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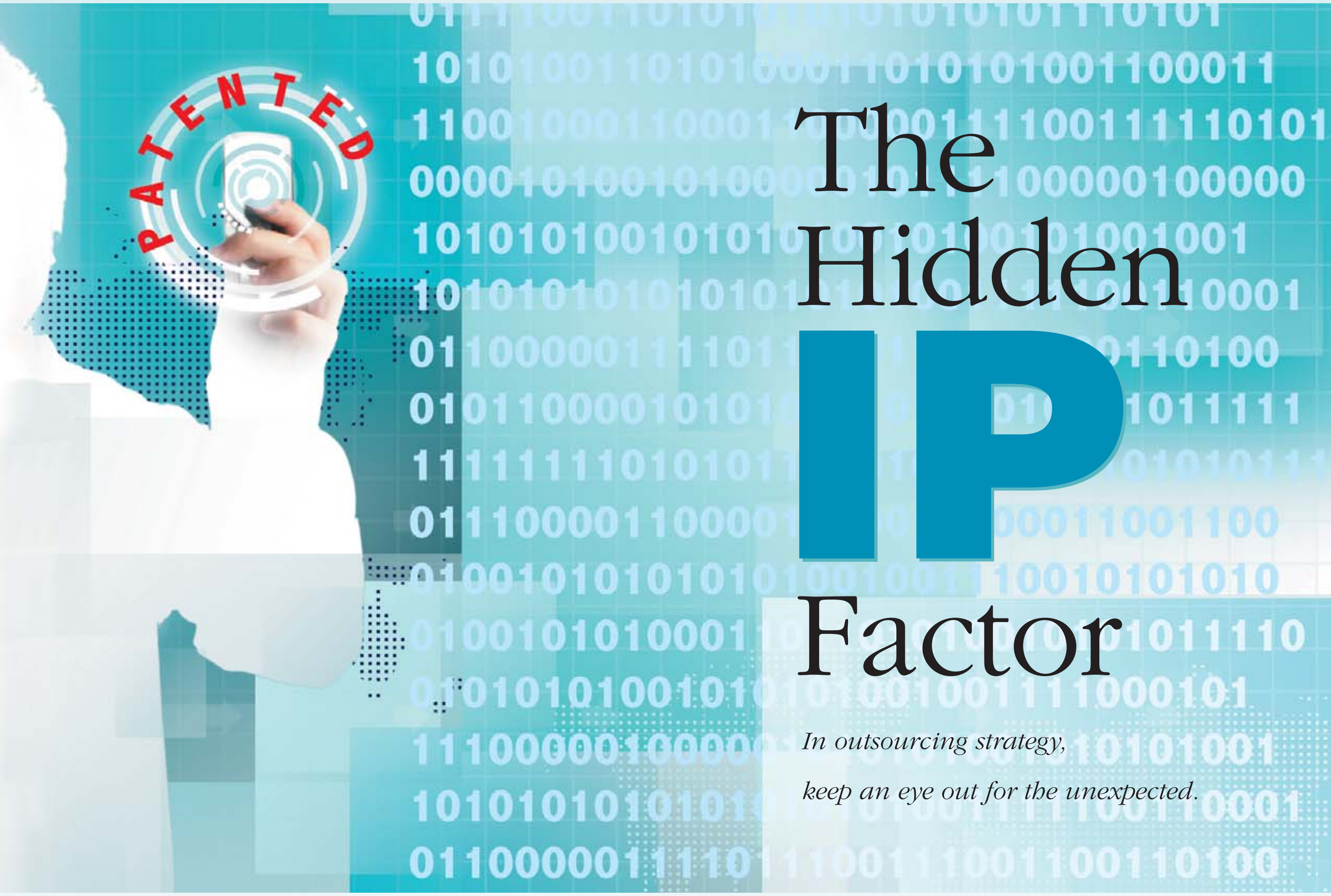

The Hidden IP Factor

In outsourcing strategy, keep an eye out for the unexpected.

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BY WILLIAM A. TANENBAUM

THE INCREASING importance of intellectual property issues in outsourcing presents both land mines and gold mines for general counsel guiding their companies through contract negotiations and transaction planning. Some IP issues are hidden in plain sight.

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Others are over-the-horizon issues that need to be recognized and planned for now. IP is important, for different reasons, in information technology, business process and business transformation outsourcing (ITO, BPO, and BTO respectively), and especially in what some in the industry are beginning to call "knowledge process outsourcing" (KPO), which encompasses offshore drug development, biotech research, data mining and other types of processing, research and development. The failure to address IP issues can have unintended consequences on both the business and legal level, and in some cases will deprive a company of the benefits it sought from outsourcing in the first place.

A general counsel should focus on identifying critical IP issues when determining outsourcing strategy and managing outside counsel. These issues include: (1) the emerging importance of patents in this field, and what new steps must be considered; (2) the potential dangers in agreeing to joint ownership of jointly developed improvements, and the need to address these in advance in the contract; (3) how the work-made-for-hire doctrine can lead to unanticipated IP results when using an independent contractor (as outsource providers often are) and/or having work performed offshore; (4) the IP aspects of force majeure provisions; and (5) the need to address post-termination IP rights when planning for the end of outsourcing.

Patent Issues

Methods of doing business are patentable (hence the term "business method patents"), and therefore a methodology or process that a vendor develops for use in delivering its services in business process outsourcing, such as automating a function in a particular way through software or inventing a particular process for mining data, can be patented, at least in the United States. (As a general matter, most foreign countries will not grant patent protection for software or business method inventions at all or to the same degree that patent protection is available in the United States.)

In fact, in the next few years, I predict that we will begin to see patent litigation in outsourcing. The issue will be whether one business process outsourcing provider can prevent another provider from using business methods that the first provider claims are patented and exclusively owned by itself. The first vendor will sue the second claiming the second has no right to use such business methods to provide services to customers. Conceivably, a customer could also be named in a suit as an infringer of patented business methods that its own provider does not own, but is nonetheless using to provide services.

I also predict we will see the emergence of a new executive position—"Chief Sourcing Officer." This "CSO" may replace the CIO or CTO in managing outsourcing transactions, and will turn to general counsel for advice on how to use IP ownership and license rights in deciding which business process to outsource and which vendors' policies present IP problems. Among other things, the scope of IP representations, warranties and indemnities will become subject to greater scrutiny, especially with respect to how common carve-outs to IP indemnities expose a customer to excessive risk and should be changed going forward.

Moreover, companies that do not get patents in the ordinary course of their business need to do so in order to protect their rights in the innovations they develop and then provide to the vendor during outsourcing. Two fact patterns that can give rise to this are as follows: First, a company which is the customer in an outsourcing transaction that has developed a special business method may need an outsource provider with superior IT resources to automate the method or to create the infrastructure to roll out and operate the method across all of the company's locations and business units. Second, a company needs the expertise of an outsource provider to develop the company's idea for an innovative method of doing business.

Each situation illustrates one of the central IP concerns in outsourcing, namely, whether the company, as the customer in an outsourcing arrangement, will retain ownership of the innovation and the IP related thereto, or whether the vendor can adopt the customer's method, including as further developed during outsourcing, as part of the vendor's business process service offerings and then sell it to other companies, including competitors of the customer. This issue is especially important in business transformation, where the development and implementation of innovative business methods are the point of the outsourcing.

By securing a patent, the cost of which is modest in light of the protection it provides, a customer can gain greater control over how the vendor can re-use the customer's innovative business method. In addition, this issue can surprise the parties because joint developments often emerge "organically" as the parties collaborate in developing improvements. In many cases, the IP implications of joint development are not recognized by the parties, are not addressed in the contract, and can result in the customer losing valuable rights it should retain both during and after an outsourcing arrangement.

A reflexive, but often insufficiently considered, "solution" to this issue is an agreement giving the parties joint ownership of the IP in jointly developed improvements. There are several potential dangers to this. The first derives from the "default" provisions of the law that give joint owners of copyrights and patents the right to grant non-exclusive licenses to third parties without the need to obtain the prior consent of the other joint owner. Thus, even if it is assumed parties are co-developers and joint owners of the IP, and that the customer in this hypothetical situation would never license the jointly owned IP to one of its competitors, the vendor would nevertheless be free to do so—unless the customer anticipated this, and drafted a contract either requiring its prior approval and/or preventing the provider from licensing the IP to third parties who are competitors of the customer or are in the same industry. (Unless varied by contract, the Copyright Act imposes a duty on one joint owner to account (pay) a share of the license proceeds to the other.)

The second danger derives from how ownership is treated differently in patent and copyright law. To use software as an example, assume that a business method is embodied in an algorithm and software is written to implement the algorithm (and the method). The party that contributes the algorithm may be considered an inventor, and hence owner, for patent law purposes, but may not be considered the author for copyright purposes, and therefore would not be a copyright owner. This is because the algorithm may be deemed to be a patentable subject under patent law but an uncopyrightable idea under copyright law. Accordingly, and probably contrary to at least one party's expectations, in this situation, all copyrights may be owned by the party that wrote the program, which in the outsourcing context is almost always the vendor.

A knowledgeable customer would use the contract to protect itself by requiring that the vendor assign or license the copyrights in the software. This would allow the customer to own and/or continue to use the software outside of this particular outsourcing arrangement, and in addition, to use another outsource provider to implement the same business method when it outsources another business method or work for another business unit. The other side of the IP coin is that the party that writes the software may not be an inventor and thus may not even be a joint patent owner. This is because the patent law may not recognize the writing of the software as a patentable contribution. The party would own copyright but not patent rights, and should obtain patent rights by contract.

For purposes of the foregoing discussion, it is assumed that the parties that contributed the algorithm and the software implementing the algorithm acquired patent rights from the employee who invented the algorithm and copyright rights from the employee who created the software. Employers acquire copyrights under the work-made-for-hire doctrine or by assignment. There is no work-for-hire doctrine under patent law. An employer can acquire patent ownership rights only by assignment.

Independent Contractors

In outsourcing, IP development is often performed by an independent contractor rather than an employee. Under U.S. law, there are two branches of the work-made-for-hire rule applicable to software written by an independent contractor. For the commissioning party to acquire copyright ownership, there must be a work-made-for-hire agreement, and the software work itself must fit within one of the limited number of categories in the Copyright Act. Software often does not readily fit within such categories. Thus, customers may be surprised to learn that when they hire an outsourcing provider to write software, the provider may keep the fees and retain ownership of all of the copyright even when it enters into a work-made-for-hire agreement—because the software does not fit within a statutory category. A knowledgeable general counsel will cure this by acquiring rights by assignment and not relying on the work-made-for-hire doctrine.

Offshore outsourcing complicates IP ownership and can result in unexpected consequences. The work-made-for-hire law in offshore countries is often different from that in the United States. To the extent the law does differ, the customer can often prevent an undesired result by proper contract provisions. Moreover, it is common for outsource vendors to outsource software or IP development to subcontractors. Accordingly, an agreement by the vendor to assign or license IP rights to the customer may fail to meet the customer's objectives if the provider did not acquire the underlying IP rights from its offshore subcontractor.

While the customer could have a breach of contract action, IP ownership may remain with the offshore subcontractor, with the result that the vendor cannot transfer it to the customer and the customer cannot use it or grant another vendor the right to use it. From the perspective of the general counsel of the customer, it is not sufficient to obtain a transfer of IP rights from the provider. The customer must also understand the IP laws of the offshore country and ensure that the provider acquires the underlying IP property rights under foreign law.

In addition, a general counsel must take steps to ensure the outsourcing agreement addresses the customer's IP needs after the expiration or early termination of the contract. For example, if the provider licenses its IP rights to the customer only during the term and only while the customer is receiving services from the provider, then the customer's activities after the termination using what it learned during the outsourcing may be considered infringing. To protect itself, the customer should obtain an IP license that survives termination. Moreover, the customer should not wait until contract negotiations to address IP rights. It should address them during the RFP (request for proposal) phase, when it often has the greatest leverage. In certain cases, it should also tie certain IP rights to specific Statements of Work.

Force Majeure Events

IP issues often arise in connection with force majeure events. As a preliminary matter, I recommend that force majeure provisions be combined with disaster recovery (DR) and business continuity (BC) provisions. The business rationale is that force majeure events are in fact foreseeable in offshore countries and it is only the exact timing of the events that cannot be predicted. Accordingly, a force majeure event should not completely excuse a vendor's performance, but should instead require a temporary lower level of performance under the terms of pre-negotiated DR and BC provisions. It is also likely that DR and BC services will be provided in another country, or that the customer will perform services itself or be entitled to retain a substitute vendor to do so during the pendency of a force majeure event.

To protect itself, the contract should grant the customer additional IP rights during such event to provide it and substitute vendors with the necessary broader IP rights (or even a grant of IP rights if such grant is not part of normal contract operations) including for use in countries where DR, BC or self-help services will be performed. Similarly, if the number of business units receiving outsourcing services increases over time, the IP grant must expand to cover the additional units.

Finally, it is common for the customer to assign third-party software licenses to the vendor so that the vendor can use the software to provide the outsourced services. If the vendor pays for upgrades during outsourcing, then it should be required to convey any ownership rights it acquired in the upgrades to the customer so that the customer can use the upgrades when it takes the services back in-house or assigns them to a new outsource provider.

In summary, in outsourcing, IP provides a particular set of potential problems as well as potential opportunities, and a knowledgeable general counsel can avoid the land mines and maximize the gold mines by looking over the horizon and drafting new contract provisions, and obtaining (or retaining) IP ownership and license rights in order to achieve the business objectives of outsourcing.