

## **OUTSOURCING TO INDIAN COMPANIES - CRITICAL ISSUES**

Outsourcing is the delegation of a company's in-house operations to independent contractors. The recent information technology ("IT") boom in India has been a direct result of foreign multinationals outsourcing IT-enabled services to Indian IT companies. Large multinational companies consider India a lucrative outsourcing hub because of the low cost skilled workforce, the high quality of work, and the preponderance of English speaking and computer savvy personnel. The work is undertaken on specific projects by way of an outsourcing contract. However, while entering into an outsourcing contract, the parties must bear certain factors in mind such as protection of IP rights, permanent establishments and transfer pricing issues under India's Income Tax Act, 1961, and employment laws.

### **Intellectual Property ("IP") Rights Protection**

Protecting an IT company's IP rights, such as copyrights, trade secrets, inventions, ideas, formulae, source and object codes, know-how, improvements, etc., must be specifically contemplated in the outsourcing contract. Under Indian copyright law, there is an automatic assignment of copyright from a software developer to his/her employer so long as there is no contract to the contrary. However, this is not the case with an independent contractor. Furthermore, Indian patent law does not have similar automatic assignment provisions, and thus inventions have to be assigned by both employees and consultants. It is, therefore, imperative that an independent contractor and its employees assign any new invention to the client during the course of the contract, as well as an assignment of the final work product.

Consider the following situation: Company A outsources certain services to Company B, an independent contractor. Company A provides Company B deliverables, which contain third party confidential or proprietary information, to generate the work product. In the course of developing the work product, Company B's employees and independent contractors make certain inventions. In this case, confidential and proprietary information must be protected by Company A at three levels, i.e.:

1. Company A's deliverables;

2. Work product and related inventions developed by Company B; and
3. Future work product developed by Company B.

### *Client's Deliverables*

In most cases of outsourcing, the client provides the contractor with third party confidential information to enable it to perform the contracted services. The client must ensure that the contractor maintains the confidentiality of such information and uses the information only for the specified purposes. Moreover, the contractor must be made to enter into contracts with its employees stating that they will not infringe the proprietary and IP rights of the client or third parties.

### *Work Product and Related Inventions*

The contractor must be under an obligation to keep confidential the work product that is developed during the course of the contract. There must be an exclusive, royalty-free, irrevocable, perpetual and worldwide assignment, to the client of any new invention that the contractor or its employees develop during the continuance of the contract. The contractor must not be permitted to retain any right to use the work product or challenge the validity of the client's exclusive rights to the work product.

### *Future Work Product*

The client must ensure the assignment of the work products not only during the subsistence of the contract, but also those developed in the future from the client's deliverables.

### **Tax Issues**

If the Indian contractor renders services to the client in India at exclusive and designated locations through dedicated employees, and if the client's employees will be training the contractor's employees in India, then there is a likelihood that a client may be regarded as having a permanent establishment ("PE") in India through the contractor. Therefore, it is very important to contractually and practically ensure that the client will not be subject to the adverse tax consequences of having a PE in India.

While entering into an outsourcing arrangement one must keep in mind the transfer pricing regulations (“TP Regulations”) that are used to compute income from international transactions between associated enterprises. The TP Regulations apply only if the enterprises are deemed to be associated enterprises. In an outsourcing arrangement, enterprises are deemed to be associated when:

1. the manufacture or processing of goods by the contractor is wholly dependent upon the use of the IP of the client;
2. one enterprise, or any person specified by it, supplies and influences the prices and other conditions relating to 90% or more of the raw materials and consumables required for the manufacture or processing of goods or articles carried out by the contractor; or
3. when the goods or articles manufactured or processed by the contractor are sold to the client at prices and conditions that are influenced by the client.

The income arising from an international transaction is required to be computed with regard to an arm’s length price. An arm’s length price means a price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions.

Further, an international transaction means a transaction, whether an oral or written arrangement, between two or more associated enterprises, either or both of whom are non-residents, in the nature of:

1. purchase, sale or lease of tangible or intangible property;
2. provision of services;
3. lending or borrowing money; or
4. any other transaction having a bearing on profits, income, losses or assets of such enterprises.

An international transaction refers to a mutual agreement or arrangement for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more of such enterprises.

The aforesaid provisions, however, do not apply in a case where the aggregate value, as recorded in the books of account, of the international transactions does not exceed Rs. 10,000,000 (US\$208,350) in a financial year.

### **Employment Law Issues**

It should be specified in the contract that the contractor shall be solely responsible for all tax liabilities in respect of its employees, including for (i) central, state or local tax, employment, withholding or reporting purposes; (ii) provident fund, gratuity, bonus, workmen's compensation, employee state insurance or other employment law deductions, private insurance, social security, or central or state withholding taxes, levies, duties, etc., of any nature whatsoever, and any claims which may be made by the contractor's employees. Also, the client should obtain specific indemnities from the contractor in this regard.

#### *Non-Compete Covenants*

An agreement restraining anyone from carrying on a lawful profession, trade or business, beyond the term of an agreement cannot be enforced under India's very onerous non-compete law. However, as an exception, if a party sells its business with goodwill to another party, it can agree with the buyer that it will not carry on a similar business within specified local limits.

In BOT and other transactions, it is advisable to prescribe a specific term of employment in the employment agreements between the Indian contractor and its employees, so the employees are prevented from competing with the contractor for the remainder of the term if they leave the employment before expiry.

#### *Contract Labor*

Manpower outsourcing is permitted in India under the Contract Labour (Regulation and Abolition) Act, 1970 (the "Act"). If the client's business is not of an intermittent nature in respect of contracts entered into by it with third party contractors for technical staff, the client will be regarded as a principal employer. A principal employer must comply with the provisions of the Act if it engages 20 or more contract workers (excluding persons appointed as managers or administrators, or supervisors drawing wages exceeding Rs. 500 (US\$ 10.20) per

month or exercising functions of a manager, and outworkers). The wages and other service conditions of a contract worker must be similar to those given to the client's employees who perform a similar function. Further, the client will have to comply with various requirements under the Act.

Presently, there is no litmus test to determine when a temporary software professional or other technical staff member may become eligible for permanency with the client, notwithstanding the client's registration under the Act. The factors that might make a permanent employment claim more tenable are:

1. A direct contractual relationship between the client and the contractor's employees. (*Before hiring contract workers, it is necessary to confirm that the contractor has appointed such workers under an appointment letter or employment agreement duly signed by them.*);
2. The level of supervision and control exercised by the client over the temporary professional's activities;
3. Whether the activity performed is of a permanent or perennial nature;
4. Whether the activity is performed continuously, and if so, for what length of time; and
5. Whether the client's employees are performing the services similar to those being rendered by the temporary professional.

### **Choice of Law/Forum**

Indian law should govern the outsourcing contract because judgments of many foreign courts are not enforceable in India unless a suit is filed on the judgments. Thus, the client should be aware that an injunction from a foreign court may not be enforceable in India, and that it might have to sue the contractor in India to restrain the contractor in the event the outsourcing contract is breached.

### **Damages**

Liquidated damages are recognized in India and can be recovered against an Indian party. As regards enforcement of contracts in India, Indian law will apply

to such enforcement, notwithstanding the fact that a foreign law governs the contract. Under Indian law, when a contract has been broken, the party who suffers by such breach is entitled to receive compensation from the party who has broken the contract for any loss or damage caused to it by, which naturally arose in the usual course of things from such breach, or which the parties knew, when they made the contract, to be likely to result from such breach; compensation will not be payable for any remote and indirect loss or damage.

Further, in estimating the loss or damage, the means which existed to remedy the inconvenience caused by the non-performance of the contract must be taken into account. However, if the amount of damages is fixed under the contract, the party complaining of the breach is entitled to receive the specified amount as damages irrespective of whether or not actual damage or loss is proved.

### **Conclusion**

Outsourcing contracts between the client and the contractor must be meticulously drawn to protect the IP rights of the client. Moreover, the TP Regulations, and tax and employment issues must be considered. To avoid the filing of multiple suits, Indian law should govern the contract to allow the client to quickly obtain injunctive relief in India in the event of a breach of the contract.