sup> In the 2004 report, 16 countries were placed on the Priority Watch List. India, the Philippines, and Russia, all outsourcing destinations, were on the Priority Watch List, designating those nations that have the most adverse impact on U.S. IP owners.<sup>32</sup> Casting a blind eye to this information is dangerous, but companies looking to expand their profit margins have done just that.

### Outsourcing as the Mechanism of Change

As nations increase dependence on the revenue generated by outsourcing agreements, some are taking steps to improve their enforcement of IP rights. Although revenue is likely the single greatest motivator, some nations are motivated by the prospect of removal from the Priority Watch List of the Special 301 reports.

While money has been cited as the root of all evil, the almighty dollar could also be cited as the root of change. In one year, India's IT sector exported \$10 billion worth of products and expects to double that figure in the coming years.<sup>33</sup> Like it or not, India will have to make its business climate friendly to prospective companies if it wishes to see this trend continue. India is fully aware that the one way to attract and keep business is to enforce and strengthen its existing IP regime. To its credit, the Indian government has intensified enforcement and implementation of IP laws.<sup>34</sup> The effect that outsourcing has had in India could be replayed across the globe. Logically, other countries will want to compete for outsourcing dollars and will likely tout their own IP enforcement programs as incentive for American companies to send work their way.

Nevertheless, many countries have yet to institute measures protecting foreign IP rights. With many American companies competing with their outsourcing brethren, it is unlikely that a "wait and see" approach is viable or affordable. So what can the cautious American company looking to outsource do to insure that it does not lose its secret sauce in the process?

### Ways to Safeguard IP

First, companies interested in outsourcing should take advantage of the resources available to American companies. Companies should investigate whether a potential outsourcing

destination is on the Priority Watch List of the USTR – companies should be cautious or simply avoid countries listed. These Priority countries will have incentives to implement and enforce IP laws if the work stops coming in. Until that time, companies are best served by refusing to send work to these IP scofflaws.

Second, when in Rome do as the Romans do, or at least know the Romans. Companies should consider filing for local IP protection in the host country. To accomplish this, the company should make a concerted effort to learn the laws of the host country. One option is retaining counsel in the host country to address any IP issues that may arise. Before shipping IP, companies should investigate the protections available and the host countries' methods of enforcement.<sup>35</sup>

Finally, companies should ensure that any company with which they enter into an outsourcing agreement with has a U.S. office or subsidiary. This suggestion directly relates to jurisdiction. If something happens in the outsourcing arrangement that would lead to a cause of action against the vendor, then the company would likely have recourse in a U.S. court. Having an outsourcing arrangement with a foreign company that has a U.S. office or subsidiary may be useless unless the American company gets guarantees from the U.S. affiliate. If jurisdiction is a concern, another way of insuring future remedies is to have the parties agree to settle all disputes in arbitration.<sup>36</sup>

It is not likely that outsourcing will slow down in the near future. Globalization has directly led to this development and the problems we face now are merely growing pains. One positive development of outsourcing is that countries' desire to attract more business leads to the increased implementation and enforcement of IP laws. It is extremely important for any company to protect its IP and to take the precautions necessary to insure it does not lose its edge in the marketplace. For now, however, outsourcing is best ruled by the advice "*caveat emptor*."

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## ENDNOTES: Christopher L. Sorey

<sup>1</sup> *Experts See Vulnerability as Outsiders Code Software*, N.Y. TIMES, Jan. 6, 2003, § C, at 1.

<sup>2</sup> *Offshore Outsourcing Will Increase, Poll Finds*, WALL ST. J., Mar. 26, 2004, at B3.

<sup>3</sup> Scott W. Pink, *Recent Trends in Outsourcing: Understanding and Managing the Legal Issues and Risks*, 781 PLI/Pat 363, 365 (2004).

<sup>4</sup> *Id.* at 367.

<sup>5</sup> *Id.* at 365-66.

<sup>6</sup> *Experts See Vulnerability as Outsiders Code Software*, *supra* note 1.

<sup>7</sup> Pink, *supra* note 3 at 367.

<sup>8</sup> See Graham Dutfield, *Does One Size Fit All?*, 26 HARV. INT'L REV. (2004), WL 64898831.

<sup>9</sup> See *id.*

<sup>10</sup> Karl Schoenberger, *Outsource Firm Sues in India; Alleged Code Theft Highlights Foreign Risk*, SAN JOSE MERCURY NEWS, Aug. 25, 2004, WL 90574687.

<sup>11</sup> *Id.*

<sup>12</sup> USTR's 2004 "Special 301" Decisions, at [http://www.iipa.com/pdf/2004\\_April\\_08\\_losses\\_full.pdf](http://www.iipa.com/pdf/2004_April_08_losses_full.pdf) (percentages reflect the number of installed programs that are pirated); see also, *Software-Piracy Data Released*, WALL ST. J., July 8, 2004, at B5.

<sup>13</sup> USTR's 2004 "Special 301" Decisions, *supra* note 12.

<sup>14</sup> *Id.*

<sup>15</sup> *Outsourcing Storm Benefits India*, WALL ST. J., June 28, 2004, at A3.

<sup>16</sup> *As Technology Matures, So Does Outsourcing*, BOSTON GLOBE, Sept. 19, 2004, at E2.

<sup>17</sup> *Outsourcing Storm Benefits India*, *supra* note 15.

<sup>18</sup> See Ken Brown, *Outsourcing and the Global IP "Devaluation"*, at <https://www.adti.net/outop.htm>.

<sup>19</sup> Chairman Alan Greenspan, Remarks at the Stanford Institute for Economic Policy Research Economic Summit, (Feb. 27, 2004), at <http://www.federalreserve.gov/board/speeches/2004/200402272/default.htm>.

<sup>20</sup> *Id.*

<sup>21</sup> See Brown, *supra* note 18.

<sup>22</sup> See Cassell Bryan-low & Victoria Knight, *Software-Piracy Data Released*, WALL ST. J., July 8, 2004, at B5 (noting that of all installed programs in the U.S., only 22% were copied illegally.)

<sup>23</sup> *Id.*

<sup>24</sup> General Agreement on Tariffs and Trade – Multilateral Trade Negotiations (The Uruguay Round): Agreement on Trade-Related Aspects of Intellectual Property Rights, Including Trade in Counterfeit Goods, Dec. 15, 1993, art. 9(1), 33 I.L.M. 81 [hereinafter TRIPS Agreement].

<sup>25</sup> TRIPS Agreement, art. 10(2).

<sup>26</sup> See, e.g., Press Release, U.S. Department of State, U.S. Releases 2004 Report on Intellectual Property Protection (May 3, 2004), at 2004 WL 59151972 [hereinafter State Department Press Release].

<sup>27</sup> Symposium, Frank X. Curci, *Transnational Business Law in the Twenty-First Century: Protecting Your Intellectual Property Rights Overseas*, 15 TRANSNAT'L LAW. 15, 29 (2002).

<sup>28</sup> 19 USC 2419 (2000).

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> See Office of the United States Trade Representative, *Special 301 Priority Watch List* (May 3, 2004), at [http://www.ustr.gov/Document\\_Library/Reports\\_Publications/2004/2004\\_Special\\_301/Special\\_301\\_Priority\\_Watch\\_List.html](http://www.ustr.gov/Document_Library/Reports_Publications/2004/2004_Special_301/Special_301_Priority_Watch_List.html).

<sup>32</sup> See State Department Press Release, *supra* note 26.

<sup>33</sup> See Michael Fitzgerald, *U.S. Companies Outsourcing Their Software Developing Offshore can get Stung by Industrial Espionage and Poor Intellectual Property Safeguard*, CIO MAGAZINE (Nov. 15, 2003), at <http://www.cio.com/archive/111503/offshore.html>.

<sup>34</sup> Zinnov LLC, *Intellectual Property Rights Protection in India: An Analysis*, at [www.zinnov.com](http://www.zinnov.com) (on file with author).

<sup>35</sup> See Curci, *supra* note 27 at 30.

<sup>36</sup> See Karin B. Sinniger, *High Tech or Bye Tech??*, 13 BUS. LAW TODAY 59, 60 (2003).

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