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Intellectual Property Newsletter

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Outsourcing of Software Development by Canadian Companies to Offshore Jurisdictions

by *Sze-Mei Yeung and Jeff Lowe*

In today's global economy, the outsourcing of software development work to offshore jurisdictions is a strategic tool that can provide a competitive advantage for many Canadian companies. In addition to the potential cost savings, outsourcing can also provide access to world class expertise and development technologies, and allows a corporation to focus on its core competencies and business activities. With this opportunity, however, comes certain difficulties and challenges.

The 2008 Deloitte Consulting Outsourcing Report, entitled "Why Settle for Less", surveyed 300 senior executives at companies in the U.S., U.K., Germany and Canada that spend at least \$50 million annually on IT outsourcing initiatives. 83% of all respondents reported their outsourcing projects had met their ROI goals of slightly above 25%. However, 39% reported terminating at least one outsourcing contract and transferring it to a different provider. Though most customers appear to be achieving a perceived return on investment, there are definitely some unique challenges inherent within IT outsourcing. Some of these challenges can be mitigated through due diligence, selecting the right developer and maximizing intellectual property and contractual protection.

In the 2008 Deloitte Consulting Outsourcing Report, 35% of those surveyed said they should have spent more time on the service provider selection process. If a customer is unfamiliar with the foreign market, it may wish to retain a business advisor that is familiar with the applicable market. The advisor can

prepare a list of potential qualified software developers and review each potential developer's overall reputation, financial stability, place in the market and ability to provide the required services. References from past and current engagements can also be requested from the developer(s). Legal counsel can be invaluable in directing the due diligence process and reviewing the resulting information and searches. Canadian counsel may need to liaise with counsel in the foreign jurisdiction.

The customer may also consider preparing a request for proposal (RFP) describing specific requirements and inviting responses from suitable developers. Including key agreement(s) as part of the RFP enables the customer to control the documentation and incorporate the legal terms as part of the service provider evaluation process. The RFP should remain non-binding in nature, and not obligate the customer to accept any proposal. The final agreement should still remain open to further negotiations between the customer and the selected developer.

In selecting a software developer, it is also a good idea for the customer to conduct a comprehensive review of the security and intellectual property protection program of the developer to evaluate its ability to safeguard the customer's confidential information, software source code and trade secrets against

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misappropriation, misuse, loss or damage. The customer may wish to have on-site involvement during the early and late development stages to ensure that suitable security measures are in place.

Before drafting an outsourcing contract, legal counsel needs to understand the client's outsourcing goals and priorities. As outsourcing often involves a long term relationship, the contract needs to accommodate changes in circumstances during the term. Important terms to address in the contract are the detailed scope of services to be performed, acceptance testing criteria of the customer, fee reductions if the developer fails to meet prescribed milestone dates, change processes, and a continuing warranty from the developer following acceptance by the customer. The agreement must also include the requirement of regular reporting by the developer to the customer.

Since most development work involves early stage ideas and designs, the customer will wish to broadly define "confidential information" to include all proprietary intellectual property, software, specifications, designs, plans, or other technical or business information and trade secrets. However, disclosure should be limited to only confidential information that is required for the developer to perform the services. The developer's employees should also be bound by strict confidentiality obligations, and there should be no sub-contracting to any independent contractors. At the end of the relationship, all confidential information should be returned to the customer.

To avoid the creation of new intellectual property (IP) being governed by foreign laws, the customer will want to have its home jurisdiction as the governing law. The customer should ideally own all improvements to its proprietary IP, as well as any new IP developed by the developer during the outsourcing. Assignments of intellectual property relating to the new IP and improvements should be obtained from the developer, as well as the developer's employees. Joint ownership of intellectual property rights should be avoided to enable the customer the ability to freely use and commercialise its own IP, improvements and any new IP.

The legal and practical challenges of outsourcing need to be managed and understood within the customer's overall

strategic objectives. Strong communication throughout the project is essential to a successful outsourcing arrangement. With appropriate planning, resources and documentation, outsourcing of software development can provide an effective tool for Canadian software companies.

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Does Your Company Need an IP Audit?

by Michael Kale

How much of the value of your company is made up of goodwill or other intangible assets? It is estimated that approximately 80 percent of the value of the companies listed on the S & P Fortune 500 is made up by intellectual capital. Before the advent of the Internet, 80 percent of the assets of the typical company were tangible, such as buildings and equipment.

Intellectual property rights are not reserved solely for companies developing sophisticated new technologies. Intellectual property will permeate some core aspect of virtually every business in Canada today. The reality is that in today's information economy, virtually every business relies on a broad array of intellectual property assets — copyrights, trade secrets, trade-marks, and software licenses. Every area of a business is involved in the use of intellectual property, including human resources, IT, marketing, sales, and research.

The real value of intellectual property is exploited when existing and potential future rights contribute to the goals of a business. For this reason it is important to regularly review how intellectual property rights fit into your company's business model, to determine their value to your business, to adjust tactics according to the objectives, directions and strategies of your business, and to mitigate risks arising from changes in your business or industry. In other words, every company should have an "IP Strategy" that takes into account its commercial goals, its competitive environment and enables the business owner to devise informed strategies that will maintain and improve the company's market position.

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The first step in developing an IP Strategy for your company is the performance of an “IP Audit”. This involves a review of the company’s registered and unregistered intellectual property. An IP Audit may include the review of patent applications and registrations, trade-mark applications and registrations and industrial design registrations and applications. Just as important, an IP Audit may entail the review of your company’s marketing materials related to branding, copyrights, confidential information and trade secrets (which may include business plans, technical data, product specifications, know-how, product plans, business methods, product functionality, customers, markets, competitive analysis, methodologies, inspection procedures, or information related to finance), employment and consulting agreements, inbound and outbound licence agreements, research and development agreements, distribution agreements, key data bases, manufacturing processes and other core business processes. These are the assets that can or already do give you a competitive advantage in your business.

Once your business has a general understanding of what intellectual property and other intellectual capital is relevant to its business, the next stage of the IP Audit is to identify, to the extent possible, any gaps that may exist.

In summary, the key steps to an IP Audit can be described as follows:

Identification:

Identify, describe and define the intellectual property which is already registered or could potentially be registered such as inventions, trade-marks, designs, plant breeder rights and the like. It also identifies other rights such as copyright, trade secrets and staff know-how.

Ownership:

Establish who owns the intellectual property.

Legal Protection:

Develop a plan for unregistered intellectual property, outline optimal methods of protection and the types of applications to be sought in order to achieve and maintain a competitive advantage

for the business. An analysis will usually provide indications on how to protect trade secrets and in-house know-how.

Liability Assessment:

Look at liabilities or risks associated with the intellectual property identified, such as:

- what, if any, ownership risks and liabilities exist?
- what are the documentation/record keeping standards?
- what risks are associated with trade secrets/know how?
- key personnel liabilities?
- potential or existing litigation/opposition issues.
- are there any obligations or encumbrances on the intellectual property?

Valuation of Intellectual Property:

Though IP Audits do not involve putting a dollar figure on a piece of intellectual property, the relative value of intellectual property assets can be estimated by assessing whether each piece of intellectual property is revolutionary in its field or whether it is a link in the chain to achieving an end result. Another issue to consider is the freedom to operate in terms of competitors’ positions. This valuation stage may also lead to rationalization of the portfolio, in cases where resources are expended on intellectual property assets that are no longer aligned with the current and/or future commercial direction of your business.

Recording:

Audit findings should be recorded and stored. They should serve as references and analyses for subsequent regular audits, as background information for due diligence exercises, as well as guide for portfolio development and eventual commercialization activities.

An IP Audit can have a big impact on the future potential of your business. Only when you have identified your company’s IP assets can you properly implement an IP Strategy to exploit, protect and value those IP assets. An IP audit is an important planning and organizational tool for all companies.

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Forms of Intellectual Property ('IP')

There are instances when people confuse the different types of IP with one another eg trade-marks with patents, copyrights and other forms of intellectual property. There are several forms of creative endeavors known as Intellectual Property, including **Trade-marks** (a word(s), phrase/slogan, symbol and/or logo design or a combination these), **Copyrights** (literary, artistic, dramatic, musical works, computer programs, communication signals), **Patents** (new inventions and any new and useful improvement to an existing invention), **Industrial Designs** (visual features of the shape, configuration, pattern and/or ornament applied to a finished article of manufacture) and **Integrated Topographies** (the three-dimensional configuration of the electronic circuits embodied in integrated circuit products of layout designs).

What is a Trade-mark?

A trade-mark (which is often referred to as a "brand") may consist of a word(s), phrase/slogan, symbol or logo design, or a combination these. Trade-marks are used to distinguish one person's products and services from another person's products and services. A trade-mark also represents the owner's reputation in the marketplace. A unique mark which is easily recognized by consumers will assist you in establishing your identity and can enhance the value of your business. Essentially, there are three types of trade-marks: **Ordinary Marks** (traditionally words and designs, i.e. the KODAK® mark), **Certification Marks** (marks used by licensees to identify that their products and/or services meet a defined standard, i.e. the Woolmark Design) and **Distinguishing Guise** (the unique shape of a product or its packaging, i.e. the shape of the Coca-Cola bottle). Examples of non-traditional marks which have been granted registration in other countries include sounds, tastes, smells, etc.

According to an article in *Financial World* (August 2, 1994), there are many companies which consider their IP to be their most valuable asset (for example in 1994, the COCA-COLA mark was valued at US\$35 billion, the NESCAFÉ mark was valued at US\$11 billion and the KODAK mark was valued at US\$10 billion). Strategic branding and retaining a Registered

Trade-mark Agent to assist in the creation, registration and protection of your trade-mark will result in a highly distinctive mark capable of increasing value as your products and services become more recognizable to your consumers. You may have products and services which are of a better quality than your competitors' products and services, however, poor choices in branding (i.e. descriptive marks or marks which incorporate words, symbols, designs, etc. used by many of your competitors) will result in your mark not establishing the reputation which the products and services are worthy.

If you would like more information on the content of this newsletter, or on other intellectual property matters, please contact Georg D. Reuter at greuter@rbs.ca or at 604.661.9208 or Sze-Mei Yeung at syeung@rbs.ca or at 604.661.9247.

WHAT WE'RE UP TO

- On April 22, 2009, Trisha Doré presented at the Surrey Chamber of Commerce on "The Fundamentals of Intellectual Property"
- Jeff Lowe presented at the Association of University Technology Managers (AUTM) Start Up Business Development Course in January 2009 regarding "Papering the Deal"
- Georg Reuter and Sze-Mei Yeung presented to the UBC UILO Technology Transfer and Sponsored Research Groups on January 29, 2009 regarding "Technology Commercialization Claims Between Universities and Inventors"
- Jeff Lowe presented to the Intellectual Property & Licensing Practice Group Meeting of the Pacific Rim Advisory Council held in Mumbai, India on November 17, 2008 on "IP/IT Concerns of IT Outsourcing from the Hiring Side Perspective"