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# The Top 8 Do's and Don'ts in Foreign Outsourcing

From a business lawyer's perspective

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Foreign outsourcing gets a lot of attention from political and economic pundits. Little of the analysis, though, is of much use to the closely-held business who might have to outsource overseas to remain competitive. We've tried to improve on the information available to closely-held businesses by developing a list of eight do's and don'ts in foreign outsourcing based on our experience and knowledge as business lawyers. We hope you find them to be practical as you seek a relationship with a foreign supplier. We think you will also find them useful in your decision *whether* to outsource overseas.

**1. Do the Due.** In dealing with foreign businesses, what really counts is who you do business with. Because of the systemic risks associated with doing business with a foreign company, this issue is of even greater importance than when doing business with a U.S. entity. Don't rely simply on the lowest bid. Do your due diligence to investigate your potential supplier. Determine if that foreign business is trustworthy, competent, and able and willing to perform as promised. Ask for samples and for U.S. and local references. Check out the company with local trade associations. Your local advisors can probably get information from professionals in most major foreign cities. The U.S. Consulate in the locale may be able to provide information. Establish a personal relationship with your counterpart within the foreign entity. Visit the company's production facilities. Get a sense for the company's experience and any production or labor problems that may exist.

After identifying a trustworthy supplier, negotiate a contract for the work. That process will tell you much about how that company will deal with future problems. Parties of good faith will fairly allocate the benefits, costs, and risks of the venture between themselves. Be wary of one who is unwilling to do so.

**2. Protect Yourself With an Arbitration Clause** Your contract should address dispute resolution. If your contract is silent on that issue, you may be defending yourself in a foreign court. That is an expensive proposition and you are highly likely to lose regardless of the merits of your case. In some countries, the legal system is not well developed or views its purpose as protecting its own companies and citizens from foreigners. It is easy for the foreign company to get a judgment against a U.S. company in the foreign court and then enforce it in the United States.

Also, don't assume that you will be able to enforce a judgment you obtained in the United States against the foreign company in its country. It is difficult for a U.S. business to obtain a judgment here that can be enforced adequately in many foreign courts.

For these reasons, every contract you enter with a foreign entity should require dispute arbitration before an independent tribunal – usually the Court of International Arbitration – and should specify a neutral forum for the proceeding. Even if you would never consider paying the cost of suing a foreign company, include

the arbitration provision to protect yourself if the foreign company attempts to pursue you in its own courts.

**3. Beware of Export Control and Customs Laws.** Before you agree to deliver the goods, technology, or software that your supplier will need to produce goods for you, be sure you are not violating one of the many U. S. export controls. Those export controls apply in ways that are not always obvious. If you allow the foreign supplier to use or even view your technology in the United States, you may have violated those laws, even though your technology never left the country. Certain goods and technology produced abroad using U.S. technology may fall within the scope of the export control laws. Violation of these laws may subject you to substantial penalties and could preclude you from obtaining export licenses.

Plan your strategy for dealing with customs issues early in the transaction. Although duties and tariffs have been falling, some still exist and even a small one can erase the profit from an international transaction. Make sure that you have all of the appropriate documentation necessary to import goods to the U.S. without costly delay. A good customhouse broker will guide you through this process.

**4. Use the Payment Method to Protect Yourself.** Both buyer and seller have an interest in protecting themselves in the transaction. The buyer needs assurance that the seller will perform while the seller needs assurance that the buyer will pay. Neither wants to rely upon a lawsuit to protect its interest. The letter of credit has developed as the most commonly used payment method addressing both concerns. A simple letter of credit involves three independent contracts. The buyer and seller agree on the terms of the underlying contract. The buyer contracts with a bank to issue a letter of credit to the seller guaranteeing payment to the seller upon the seller's presentation to the bank of certain documents, for example the bill of lading, insurance documents, certificate of origin and certifications of quantity and quality of the goods. The bank contracts to pay the seller upon the seller's strict compliance with those documentary requirements. The independence of the contracts protects both the buyer and the seller. The seller knows it will be paid if it delivers the required documents to the bank. The bank cannot look to the performance of the underlying contract to determine if it should pay the letter of credit, but only to the seller's delivery of the required documents. The buyer has assurance of the seller's performance, because the seller cannot obtain the required documents to deliver to the bank until it has produced the goods and the goods are ready for shipment and have been inspected.

**5. Protect Yourself Against Production Setbacks.** You've found the supplier, you've made the deal, and you're awaiting your goods. And you are still waiting. Make sure the supplier understands your delivery and shipping requirements. Your contract should include a production schedule and a shipping date. Make sure the supplier meets interim deadlines, such as proto-type delivery and production sample testing. Make frequent inquiries about production status. Be certain that you meet your obligations that may affect the schedule, such as the timely delivery of specifications, technology, or approvals to the supplier. Have a back-up source available whenever possible.

**6. Don't Lose Your Intellectual Property.** You can easily lose control of your intellectual property when outsourcing overseas. Take the following situation, which is based on a true story. (Names and certain facts have been changed to protect confidentiality.) Wake Up, a Washington limited liability company, developed a process for manufacturing wake boards that perform better than the competition's. Wake Up protected the process as a trade secret. As time progressed, Wake Up

decided to manufacture the wake boards in India to reduce costs. The Indian manufacturer signed an agreement to keep the process a trade secret. However, Wake Up later discovered that an employee-engineer of the Indian manufacturer had stolen its process and begun his own wake board manufacturing operation in India. Wake Up planned to sue him for trade secret theft, but it discovered that, unlike U.S. courts, Indian courts rarely stop a trade secret thief unless he has signed a confidentiality agreement. Since the former employee hadn't signed such an agreement, Wake Up couldn't enforce its trade secret in India.

Because of stories like this one, we highly recommend that you don't share your intellectual property with a foreign supplier. If you really must share the IP to make the transaction work, then we highly advise the following:

Do a thorough check on the trustworthiness of your supplier and its employees. If you're uncomfortable after the check, find a different supplier.

Locate a supplier in a country with a well-developed legal system.

Ask foreign counsel about the strength of patent protection in the foreign country. File for a patent if patent protection is effective in that country. If your process or invention is not protected by patent in the foreign country, disclose only that information that is absolutely necessary for the supplier to do its job. Get the supplier and its employees to sign a confidentiality agreement. Ask foreign counsel if the agreement will be enforced by the local courts and how much enforcement would likely cost. Ask the foreign supplier whether it intends to subcontract any of the work. If it does, then do your due diligence on the subcontractor and get confidentiality agreements from the subcontractor and its employees. If your due diligence raises questions about the subcontractor, ask the supplier to find another subcontractor.

**7. Minimize Your Exchange Rate Risk.** Foreign outsourcing can create a currency risk. That is, the foreign currency with which to pay the foreign supplier could appreciate in value before the foreign currency payment is due.

There are number of potential solutions to this risk. The first is to contract for payment of the foreign supplier in US dollars. This option is the simplest and usually the cheapest, but may be the least acceptable to the foreign supplier, because it shifts the currency risk to the supplier.

Another possible solution is a currency call option. This method gives the American outsourcer the option to buy an amount of foreign currency at a certain price in US dollars at the date the payment will be due. The buyer of the call option pays to the seller of the option a fee, called the premium. If the exchange rate has moved against the dollar by the time payment is due, the option can be exercised to acquire the foreign currency to pay the supplier. If the exchange rate moves in favor of the dollar, the option holder can let the option lapse and purchase the foreign currency on the spot market to pay the foreign supplier.

In either case, the cost of the transaction will not exceed the original price plus the premium. Thus the effect of buying a call option is to place a ceiling on the cost of the foreign supplier's goods without limiting the potential benefit if the exchange rate moves in favor of the dollar.

Other solutions that are potentially available are use of the forward market and foreign money markets. However, be aware that banks in these markets are often

reluctant to deal with small customers or in small amounts. Amounts less than \$500,000 can be considered too small.

**8. Hire a Foreign Lawyer.** Mistakes will be made if you outsource overseas without consulting a foreign lawyer. For example, do you (or your American lawyer) know that some countries maintain a corporate authority registry? The registry tells the public who has authority to sign contracts for any particular corporation located within the country. If you sign a deal with a foreign supplier without checking the registry, you might well sign a contract that you can't enforce. This is only one of a multitude of issues that you could overlook if you don't consult with a foreign lawyer.

Most often, you should engage a lawyer qualified to practice law in the country where the supplier is located. Your American lawyer can help you to structure the deal with the foreign supplier, but the deal should not be signed until reviewed by foreign counsel.

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