

*Key IP issues in outsourcing*  
*Kuhnen & Wacker*

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# Key IP issues in outsourcing

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The idea of outsourcing has existed for hundreds of years. Outsourcing occurs when a firm allocates responsibility for an internal business function to an external service provider; it is used as a strategic management option, rather than just a cost-cutting measure. Potential targets for outsourcing include:

- information technology;
- business processes;
- manufacturing;
- data centre management;
- application management;
- human resources and/or selected human resources functions; and
- customer service/call centres.

However, large law firms and in-house patent and legal departments also outsource much of their IP work – for example:

- patent prosecution processes;
- prior art searches;
- preparation of patent illustrations;
- patent proofreading;
- patent drafting;
- patent and trademark docketing support;
- IP portfolio management;
- calculation of inventor remuneration;
- trademark identity or/and similarity searches; and
- searches for opportunities to assert IP rights.

An outsourcing supplier may be domestic or offshore (eg, an India-based call centre or supplier of prior art searches or patent drafting assistance). In the past, in order to reduce costs, manufacturers began to outsource complex production tasks rather than building

their core competencies by controlling the whole production process. Many large manufacturing firms established outsourcing relationships (eg, the relationship of the automobile industry with many different producers of metal, glass, rubber and electrical parts). As a result of global outsourcing, cost savings and productivity benefits could be achieved. Thus, many companies began turning over some or all of their production processes to business partners. Today, the outsourcing of primary supply chain activities is common and contract manufacturing is the norm in industries ranging from electronics and telecommunications to biotechnology. Outsourcing in the form of granting a licence to manufacture is also a well-established part of any IP licensing contract.

As information technology has continued to evolve, more sophisticated functions are now being outsourced – for instance, data management, document storage and technology platform maintenance. In the 1970s companies began providing computer services such as accounting and payroll processing on a contract basis. The primary benefit for customers was access to the latest equipment and skilled staff without a large upfront investment. As computers became cheaper and more widely available, IT services also evolved to converging computing platforms, open architectures, distributed computing, low-cost and high-quality networking, and packaged software.

This chapter first summarises the benefits and risks of outsourcing, and then considers the key IP issues in outsourcing. ‘Intellectual property’ is defined as rights such as patents, copyrights, trademarks, trade secrets, design rights and know-how.

### Reasons for outsourcing

In practice, in order to compete with other companies, a company should do its best to obtain useful sources from different channels and to build sustainable comparative advantages through different approaches (Hunt and Morgan, 1995). Companies outsource their business activities for various reasons, such as to:

- reduce costs and delivery time;
- reduce labour costs;
- avail of tax benefits in foreign countries;
- avoid strict obligations due to working contracts;
- improve quality and reliability by focusing on the core business and 'buying' specific knowledge from external partners;
- increase exposure to worldwide technology;
- use resources that are not available internally;
- gain access to materials available only externally;
- establish a presence in foreign markets;
- maintain sufficient flexibility to respond to changing market conditions;
- reduce the overall amount of specialised skill and knowledge needed;
- make capital funds available for more profitable operations;
- mitigate the risk of, for example, lost or disrupted business operability, resources and data in the event of a natural disaster; and
- combat the introduction of competition to the domestic supply.

Such comparative advantages will help companies to maintain and increase their market shares and profits. Gaining access to the best specialists and their knowledge without the obligation of a long-term working contractual relationship and while retaining competitive flexibility is – aside from cutting costs, by accessing a service provider which has lower-cost structures – the major reason to push companies to conduct global outsourcing strategies.

### General risks of outsourcing

Outsourcing does not offer only advantages. Efficient and effective communication is essential in business. However, the language problem can be fatal in systems analysis and design, especially for the development of application-oriented products. In addition,

cultural differences can present problems in outsourcing business in foreign countries.

Therefore, particularly in the case of long-term outsourcing, companies must deal with various problems and may experience disadvantages such as:

- a loss of future talent;
- difficult communication due to language problems;
- a loss of control over the services delivered;
- cultural differences between the parties;
- a loss of expert knowledge;
- a loss of leadership in R&D;
- primitive and unpredictable legal systems in certain countries, which are unable to cope with major disputes between companies and the government or between companies;
- a lack of transparency in local regulations, which can discourage foreign firms from doing business in some countries (eg, western businesses may find that rules and regulations are not published or are amended without prior warning);
- a loss of organisational performance;
- a loss of intellectual assets;
- a loss of confidential information and misuse of supplied information by the external supplier; and
- a loss of a monopoly because the external supplier also supports competitors.

Therefore, outsourcing companies need to find a way to maintain the advantages of outsourcing while avoiding or limiting the disadvantages.

### Outsourcing contracts

Given that many outsourcing projects are complex and business critical, negotiating terms and settling contracts are significant tasks to make outsourcing legal and binding. Outsourcing contracts set out the scope of the services, the performance standards, the pricing schedules and the terms and conditions. There are several critical components of a good outsourcing agreement. In every outsourcing arrangement a number of key contractual issues must be addressed, such as service description and measurement, statutory and regulatory requirements, transfer of employees, flexibility, IP rights, the term and the termination process. While

the traditional market valuation focuses on physical assets and inventory, the knowledge market values focus on intellectual capital. IP protection for assets such as patents, trademarks, design rights, know-how and copyright is vital to the success of a globally active company.

For this reason, some of the major stumbling blocks in the negotiation of an outsourcing contract can arise from the use, licensing, sharing, upgrading and return of intellectual property. The customer has, for example, trade secrets, trademarks, processes, patents and know-how that it has used in its business for many years, and the outsourcer needs access to all of these IP rights in order to run the outsourced business. The issue is complicated by the fact that some of the intellectual property may belong to a third-party licensor; some of it may be subject to confidentiality restrictions that prevent the outsourcer from seeing even the agreement; and some of it will be contributed by the outsourcer over the life of the contract, which can span several years. From an IP perspective, the parties must not only deal with what is transferred to the outsourcer when the relationship starts, but also think ahead to the ongoing operation, maintenance and upgrading of the various systems and databases involved, the confidentiality challenges that will arise and the inevitable overlapping of the IP rights of the customer and the outsourcer as their businesses become entwined. Perhaps even more importantly, they must agree on what happens when the relationship ends and the customer wants everything back – including intellectual property developed by the outsourcer.

Each party brings valuable intellectual property to the outsourcing relationship in one form or another, and each party or both parties in cooperation will continue to create new intellectual property during the term of the agreement. The process of working all this out can be time consuming and tedious, but it is imperative that it be done before anything is transferred to the outsourcer or the parties commit to a future relationship.

### **Key IP issues**

The following key IP issues must be considered when outsourcing:

- Define rules on how to handle confidential information within the outsourcing agreement or by a separate non-disclosure agreement, including trade secrets owned by the customer or belonging to a third party and in the control of the customer. This could also include personal information in the customer's possession that relates to its own customers or employees and that may be subject to federal or provincial privacy legislation.
- Conclude an agreement on the ownership of the IP rights generated before the outsourcing agreement comes into force.
- Conclude an agreement on the usage (including the timeframe and scope) of the IP rights generated before the outsourcing agreement comes into force.
- Conclude an agreement on who will be the owner or licensee of the IP rights generated during or based on the outsourcing contract (intellectual property developed jointly or by each party) – this is usually the most problematic issue, as both the supplier and the customer will want to own these IP rights. When drafting the agreement, the parties should consider carefully the ownership and licensing provisions. For example, if the supplier owns the rights, the customer should seek a royalty-free licence lasting beyond the end of the agreement and potentially extending to any replacement suppliers after termination.
- Define rules on how to enforce jointly owned intellectual property.
- Define rules for the procedure (ie, the transfer, assignment and remuneration of the inventors) if an IP right is abandoned by the rights holder.
- Consider any specific rights of the inventors employed by the outsourcing partner or its contractors (eg, rights of the inventors under the German or Austrian Inventors Act).
- Think about a licence for the company's own products even if the patent belongs to the outsourcing partner.
- Conclude an agreement regarding intellectual property previously licensed to the outsourcer by a third party and used to process the customer's data or to run the outsourced business.

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- Conclude an agreement for intellectual property licensed to the customer by a third party that the outsourcer needs to use.
  - Address appropriate cross-licences.
  - In the case of outsourcing development activities to universities, ensure that the resulting inventions are not published in scientific papers before the IP rights are filed for registration.
  - Include a liability clause for indemnifying the customer in case the product manufactured by the outsourcer infringes third-party rights.
  - Consider software licences as well as any third-party software required to perform the services (eg, specific testing software for manufacturing semiconductor components), including which party is responsible for obtaining the appropriate licences or permissions. It is common for the customer to seek an indemnity from the supplier stating that the provision of services does not infringe the IP rights of any third parties.
  - Consider data ownership.
  - Determine the privacy policies in the vendor's jurisdiction and the likelihood that the government there will attempt to access the intellectual property.

### Comment

This chapter summarises some important aspects which should be borne in mind with respect to intellectual property when parts of the business are outsourced. However, although the importance of intellectual property increases steadily, intellectual property is only one aspect to consider in third-party cooperation. Other issues that should be considered include:

- warranties;
- indemnification;
- liabilities (ie, damages, exclusions and exceptions);
- dispute resolution;
- non-compete/non-solicit provisions;
- tax issues; and
- employees and vendor personnel. *iam*

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Before joining Kuhnen & Wacker, Dr Zeitler was the head of patent and trademark prosecution at Qimonda AG, IP manager at Infineon Technologies and patent expert in Infineon Technologies' patent department. He frequently lectures on German and European patent practice and has presented seminars in Germany and the United States.