

# Software Outsourcing— Business and Legal Issues Checklist

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## Introduction

Outsourcing particular business functions is not something new. In the late 1970's and early 1980's many companies "outsourced" many of their "back-office" functions to service bureaus that performed these services for many customers, thereby gaining economies of scale from their investment in what was then, and is still, expensive mainframe computer hardware and software systems. Similarly, in the 1980s, large U.S. integrated circuit chip ("chip") design companies began moving manufacturing of their chips to offshore fabrication facilities (or "fabs") that also leveraged economies of scale to produce large volumes of chips for many chip companies. This eliminated the need for chip companies to raise capital or spend the time necessary to establish their own manufacturing capabilities. The benefit for these companies included reducing their costs to produce their chips, while freeing up capital and time to develop newer and better chips. Today, almost every new U.S. chip company is "fabless;" they design their semiconductor products and turn to offshore fabrication facilities to produce them. This model for outsourcing allowed the U.S. chip design industry to remain vibrant and it continues to attract investment capital.

While outsourcing is not itself a new business phenomenon, turning to non-US, offshore companies to perform non-manufacturing outsourced functions is the recent twist, which adds layers of business and legal complexity to the process. As the global economy continues to grow and develop, more companies are evaluating other parts of the world with lower cost business and technology talents where they can parse at least certain parts of non-manufacturing operations currently performed in the U.S. Many experts assert that the current "jobless" economic recovery in the U.S. reflects that companies are meeting increased demand for their goods and services by looking offshore for more cost effective "suppliers."

Over the last ten years, outsourcing has captured the attention of many in the software development industry. Initially, most software-related outsourcing occurred domestically, with companies outsourcing certain development projects to domestic entities - often specialized "body shops." For example, a company needing Java development assistance could find a local company with the right expert team of software engineers to get the job done easily and quickly, instead of having to staff up its own development organization with Java experts that would only be needed for a limited time period. Hence, these outsourcing activities were primarily undertaken to help a company reduce its cost structure and/or move non-core development activity outside the organization, so the company could focus on its core architecture development.

More recently, software development outsourcing is undertaking a transformation already seen in other industries, namely, core development outside the U.S., *i.e.*, offshore, by contracting with third parties, *i.e.*, outsourced. Primary reasons for offshore outsourcing in software development include potentially less costly development resources in other parts of the world, *e.g.*, India, Eastern Europe or Russia for more complex software development, and specialized talent not widely available elsewhere, *e.g.*, China for Asian language software development or Mexico for Spanish language software development. As more and more companies seek to do some offshore software development, questions arise as to what a software company should consider before deciding to outsource software development activity offshore.

With this background in mind, the checklists below provide a starting point of "top-10" business and legal issues a company should evaluate before deciding whether to engage in offshore outsourcing for software development. For convenience and ease of organization, the list is broken down into business considerations followed by legal considerations.

## Business Considerations Checklist

- What and Timing
  - What will be outsourced?
  - Is the development and market timing right to outsource it?
- Costs
  - Will cost savings actually be realized after accounting for management of the project, revision and change orders, and customer acceptance?
  - Have the cost associated with knowledge transfer, software licenses, and local resources been accounted?
- Quality
  - What level of quality are you expecting from the offshore third-party and can they deliver it?
  - How will quality be determined and measured?
  - What risk management or contingency plan is in place in the event of a failure to deliver?
- Conflicts
  - Is the offshore third-party doing development for your competitors or others for whom there would be concern about disclosure of your technology and/or intellectual property?
- Control
  - What part or parts of your overall technology and/or intellectual property are you comfortable with being in the hands and control of the offshore third-party?
  - What business knowledge may be lost through the outsourcing engagement?
- Communication
  - How easy is it to communicate with the offshore third-party?
  - Does the offshore third-party listen and do they understand what is being said or stated?
  - Are there a sufficient number of individuals that speak and understand the primary language that you need to communicate in?
  - How responsive is the offshore third party to your communications?
- Management and Measurement Methodologies
  - What type of management and reporting structure will be in place to manage the project at different levels?
  - What measurement criteria will the offshore third party use to measure and track metrics for the project at different levels?
  - How will measurement criteria be reported and presented?

- Skill Sets
  - Does the offshore third-party have the needed skill sets (including domain knowledge) to do the project or will they be training themselves on your time and budget?
- Resources
  - Will the offshore third-party dedicate the resources necessary to complete the project on time, within budget, and at an expected quality level?
  - What is the expected personnel turnover at an account-level and how will the offshore third-party mitigate it?
- Viability
  - What is the viability of the offshore third-party?
  - Where is the offshore third-party incorporated?
  - Will they be around in three to five years?
  - If not, what happens to your technology and/or intellectual property?

## Legal Considerations Checklist

- Ownership
  - Who owns the technology and/or the intellectual property that results from the development?
  - What should the offshore third party be prevented from doing with respect to your intellectual property (*e.g.*, no use for others? no subcontracting to others such as companies they outsource to? no disclosure to others?)?
  - Under what conditions, if any, is use of open source code acceptable?
- Control of Intellectual Property
  - Who controls how intellectual property paid for by the company is protected?
  - What mechanisms will be constructed to ensure protection of intellectual property?
- Process Management
  - What are the specifications for development and are they adequately set forth in the contract (agreement)?
  - Are contract incentives properly aligned with business goals?
  - What milestones will be agreed to?
  - What happens if those milestones are not met?
  - What are acceptance criteria?
  - What happens if they are not met?

- **Liability**
  - What liabilities does offshore outsourcing expose you to in the U.S. and in the country of offshore third party, *e.g.*, intellectual property infringement, privacy, employee or contractor rights, etc.
  - Are there export control issues with respect to the type of development you want done?
  - What insurance is carried by the offshore third-party and how, if at all, does it protect you?
- **Infringement Indemnity**
  - Can you obtain an indemnity against infringement of third party IP rights from the offshore third-party?
  - Will it be enforceable or practical to enforce?
- **Dispute Resolution**
  - How and what process will be used to resolve disputes?
  - Where will disputes be resolved?
  - What law controls and can that law control?
  - Who bears the costs of dispute resolution?
  - Is there a jurisdiction most favorable to you?
- **Enforcement**
  - What are your enforcement options for breach of contract, infringement of intellectual property, theft or misappropriation of trade secrets, etc.
  - How likely are you to obtain relief in the form of an injunction and/or damages?
  - Will that judgment be enforceable in the country of the offshore third-party or the U.S.?
- **Termination**
  - Is there a right to terminate?
  - Under what circumstances can termination occur?
  - What happens to technology and/or intellectual property at termination? What if the project is only partially completed?
- **Taxation**
  - What tax (federal, state/province/region, and local) obligations must be accounted for and how will they be accounted?
  - Who pays tax obligations?
- **Local Counsel**
  - Do you or your law firm have counsel in the country of the offshore third-party that understands the cultural and legal environment?

## Conclusion

Offshore third-party outsourcing is a strategic tool for some software companies in the U.S., if it is properly timed, executed and managed. Using the checklists above, you can begin your diligence in determining whether outsourcing to an offshore third party is right for your company and, if so, under what circumstances.

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The authors would like to thank Billie Spell, Director (Software Delivery), Covad Communications Group, Inc., Nicki Mehra, Managing Director, Headstrong Corp., and Sajai Singh, Partner, J. Sagar Associates (India) for their insights to this article.

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