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Unlawful SOX Helplines

By Jonathan Armstrong

The international corporate governance community has been greatly troubled by the reporting of decisions from France and Germany that have been said to make the running of Sarbanes-Oxley Act (SOX) helplines unlawful in Europe. Much of the furor has been caused by mistranslations of the decisions in both of these countries, and a misunderstanding of the ability of the authorities in one country in Europe to make cross-border rulings. As we will see, the decisions taken in France and Germany affect only those two countries and are not in themselves of pan-European effect. Problems do however remain in particular for U.S. corporations that run whistleblower hotlines in Europe.

FRANCE

On May 26, 2005, the French privacy regulator (known as CNIL) refused requests from CEAC (an affiliate of Exide Technologies) and McDonalds France to authorize the use of anonymous whistleblower hotlines. In order to comply with SOX requirements, both companies intended to set up anonymous employee hotlines and had contacted CNIL to register them under the French system of mandatory prior registration with CNIL of databases containing personal information. It is important to stress that certainly in McDonalds' case, the hotline

continued on page 8

Protecting Technology in a Global Market

By Evan R. Witt

Innovation and technology drive our economy. With the help of international treaties and agreements, foreign markets are becoming increasingly important. Successful businesses must be able to protect and profit from their innovation. U.S. and foreign patents represent one way of protecting innovation in our technological economy. However, many businesses, especially small businesses, face impediments to protecting their goods and services abroad. This article will offer some suggestions for obtaining effective foreign patent protection.

Each nation typically has its own laws governing patent rights. Even though patent rights vary by country, generally a patent grants the inventor the right to exclude others from making, using, offering to sell, selling, or importing the invention in the country. Patents contain "claims" which legally describe the invention and define the scope of the patent right. The rights granted by one nation do not extend beyond the nation's border. As a result, U.S. companies and inventors that seek foreign patent protection must do so in every individual nation of interest.

Businesses must weigh complex factors and issues to decide whether obtaining foreign patents is appropriate. Some factors include costs, benefits, location of markets and manufacturing sites, and foreign patent laws and enforcement. Other issues, such as long-term maintenance costs, possible future changes in market or legal conditions, and projected life-span of the invention should be considered. No single factor is controlling. All factors must be weighed in the analysis.

Costs. Foreign patent protection is usually very expensive. Many businesses fail to consider the "cradle-to-grave" costs of obtaining, maintaining, and enforcing foreign patents. The total costs may include application filing fees, search fees, examination fees, grant fees, maintenance fees (usually incurred yearly), U.S. patent attorney fees, foreign patent attorney fees, and translation fees, if necessary. A government study estimated that the total cost to obtain and maintain a simple foreign patent in nine countries (Canada, France, Germany, Ireland, Italy, Japan, South Korea, Sweden, and

continued on page 2

In This Issue

Protecting Technology

continued from page 1

the United Kingdom) would be about $160,000 to $330,000. GAO-03-910 International Trade, page 54.

Benefits and Country Selection. The benefits enjoyed with foreign patent protection are closely tied to the countries selected. A patent in Monaco, for instance, may not provide the benefits of a patent in Germany. Given the expense of foreign patents, businesses should limit foreign patenting efforts to locations that will provide the most appropriate and useful protection they can afford. An "ideal" country list may include locations where the business expects to sell or manufacture, import, distribute, use, or transport its products or services. The ideal list might also include locations of potential future market growth and locations where competitors manufacture their products or services. From this potentially long list of "ideal" locations, business can select a few key countries to achieve effective patent protection for less cost.

Barriers to market entry may influence the locations to file foreign patent applications. For example, if the barriers to market entry are high and the number of competitors is low, then patent applications may be filed in countries where competitors' manufacturing facilities are located. However, if the barriers to market entry are low and competitors may spring-up anywhere, then patent applications should be filed in the most important foreign markets.

Foreign Patent Laws and Treaties. Businesses should seek foreign patent protection in countries that provide appropriate patent protection and meaningful enforcement. Certain inventions that are patentable in the United States may not be patentable in foreign countries, or may have a narrower claim scope. This applies particularly for some software and business method, biotechnology, and medical treatment inventions.

Most foreign nations have an "absolute novelty" patentability standard that, in practical terms, means a patent application must be filed in that nation before any public disclosure of the invention. Fortunately, almost all commercially significant foreign nations are members of the Paris Convention — an international union which facilitates filing foreign patent applications.

Under the Paris Convention, one may file patent applications in member nations after public disclosure of the invention if a patent application was initially filed in a member nation before the public disclosure and the subsequent patent filings are made within a year of that first patent filing. Thus, if a company files a patent application for an invention before the first public disclosure of the invention, foreign patent filings can be postponed up to one year after the original patent application filing date.

The ability to postpone foreign patent filings is a tremendous benefit. Otherwise, businesses would be forced to file domestic and international patent applications before a new product containing the invention is even marketed.

The Patent Cooperation Treat (PCT) provides a system that further facilitates the obtaining of patent protection in many countries around the world. Under the PCT, a single international application is filed which "designates" the various nations for which regular national filings are desired. Currently, nearly 130 countries and regional patent offices may be designed in a PCT application. (The number increases regularly as more countries join the PCT system.) Each international application receives an international patent search and optionally a preliminary examination report whether the claimed invention meets harmonized patentability criteria.

With the international search report and the international preliminary examination report, the applicant is

continued on page 12

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Securing Protection for Foreign Investments

By Ian Meredith and Clare Tanner

As corporations, investment funds and individuals continue to globalize their operations, their exposure to political risk in its various forms increases. One way in which a degree of protection can be secured is by ensuring that investment vehicles are structured in such a way that scope is created to utilize the investor protection provisions contained within the very significant number of Multilateral Investment Treaties (MITs) and Bilateral Investment Treaties (BITs) that now exist.

Overview

Inevitably, parties engaged in all forms of investment that create exposure to politically unstable regions of the world will, in the first instance, seek to protect their position through contract terms and the nature of their commercial arrangements. In many cases, however, they overlook the additional levels of protection which can be secured through careful structuring so as to ensure that the "investment" constitutes a qualifying investment for the purposes of a MIT such as NAFTA, the Energy Charter Treaty, or one of the around 2,200 BITs which are currently in place (and which are listed at www.worldbank.org/icsid/treaties/treaties.htm).

What Form Does Investment Treaty Protection Take?

Progressively, over the course of the last 40 years, governments across the world have entered into BITs in order to afford their nationals with a degree of protection against infringement of certain of their basic rights by the host state into which their national "invests."

Whilst the precise wording of BITs varies — and so must be checked carefully — most provide some or all of the following seven areas of protection:

1. Protection against expropriation. This is generally taken to be regulatory or other legal measures taken by the host state that deprive an investor of substantially the whole of the anticipated economic benefit of its investments *without* prompt adequate and effective compensation.

2. An absence of arbitrary or discriminatory measures adversely affecting the investment. This is a twin test with arbitrary actions generally taken to be those that infringe the rule of law. Discriminatory measures are judged against the manner in which the host state treats its own nationals.

3. A right to fair and equitable treatment. Whilst an evolving concept, this is generally seen to be a requirement that the host state maintains a stable investment environment consistent with reasonable and investor expectations.

4. National treatment. Treatment no less favourable than that accorded to domestic investors of the host state.

5. Most favored nation treatment. The host state may not treat investors from one country less favourably than those from another.

6. The right to the free transfer of investments and returns. Foreign investors are entitled to compensation if they are adversely affected by currency control regulations or other actions of the host state that effectively freeze funds.

7. The provision of full protection and security by the host state to foreign investments. The host state must take measures to protect the real and tangible assets of the foreign investor.

What is an Investment?

The definition of "*investment*" in most BITs is very broad. It includes all embracing wording such as "*every kind of asset …*" or "*… every kind of investment in the territory…*". The definition of investment has been held to include both direct and indirect investment. This means that, in addition to affording protection to joint ventures and standalone commercial activities, the funding of projects, and even the commitment of assets within a host state, could constitute qualifying investment. The definition is not, however, completely open-ended, and a recent case under the UK/Egypt BIT established that bank guarantees did not constitute an investment under that BIT. Where more restrictive definitions exist within a particular BIT, this may not bar a qualifying investment if there is a "*most favored nation*" clause and other BITs with the same host state are on more advantageous terms.

How are the Foreign Investors' Rights Protected?

The various MITs and BITs sit beneath the Convention on the Settlement of Investment Disputes between States and Nationals of Other States. The Convention established the International Centre for the Settlement of Investment Disputes (ICSID). ICSID's jurisdiction extends to any legal dispute arising directly out of an investment between a contracting state and a national of another contracting state (there are now over 130 countries that have ratified the Convention — see, www.worldbank.org/icsid/constate/constate.htm). ICSID tribunal awards are enforced by the Courts of Convention countries as if they were final judgments of national Courts.

One of the significant developing areas of international investment treaty protection is the way in which nationality is determined. It is not necessarily the case that for a corporate entity its nationality is solely determined by the state of its incorporation and it is possible to establish nationality through that of majority shareholders and the primary country of operation. Increasingly parties are seeking to establish the rights of minority shareholders to claim nationality in order to gain protection of particular BITs.

Can a Foreign Investor Seek Redress Against a Party Other Than a Host State?

A foreign investor has scope to seek redress against the component parts of the host state, such as provinces or municipalities (known as constituent subdivisions of the host state) and bodies performing a governmental function on behalf of a host state or its constituent subdivisions (known as agencies of the host state). In order

continued on page 4

Foreign Investments

continued from page 3

for a foreign investor to obtain such redress, the host state must designate the constituent subdivision or agency to ICSID. For example, Australia has designated The State of New South Wales, whilst Kenya has designated the Kenya Ports Authority. A list of designated constituent subdivisions and agencies appears at www.worldbank.org/icsid/pubs/icsid-8/icsid-8-c.htm.

Generally, the host state must also approve the consent to submit to ICSID's jurisdiction given by the constituent subdivision or agency. However, some host states, such as Australia, do not require such consents to be approved. A list of the host states which do not require such approval also appears at www.worldbank.org/icsid/pubs/icsid-8/icsid-8-c.htm.

WHERE DO CONVENTION CLAIMS ARISE?

Convention claims have traditionally been connected with oil exploration, gas transportation, electric/hydro power generation and mining. However, the Convention is not only relevant to heavy industry. As of Sept. 12, 2005, there were 97 pending cases before ICSID — including four cases relating to fisheries and farming, seven to telecommunications, two to insurance and one to a law firm.

The perception that Convention claims are of most relevance to corporations or individuals investing in emerging nations is supported by the statistics. For example, as of Sept. 12, 2005, there were 35 pending cases against Argentina, seven against Mexico, six against Egypt and five against Ecuador. However, proceedings against Western governments have become more common. (See the breakdown per country at left.)

A Canadian developer, Mondev International Limited, brought proceedings against the United States government claiming that the actions of the City of Boston, the Boston Redevelopment authority and the Massachusetts court system, meant that a real estate development project was unfairly taken from Mondev without proper treatment or compensation. The claim failed, but the Tribunal had sympathy for Mondev and found that the United States had succeeded, but only on rather technical grounds.

Most recently, a Canadian corporation, the Loewen Group, who had brought proceedings against a Mississippi competitor in the funeral home and insurance industry in the

continued on page 12

Country	Number of Cases Pending Against it at ICSID as of Sept. 12, 2005
Algeria	1
Argentina	35
Bangladesh	1
Bolivia	1
Bulgaria	1
Burundi	1
Chile	3
Democratic Republic of the Congo	3
Ecuador	5
Egypt	6
El Salvador	1
Estonia	1
Gabon	1
Grenada	1
Hungary	2
Indonesia	1
Jordan	1
Kazakhstan	1
Kenya	1
Lithuania	1
Malaysia	1
Mexico	7
Mongolia	1
Morocco	1
Pakistan	2
Peru	2
The Philippines	2
Romania	2
Togo	1
Trinidad & Tobago	1
Tunisia	1
Turkey	2
Ukraine	2
United Arab Emirates	1
Venezuela	2
Zimbabwe	1

There are 97 cases pending before ICSID, involving a wide range of countries (see table above for breakdown). Equally surprising as the different countries involved in such cases is the range of investments at issue. Of the 97 listed above, the usual areas are all covered - oil exploration, gas transportation, electric/hyrdo power generation and mining. Also covered are cases relating to fisheries and farming (four), investment in telecommunications (seven), cotton production (two), insurance (two), a duty free concession (one) and a law firm (one). There are cases concerning consumables (five) and concession agreements at ports and airports (three). There are also a large number of cases concerning water and sewage contracts (seven).

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Offshore Outsourcing: Trends and Issues

By Vivian L. Hanson

The phenomenon of international outsourcing has increasingly become a part of the fabric of corporate America. The pressure to cut costs and to focus on core competencies has forced many companies and institutions to outsource a variety of information technology, business process functions and operations to external vendors who can offer economies of scale, specialized expertise and other benefits. In order to take advantage of further cost savings, companies and institutions have inexorably turned to service providers in such countries as Canada, China, India, Ireland, Mexico, the Philippines and Russia.

Today, companies are not only offshoring their informational technology (IT) functions (such as application development and maintenance work, data processing functions, help desk services and the like), but are also engaged in overseas business process outsourcing (BPO). BPO activities range from call center operations to such activities as financial analysis and the preparation of radiology reports.

The current offshoring trend has been driven by a number of forces — *eg*, difficult economic conditions in the U.S., dramatic reductions in telecommunications costs, increased powers of the Internet, and improved overseas supplier capabilities. The primary driver is, however, cost savings. Forrester Research Inc., a Cambridge, MA research firm, reports that companies can experience cost savings of as much as 25% to 40% from offshoring.

Whatever the range of savings, offshoring is on the rise:

- Forrester Research estimates that, by 2015, 3.3 million high-tech and service industry jobs will move overseas.
- The market research firm, International Data Corporation (IDC), reports that the IT offshore market will nearly double to $14.7 billion by 2009.
- In the financial services sector, Deloitte Consulting estimates that approximately 2 million jobs, or 15% of the industry's total, could move overseas in the next 5 years.

Factors Influencing the Offshoring Decision

India is by far the undisputed leader in the offshoring market, whether in the IT sector or in the fields of call centers, financial services, human resources and the like. The main driving force behind this movement to India is cost, but there are many other factors building the offshoring marketplace. Many experts claim that India has captured the offshoring market in large part because of the initiatives of the Indian government to encourage outsourcing to India. These initiatives include the building of telecommunications infrastructure, particularly in technology parks, and incentives for exporting of software from India. In addition, broad-based English language skills as a result of the British colonial legacy, as well as a large, college-educated population with some 2 million English-speaking graduates per year, particularly in the technology area, have fueled the ability of India to become increasingly competitive in the marketplace. India boasts many technical universities (including one of the best in the world, the Indian Institute of Technology), which graduate some 75,000 students per year.

Other countries, such as China, the Philippines and Russia are gaining market share, particularly as a result of their lower-cost labor markets. Those countries do not, however, have the confluence of factors conducive for encouraging broad-based, sophisticated outsourcing of IT and other services to their marketplace. For example, while China may have an enormous pool of low-cost labor, it does not have the cultural compatibility (*eg*, language skills), widespread, highly sophisticated technical skills or a welcoming legal environment to attract a wide range of outsourcing work. While the Philippines has a large English speaking population, low wages and many government-supported incentives, comparatively speaking it has a small population with only about 380,000 college graduates per year, of which 15,000 are technical graduates. Russia, while lacking the wide-spread English language skills boasted by India and the Philippines, has developed a niche market of complex software development and aerospace engineering, thanks to its large population of engineers and scientists, and Mexico is capturing the market for Spanish-speaking call centers.

In any event, in selecting a country for offshore operations, companies and institutions should consider such factors — not in any particular order — as labor and infrastructure costs, the size and sophistication of the labor market, domestic infrastructure, government support for industry, process quality, cultural compatibility, political risk and the local legal system. In addition, careful consideration should be given to certain cultural issues.

Quality Control & Governance

One key issue associated with offshore outsourcing is quality control. Quality control begins prior to negotiating any vendor contract and continues with the active involvement of the customer through the term of the outsourcing relationship.

A customer seeking to ensure that an offshore vendor is capable of providing consistent, high-level services should conduct thorough due diligence of the vendor prior to executing a contract. Any due diligence review should cover such matters as the vendor's financial standing, sufficiency of resources, expertise, skill levels and competitiveness. In addition, a customer may wish to determine the availability of dedicated vendor management personnel to oversee the project, whether appropriate industry certification levels are maintained and the existence and sufficiency of back-up facilities. Such due diligence can begin with informal discussions with existing and prior customers, and be followed with advice and recommendations from industry experts.

Once the customer is satisfied with the results of its due diligence efforts and is proceeding to contract, it should be certain to negotiate terms

continued on page 6

Outsourcing

continued from page 5

which would facilitate quality control. Such terms should not only cover specific service level requirements, references to industry certification levels and other quality assurance and performance standards, but should also include extensive and detailed governance terms with respect to the outsourcing relationship and the outsourced services. Such governance terms are of particular importance in overseas outsourcing contracts where the difficulties and cost of management and oversight are increased by virtue of physical distance and differences in culture, as well as in standards and practices.

The governance terms would depend upon the nature and extent of services moved offshore, but should include such measures as the following:

- Appointment of project managers, both on the vendor and customer sides, who would meet frequently and would have specified management, decision-making and reporting responsibilities;
- The establishment of a project office for the outsourced services, particularly in cases where services would be performed in various locations or where coordination would be required amongst varying business units within the vendor organization and/or customer organization;
- The establishment of a steering committee, with senior representatives from both customer and vendor, to oversee the outsourcing project and to resolve disputes between the parties;
- Appropriate training sessions at customer facilities to educate vendor staff about the business practices and operations of the customer;
- Relocation of customer personnel to vendor facilities to oversee, for example, transition and implementation activities;
- Identification of measurable data and adoption and use of tools to measure performance; and
- The establishment of regular reporting requirements (applicable both internally and by vendor) to surface issues.

To ensure quality control, the terms negotiated in a contract will be worth only the paper they are written on unless there is appropriate management of the outsourced services. Not only must the customer monitor contract compliance, but it must also adopt internal procedures and practices to maximize the benefits of the offshore arrangement, as well as to mitigate against its risks.

The customer should be actively involved in the transition of services to the offshore vendor, as well as with the implementation of any phases of the operations. In this regard, the matching of a vendor's environment to the customer's will be critical. A dedicated team of customer personnel should be assigned to the project with clear instructions as to roles and responsibilities. Furthermore, a project plan should be developed that, among other things, specifically identifies subject matter expertise and diagrams appropriate knowledge transfers to vendor counterparts.

One risk that the customer must mitigate against is the potential loss of subject matter expertise. As operations are moved offshore, there is a risk that, over time, with personnel movement and attrition, the customer will lose its internal knowledge base. To mitigate this risk, the customer should engage in preplanning and carefully track knowledge developments and transfers to preserve subject matter expertise.

The customer should also periodically review compliance with contract terms and on an annual basis, for example, review the offshoring relationship and establish targets to be achieved.

Business Continuity

Another key issue to address in any outsourcing transaction — particularly where critical functions and operations are being outsourced overseas — is business continuity. The customer and vendor must develop and implement viable contingency plans in the event of any inability of the overseas vendor to deliver services, whether as a result of war, terrorism, natural disaster, governmental action, power failures or otherwise. Certain regions of the world may pose greater political risks or may be more prone to natural disasters.

Risk mitigation strategies include the following:

- Establishment of disaster recovery sites in geographically disparate locations;
- Development of rigorous and detailed contingency plans for each functional area of outsourced services;
- Contracting for alternate source(s) of services in the event the offshore vendor is unexpectedly precluded from providing services; and
- Contractual provisions for adequate and periodic knowledge transfer and delivery of, for example, source code and back-up data from the offshore vendor to the customer or to other service providers.

The customer should bear in mind that disaster recovery or business continuity measures are bound to increase the fees charged for services. Of course, such costs may be mitigated by any economies of scale the vendor is able to offer through shared disaster recovery sites.

Intellectual Property Protection

Ownership and the licensing and protection of intellectual property rights are, of course, critical issues in outsourcing, particularly in the context of offshore outsourcing arrangements. Offshoring greatly complicates matters.

One of the first issues a customer will need to consider in contemplating

continued on page 7

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Outsourcing

continued from page 6

offshoring is whether software and other technology currently licensed by the customer from third parties will need to be transferred overseas for purposes of the offshoring, and whether the third-party vendors will permit such overseas transfer.

Another issue to consider is whether any proprietary customer software or technology will need to be moved overseas and whether the customer should be concerned about doing so in light of inadequate legal protections offered in most lower-cost markets. Even though China, India and other countries have laws on their books to protect against piracy and infringement, in practice they are generally difficult to enforce. Once one copy of a software application is leaked, it may be impossible to prevent its widespread distribution. A customer may therefore wish to reconsider the offshoring of certain sensitive operations. Alternatively, it may consider fragmenting its outsourcing activities so that, for example, application development and maintenance work is parceled out in a manner to ensure that no single outsourcer is given a complete copy or understanding of all critical functions of a software system or other technology.

Ownership of newly developed intellectual property rights also deserves careful attention. As in domestic outsourcing transactions, customers will typically wish to seek ownership rights in software and other technology developed for the customer by the overseas outsourcer. Ownership rights in offshoring contracts will, as in domestic outsourcing contracts, generally be based upon negotiated terms. While parties may agree to have such contracts governed by U.S. law, a court in a foreign jurisdiction may not recognize its application (see, "Governing Law", below). Accordingly, U.S. customers should seek legal advice from local counsel to determine the effect, if any, of the application of local law to a contract and to tailor the contract accordingly.

Case in point: India's intellectual property laws are quite similar to those in the U.S. There are, however, sufficient differences that could trap the unaware. For example, while Indian intellectual property laws include the concept of "work made for hire" and recognize assignments of intellectual property ownership rights, there are subtle differences. If the territorial extent of assignment is not specified as "worldwide", assignment will be construed to be limited to rights in India. In addition, if an assignee of rights does not exercise the rights within 1 year of assignment, the assignment would lapse under Indian law unless the assignment specifies otherwise. Accordingly, any assignment of IP rights to software developed in India should specify that the assignment pertains to worldwide rights and that it is a perpetual assignment that would not lapse in case of non-exercise within 1 year.

Governing Law and Jurisdiction

Most offshoring contracts between U.S. companies and overseas vendors are governed by U.S. law — for example, New York law. This is typically the case because customers, in the driver's seat during negotiations, insist upon U.S. law for reasons of familiarity and enforcement. In addition, sophisticated foreign outsourcing vendors negotiating with U.S. customers are accustomed to having their contracts governed by U.S. law.

Choice of law and exclusive jurisdiction provisions might not, however, be upheld by foreign courts. For example, while Indian courts, which follow English law on the choice of law question, will generally recognize the application of New York law, there is some risk that the agreed upon choice of law will not be recognized for reasons of public policy. Similarly, whether or not exclusive U.S. jurisdiction is upheld will depend in large part on which country has a greater nexus to the transaction. As such, an Indian vendor may be able to have an action heard in an Indian court, regardless of a U.S. exclusive jurisdiction provision.

Additionally, even if the U.S. customer seeks and wins a judgment in a U.S. court, it may not be able to enforce the judgment in India. Most foreign judgments cannot be directly enforced in India, except certain decrees granted by "superior courts" in "reciprocating territories". However, the U.S. is not a reciprocating territory and, as such, judgments awarded in the U.S. would currently not be enforceable in India. As noted above, a U.S. customer should therefore be cognizant of what effect the application of local laws could have on the interpretation of the commercial terms agreed to by the parties.

One point to bear in mind when negotiating exclusive jurisdiction provisions is injunctive relief. The negotiator of a contract should be mindful that if it insists upon the exclusive jurisdiction of U.S. courts in all cases, it may preclude its ability to seek an injunction in the local jurisdiction. An injunction granted by courts in the U.S. may not be executed in a foreign jurisdiction — this would certainly be the case in India. Accordingly, the parties may wish to consider a nonexclusive jurisdiction provision or an exclusive U.S. jurisdiction provision, except in the case of injunctive relief.

Parties to an overseas outsourcing contract may also wish to consider the alternative of an arbitration provision, particularly if the contract involves an Indian service provider, since U.S. arbitral awards are generally enforceable before Indian courts if properly drafted to meet Indian requirements. India is a signatory to the United Nations Convention on the Recognition and Enforcement of Arbitral Awards (commonly known as the New York Convention).

Data Security

Data security laws present particularly thorny issues for outsourcing transactions, especially in offshoring. Most of the developing countries to which services are outsourced do not have data protection laws consistent with those of the industrialized countries from which services are outsourced.

The European Union (EU), for example, has broad-based data protection requirements that govern the collection, use and transfer of certain personal data, while the U.S. has adopted a sector-specific regulatory framework protecting data. Whatever

continued on page 9

Unlawful Helplines

continued from page 1

was not yet running in France. The company was simply seeking prior authority from the CNIL. The proposed hotlines allowed employees to 'blow the whistle' on perceived wrongdoings by colleagues using telephone, fax, post or e-mail. The CNIL thought that these hotlines were "*disproportionate in view of the objectives pursued and of the risks of slanderous denunciations …*" Although both companies had apparently complied with the 1978 French Data Protection Act as modified in 2004, the CNIL decided that hotlines would be illegal for the following reasons:

- **Lack of transparency.** Individuals who are the subject of a whistleblower's allegations may not be able to hear or reply to the accusations made against them. In their decision, the CNIL said that French personal data protection laws are designed to make sure that individuals whose data is being processed know who has that data and can have access to it, and if necessary, correct it. The hotlines under consideration however, were designed to ensure anonymity. The hotlines were then not "transparent" in the manner that French law requires.
- **Natural justice.** Accused employees would not have the means to defend themselves or oppose the proceedings that may involve criminal charges.
- **Professional ethics.** The hotlines were said to be disproportionate to the aim they sought to achieve.

The CNIL said it was aware of the conflict with SOX and has asked the French Employment Minister and the competent authorities in the U.S. to resolve this issue. We understand, however, that in the meantime more decisions are pending.

In its decisions, the CNIL did provide some short-term comfort in pointing out that French law already allows employees to report bullying, sexual harassment or discrimination. They can complain to their management, to their employee representative (*delegues du personnel* or *comite d'entreprise*) or even complain directly to the Labor Inspector (*Inspection du Travail*).

GERMANY

Less worrying for many U.S. employers is the German decision from the Arbeitsgericht Wuppertal (the German Labor Court in Wuppertal) on June 15. The German and French decisions are however not nearly as similar as some earlier reports had suggested. The Wuppertal case involved the unnamed German subsidiary of a U.S. stores group referred to in court as "Firma X.-Stores, Inc." and was also said to make whistle-blowing hotlines "illegal" in Germany. However, closer examination of the German court's decision reveals that the court did not make any general finding of the unlawfulness of whistle-blowing hotlines. It did not address any issues of data protection or privacy laws. The decision deals solely with question of German Works Council rights.

The Litigation

The circumstances leading to the litigation were these: "Firma X," a NYSE-listed entity had issued a detailed "Code of Business Conduct and Ethics" on a global basis by placing it on its Intranet, issuing a communication to employees summarizing the key points of the Code and informing them that all employees were obliged to adhere to the Code. They also had posters made to bring the Code to the attention of employees. Crucially, when doing so in Germany, they did not involve their Works Council (a designated employee representative body that exists in much of Europe), which then applied to the Labor Court in Wuppertal to order it not to implement the Code as well as the telephone hotline for global company ethics.

The Works Council argued that the relevant parts of the Code and the telephone hotline regulated conduct and order in the German business and therefore required its consent under the Betriebsverfassungsgesetz — the German legislation dealing with Works Councils. In the absence of this consent, the Code and hotline had not been lawfully implemented and should not be allowed. The employer argued that the Code contained only abstract guidance and no mandatory conduct rules which in many instances reflected only pre-existing obligations under German law, either under statute or under implied duties under the employment contracts.

The court's decision, which stretches to around 27 pages, examines each contested provision of the Code in turn and holds that some, but not all of them, did in fact require prior Works Council consent. In relation to the telephone hotlines specifically, the Court states that: 1) because the Code contained a specific whistle-blowing procedure and threatens disciplinary action in case of breach, it sets out mandatory conduct rules which require Works Council consent; and 2) the telephone hotline constitutes technical equipment designated to monitor employee conduct the introduction of which also requires consent.

In reality, then, the case does not make any new point of law. It does not ban SOX hotlines *per se*. It merely applies long-standing principles of German labor law requiring the involvement of the Works Council in the process of implementation. Interestingly the French CNIL decisions also stressed the need to consult the

continued on page 11

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The Roots and Practice of Chinese Law

By George T. Haley and Usha C. V. Haley

The traditional Chinese view towards the law and government rule continues today. According to the 2004 American Chamber of Commerce in China White Paper, 92% of American companies identified the top challenge in China as unclear regulations. The other challenges that the American companies perceived also dealt with the regulatory environment and included, in order of importance, bureaucracy, lack of transparency, inconsistent interpretation of regulations, poor intellectual property rights protection and difficulty enforcing contract terms.

The Supreme People's Court indicated in an initial report on its records that Chinese courts dealt with 23,340 civil and commercial cases involving foreign parties between 1979 and October 2001. The actual number of cases could be much higher. Grass roots and intermediate courts can hear commercial cases involving foreign parties under current practices. However, the traditional overlap between administrative and judicial divisions contributed to local protectionism in local Chinese courts and hindered the fair handling of cases. In response to these concerns, China's

continued on page 10

Outsourcing

continued from page 7

the applicable regulatory framework, one important consideration for the customer is that it will remain responsible for compliance with any applicable data security requirements. In contrast with other types of responsibilities, it cannot shift responsibility to the vendor. As such, it is imperative that the customer oblige the offshore vendor to comply with any applicable requirements as well. Given that an offshore vendor is unlikely to be subject to such laws independently or by virtue of simply being a service provider to the customer, the customer must contractually require compliance with data protection standards. In addition, careful analysis of the regulatory framework may be required to ensure appropriate deal structure and data flow to comply with applicable requirements.

TAXATION

Taxes are also a significant concern in outsourcing arrangements. It is important that the customer consults with international tax counsel, as well as local counsel, to minimize tax liabilities when structuring any transaction.

In India, there had been some uncertainty about whether foreign companies that have outsourcing operations in India would be deemed to derive income from offshoring operations, including those contracted to third-party vendors, and therefore be subject to Indian taxation. The Indian Finance Ministry has, however, clarified its position on the question of such taxation. It stated, in essence, that where a foreign entity outsources "incidental activities", such as call center services, to India, any profits derived from such incidental activities would not be separately taxable in India; provided that the prices charged for such outsourced services are at arm's length. On the other hand, where a foreign outsourcing entity outsources the whole or a part of its "core revenue generating business activities" to an Indian entity (assuming such Indian entity qualifies as a permanent establishment of the foreign outsourcing entity), the Ministry's position is that considerable profits derived by the foreign outsourcing entity would be attributable to activities performed by the Indian entity and therefore would be taxable in India.

Whether or not outsourced activities in a foreign jurisdiction would be taxable must be determined on a case-by-case basis. Accordingly, any proposed offshoring arrangement should be carefully analyzed.

OTHER CONSIDERATIONS

The customer should also evaluate whether U.S. export controls apply to any software it desires to ship to its foreign vendor. If they do apply, the customer should bear in mind that not only must it comply with the laws, but it will also be responsible for vendor compliance as well. Failure to comply could lead to both monetary and criminal penalties. In addition, customers operating in certain regulated industries may also be subject to legislation or industry standards requiring specific consideration. In the financial services sector, for example, offshoring arrangements may be scrutinized by U.S. regulators.

CONCLUSION

In summary, the outsourcing of IT functions and business processes overseas has become an increasingly wide-spread practice, particularly among sophisticated multinational corporations, with the potential for significant impact on the way we conduct business in the U.S. and other industrialized nations today. India has captured a bulk of this market with its ability to offer language and legal-system compatibilities, governmental initiatives and highly sophisticated vendors. It is, however, experiencing growing competition from such countries as China and the Philippines, as well as from Eastern European countries.

The customer seeking to negotiate an offshore outsourcing contract must grapple with issues and commercial terms common to any domestic outsourcing transaction. In addition, it must be prepared for offshoring-specific issues and considerations, including those outlined in this discussion. With increased competition in the international marketplace and further legislation addressing data security and other concerns, customers and vendors will be required to develop an even greater sophistication in addressing increasingly complex issues affecting offshoring transactions.

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Chinese Law

continued from page 9

central government took dramatic steps to improve the situation by announcing that after March 1st, 2002, only approved courts could handle cases involving foreign interests. Such courts include the high courts; intermediate courts in municipalities, capital cities of provinces and autonomous regions, special economic zones and cities directly under State planning; and some courts in the cities' economic and technological development areas. Additionally, listed companies and large companies in China were required to hire chief legal advisers. However, the new practices did not apply to cases of border trade, real estate and intellectual property-right violations involving foreign parties, the primary concerns of foreign companies.

Historical developments can explain many of the contradictions in China's legal system, including the central government's commitment to initiate reform and the obdurate problems of implementing this reform. The Chinese economist, Chen Yun, described the Chinese economy as a "bird in a cage." The owners must let the bird fly, *ie*, the central government must introduce market forces and some measures of decentralization, but only within the cage's confines, *ie*, the central plan, lest the bird escape. Both the imperialist legacy and the Maoist overlay failed to differentiate between the functions of law and administration; both placed the judicial system at the same level as the state's bureaucracies in the political hierarchy. Thereby, both the emperors and the Communists failed to give authority to the courts over administration and limited the powers of judicial interpretation. Despite its burgeoning market economy, law in China still serves more as an instrument of control than as a framework to facilitate private transactions or to protect rights.

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Historical Influences on China's Legal System

Westerners generally differentiate between common-law and code-law systems. Yet both legal systems converge, especially on issues of commercial law. By guaranteeing their citizens basic minimum rights, both constitute rights-based legal systems. Additionally, common-law countries have adopted commercial codes to apply in business situations. Superficially, China's legal system appears similar to code-law systems; yet, substantial differences exist.

China enjoys a public law rather than a rights-based system as in the West. Public-law systems do not guarantee individuals' rights; instead, individuals' rights exist at the rulers' behest, and the rulers can withdraw the rights at whim from either an entire class of people or from a single individual. To ensure that the emperors could enforce their wills without legal challenges, the imperial Chinese courts desired that commoners possess no knowledge of the law.

China's public-law system seemingly froze in the era of customary laws until the 20th century.

The Communist government has made several attempts to move towards a code-based legal system, including drafting five constitutions; however, it has failed in practice. The Chinese Communist Party's (CCP) overwhelming power, together with no legal precedents and poor legal training, have directed the country towards a public-law system in practice. The Chinese judicial branch has no independence from the executive branch. On issues that the national or provincial CCP hierarchies consider strategically important, the courts follow the governments' directives. This characteristic can be a significant concern in some industries. For instance, because of national security concerns, the Chinese government has always been suspicious of foreign software and foreign-owned intellectual property in the Information Technology (IT) sector, and has sometimes even encouraged the cracking of computer codes.

Unlike the U.S., the Chinese legal system also places much greater emphasis on mediation of conflicts rather than litigation in courts. Mediation reflects the Chinese culture's historical tendency to seek social harmony through compromise. The Chinese tend to view disputes that result in blatant conflicts, such as court cases, as systemic failures, not as efforts to seek justice or equitable settlements. Also, as indicated earlier, until the early 20th century Chinese law did not incorporate the concept of commercial law, much less practice it. In the Communist era, no commercial laws dealt with domestic business until Deng Xiaoping promulgated his reforms, and adopted the General Principles of Civil Law (GPCL) and the Bankruptcy Law in 1986. Laws dealing with Foreign Direct Investment (FDI) first appeared in 1979. China's evolving Law for Foreign Business now comprises a nine-volume set available in Chinese and English. For Western companies in modern China, however, mediation produces compromises in commercial complaints more than victory for the aggrieved parties.

Characteristics of Chinese Commercial Law

The Chinese government has enacted commercial laws approximating those in Western democracies; yet, these laws continue to operate within the constraints of Chinese society and culture. Compromise and negotiation remain at the crux of China's legal structure.

Foreign companies can settle commercial disputes in China through conciliation, arbitration and litigation.

Conciliation v. Arbitration

Both negotiated settlements in China's legal system, conciliation and

continued on page 11

Chinese Law

continued from page 10

arbitration, differ in practice and effect. Conciliation comprises a consensus-based dispute-resolution process in which the parties to a dispute meet with a third party to discuss mutually acceptable options for the resolution of the dispute. The contending parties choose mutually agreeable individuals as conciliators. The conciliators strive not to establish fault, but to help the parties attain compromise. Conciliation carries less cost and has more informality than arbitration.

Governmentally approved centers conduct both conciliation and arbitration: 35 government-sanctioned centers engage in conciliation; and over 400 government-licensed arbitrators, about 25% of whom come from foreign countries, perform arbitration. In conciliation the parties may negotiate any mutually acceptable settlement. In arbitration, the arbitrator must additionally consider the settlement as fair. For disputing joint-venture (JV) partners, fairness includes the partners' relative capital contributions limiting the settlements. Chinese arbitrators generally assume at least a 10% capital contribution on the part of the Chinese JV partner even when they have not made any contribution to capital. Chinese law enforces arbitration, but not conciliation without arbitration or litigation, thereby giving this more costly alternative a decided advantage for foreign companies. Both conciliation and arbitration have substantial procedural advantages over litigation, as they utilize more developed infrastructures.

Business-Government Influences on Litigation

True litigation constitutes a relative newcomer to China and many Chinese managers consider litigation as a failure. Additionally, especially when the litigants operate in strategic industries, the Chinese government (central, provincial and municipal) and CCP intervene openly in courts. Consequently, the litigants must consider the provincial and municipal governments' strategic interests, as well as the central government's. Finally, the central government has little effective control over provincial governments. To succeed in China, and to ensure smooth operations, companies must build strong relationships with China's many levels of governmental authority.

Kenneth DeWoskin, Partner, Pricewaterhouse Coopers, China, highlighted aligning companies' interests with local interests to facilitate the building of sustainable and profitable businesses in China. He advised against excessive dependence on legal instruments and for a thorough understanding of regulations and actual practices. Foreign companies should embark upon expansive and systematic identification and selection of local partners to obviate litigation. Finally, he recommended that foreign companies should invest in due diligence to assess the real-revenue potentials of investments in China and again sidestep time-consuming and often futile litigation. In sum, it is always better to avoid conflict and litigation in China whenever possible.

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Unlawful Helplines

continued from page 8

Works Council or staff delegates on the implementation of internal regulations regarding health and safety, disciplinary procedures, harassment and discrimination issues.

UK

In the UK, Works Councils are less of a concern, and the UK Information Commissioner's office has said that their initial reaction is that they would decline to follow the French approach. Their view is that the appropriate use of hotlines would not, in principle, raise data protection concerns. However, where organizations misuse anonymous hotlines for inappropriate information gathering purposes (*eg*, recording details of employees' romantic relationships or other out of office activities), there may be data protection implications. To date, the Information Commissioner has not received any complaints from individuals affected by anonymous hotline reporting.

However, the rulings are still likely to be of concern to corporations employing in the UK, since anonymous hotlines are commonly used to enable compliance with UK whistleblowing laws in addition to requirements under SOX. Under the Public Interest Disclosure Act, any employee who is dismissed or subjected to a detriment on grounds of "blowing the whistle" can be awarded unlimited compensation, regardless of age or length of service.

CONCLUSION

These cases are clearly a concern to any corporation operating a hotline with operations in Europe. While the German decision is not as worrying as first reported, it does emphasize the fact that proper care must be taken in adopting helplines and that a "one-size-fits-one" approach to each country in Europe must be considered. Approximately 33 countries in Europe have some form of data protection or privacy law in place. While there are commonalities between most of these sets of regulations, each nation state appoints its own privacy regulator to enforce its laws. There are local variations, and importantly even where the law looks the same, interpretation and enforcement will vary from country to country.

The French case is more of an immediate concern with an objection in principle to the type of hotlines most U.S. corporations operate. Organizations that deal with all calls in the U.S. are likely to be particularly at risk — for them, in addition to issues caused by the collection of data, additional issues with the transfer of that data outside Europe will have to be managed. While steps can be taken to mitigate the effects of the French decisions (for example, by putting proper agreements in place with the operators of an outsourced hotline and by a proper legal audit of the data flow), this will remain a significant issue unless and until some clarification is provided or CNIL backs down — and that should not be expected any time soon.

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Protecting Technology

continued from page 2

better informed to decide whether to initiate the national patent filings in the various designated patent offices. Only if the applicant is convinced, in light of such reports, that it is worthwhile to seek patent protection in the various countries, will it be necessary to pay the national filing fees, the cost of translations, and foreign patent agent fees. This needs to be done 30 months from the original priority patent filing date. Thus, under the PCT, the decision and cost of filing national patent applications can be postponed an additional 18 months later than under the traditional Paris Convention system.

The European Patent Convention (EPC) is a system to make protection of inventions in Europe easier, cheaper and more reliable. The EPC provides a single European procedure for the searching, examination, and grant of patents. Under the EPC, a single application is filed with the European Patent Office (EPO) that "designates" the various European nations for which patent protection is desired. Once the European patent is granted, the applicant must then validate the patent in any or all of the nations originally designated. A European patent confers on the applicant the same rights as would be conferred by a separate national patent granted.

Steps to Improve Foreign Patent Efforts

A few simple steps can dramatically improve the effectiveness of foreign patent efforts.

1. Do not commercially use or disclose information about the invention before filing a U.S. patent application. Non-confidential disclosures or sales of the invention before a U.S. application is filed may limit or bar the ability to obtain foreign patents for the invention.

2. Understand, and comply with, deadlines established under U.S., foreign, and international laws. Specifically, the Paris Convention requires foreign patent applications to be filed within 1 year of the first-filed patent application for the invention. Most foreign countries require payment of annual maintenance fees at specific deadlines. Some foreign countries require other steps, like requesting examination, within specified deadlines.

3. Develop a sound foreign patent strategy based upon a careful review of long-term business plans and foreign market interests. Regularly review foreign patent holdings and assess whether the business value provided by the patents justifies their annual maintenance costs, and abandon foreign patents and applications that lack sufficient value.

4. Assess the nature and patentability of the invention when deciding to file foreign patent applications. If the invention is a core item or very important to the company's business, then foreign patents may be justified. Inventions with a short lifespan or of marginal improvement may not warrant foreign patents.

Summary

Foreign patent decisions are complex because of the many factors and issues that must be weighed before deciding whether the investment in foreign patents is appropriate. Businesses that carefully apply sound foreign patent strategies may obtain meaningful patent protection that will produce a return on investment.

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Foreign Investments

continued from page 4

Mississippi Courts, brought a claim which, whilst failing on technical grounds due to Loewen having failed to exhaust local remedies and the claim being found to lack international diversity, drew strong criticism from the ICSID Tribunal concerning the conduct of the Mississippi Court and recognised that Loewen was treated unfairly.

Claims under the Investment Treaty regime against western governments seem set to grow in number.

Prudent Steps to Maximise Scope to Bring a Treaty Claim

When seeking to structure investments, parties give consideration to the tax implications, the availability of sources of future funding, regulatory requirements and a host of other factors. Where commercial activities or other enterprises which have potential to fall within the definition of "*investment*" are contemplated, particularly in countries with potential for political risk, serious consideration ought to be given to structuring the investment in a manner which affords the investor the opportunity to claim nationality in a state which is a party to MITs and/or BITs with the host state. Thereby maximizing the scope for the investor to take the benefit of investment treaty protection.

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