Using offshore contractors or outsourcing operations can present some specific legal risks. Using offshore contractors for software development or outsourcing higher-level business process operations presents some specific legal risks that companies can easily overlook until the risk becomes an unpleasant reality, reports Senior Associate Ken Shiu.

**Going offshore locally**

There has been a growing trend to use offshore contractors in Asian countries such as India, China and the Philippines, which tend to offer lower costs than industrialised western countries. When sending products or services delivery offshore, an important first issue to consider is selecting the right legal structure to receive delivery of the offshore services. The options range from the most common method of directly contracting with an offshore provider to setting up an overseas subsidiary.

A less risky approach to contracting offshore is to engage a local multinational who internally subcontracts parts of the services to its lower-cost overseas subsidiaries. Although less risky, a disadvantage is that the supplier may not fully pass through the offshore cost benefits.

Setting up an offshore subsidiary requires significant upfront investment and ongoing compliance with foreign laws. The advantages, though, are a direct level of control over the provision of services and the handling of proprietary assets or information offshore.

More hybrid arrangements include moving IT assets into an offshore joint venture with the service provider. The balance sheet benefits can be offset by the potential erosion of service levels, as the joint venture seeks to increase its profit.
Cultural differences

Offshore outsourcing introduces an extra mixture of geo-political and cultural issues that may demand more time than originally anticipated before the offshore services are comfortably integrated with the business. These issues include language, time-zone differences, geographic distance, political risk and host-country technical infrastructure.

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Protecting the crown jewels

Despite recent legislative initiatives in many countries to improve domestic intellectual property (IP) laws and enforcement, there are important cultural differences in the perception and recognition of IP in western and other countries.

Although not representative of all offshoring arrangements, several reported incidents highlight the hidden risk of indifference to IP. These incidents have ranged from employees of offshore service providers reusing proprietary code in other projects or creating competing software, to employees intentionally auctioning source code or customer data to competitors or bidders.

Some of these misappropriation risks can be mitigated by imposing extra physical security controls and exercising audit rights.

Manage the process

As in domestic outsourcing, sufficient internal resources to address work-scoping, project management and service measurement are essential to the viability of any offshoring initiative.

Employee relations

As shown by recent media coverage, perhaps the most sensitive public relations issue for management is the need to address the displacement of local employees.1 The Australian political debate on the employment aspects of offshoring has yet to reach the more advanced legislative proposals of the United States, such as the US Workers Protection Act, which attempts to prohibit the use of taxpayer revenues supporting any offshoring in federal government privatisation work and federal and state government procurement. Despite this, companies will still need to be aware of any union concerns and of relevant industrial relations laws for redundancy and employment transfer arrangements.

Case studies have shown the benefits of management engaging in early discussions with affected employees2. Offshoring projects will have little chance of success, unless key customer staff cooperate to ensure the efficient transfer of knowledge to the external services provider’s staff. The offshoring contract will need to provide for the cross-border movement of staff and this knowledge transfer process. The contract should also address the adverse operational issues that might arise if the offshore service provider itself experiences high levels of staff attrition or turnover.

The regulatory mix

Currently, Australian companies are not subject to any overarching regulatory restrictions on offshoring. However, specific legislation does impose certain regulatory requirements in specific industries. For example, in the financial services industry, the Australian Prudential Regulatory Authority’s prudential standards on outsourcing also extend to services by

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offshore providers, and businesses in that industry will need to ensure that their offshore arrangements comply with those standards.

The current strength of the Australian dollar has provided greater incentive for companies to seriously consider the cost advantages of offshoring. To enjoy the promised cost benefits, sufficient due diligence, pre-planning and continuous monitoring is essential.

Federal and state privacy laws also prescribe obligations on companies when dealing with personal information and the transfer of this information offshore.

Naturally, tax, transfer pricing and foreign exchange considerations may also play a significant role in determining the most appropriate structure for an offshoring exercise.

Losing the toss (the home-ground advantage)

The practical issues of contract enforcement and dispute resolution between parties in different countries mean private international law issues, such as the selection of a governing law, the processes for dispute resolution, the use of international arbitration and the choice of venue for resolving contractual disputes, need to be considered and agreed.

Conclusion

The current strength of the Australian dollar has provided greater incentive for companies to seriously consider the cost advantages of offshoring. To enjoy the promised cost benefits, sufficient due diligence, pre-planning and continuous monitoring is essential. If the offshoring involves key intellectual property or customer data, additional security and management measures should be adopted to minimise the risk of this material appearing in the hands of strangers (or competitors).
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