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Licensor beware

Technology law in China is full of provisions that work only to the advantage of a Chinese licensee. By J. Benjamin Bai

An American pharmaceutical company entered into a joint development agreement with a Chinese drug discovery company in Shanghai three years ago to develop a diabetes drug for the U.S. and Chinese markets. The Chinese company received compensation for the contract R&D work. Under the agreement, the American company licensed certain trade secrets and patents to the Chinese company, and the Chinese company dedicated a team of experienced Ph.D. chemists to the drug discovery process. The two companies also entered into a license agreement: The Chinese company agreed to assign any and all improvements to the licensed intellectual property to its American counterpart, and there was no separate recitation of consideration for the grant-back of ownership rights in the improvements.

After three years of extensive research by the dedicated team, the Chinese company discovered a new molecule that was a modification of its American counterpart's patented active ingredient for treating diabetes. The Chinese company filed an application under the Patent Cooperation Treaty in China covering the composition and method of making this new molecule. When the American company learned of the patent application, it promptly demanded that the Chinese company assign the PCT application to it. The Chinese company refused.

Because the Chinese company did not have assets or operations in the U.S., the American company could not sue the Chinese company in the U.S. On advice of Chinese counsel, the American company filed a breach of contract suit in Beijing. The trial court found that the new molecule had been discovered solely by the dedicated team of the Chinese company, which the American company did not dispute. Instead it relied on the assignment clause in the license agreement. The court, however, held that such an assignment was anticompetitive and therefore could not be enforced. Today, the Chinese company owns the patent application, and the American company has no right to it.

This American company—like many others—lost valuable intellectual property because it failed to understand relevant Chinese laws. In this case, the American company could have avoided this unfortunate situation if the agreement had provided for separate compensation to the Chinese company for the improvements. The U.S. company was tripped up by the Chinese Regulations on the Administration of Technology Import and Export of 2002, under which improvements to transferred technology belong to the improving party. Under the Chinese Supreme Court's Judicial Interpretation (which has the force and effect of law and is binding upon lower courts), a foreign licensor cannot require the Chinese licensee to assign the improvements or grant an exclusive license to use the improvements unless the licensee receives compensation.

IP licensing in China is fraught with traps for the unwary. **Chinese laws on contracts, patents, unfair competition, and foreign trade differ from U.S. law** in important ways.

IP licensing in China is fraught with traps for the unwary, as applicable Chinese laws, such as contract law, patent law, unfair competition law, and foreign trade law, can differ from U.S. law in important ways. Approaching technology agreements in China with boilerplate language common in U.S. legal documents is likely to cause problems. Among the many IP licensing pitfalls:

Failure to recognize mandatory provisions of Chinese law. When a foreign company transfers technology to China, the parties can generally agree that non-Chinese law, such as the law of the state of New York, governs the agreement. This has given many foreign companies the false impression that if they select a foreign governing law for the technology transfer agreement, they need not comply with any Chinese laws. In reality, certain provisions of Chinese law are mandatory. For example, the Chinese contract law provides that any technology contract that illegally monopolizes technologies or

impedes technological progress is null and void.

Misunderstanding of dispute resolution provisions. Chinese law allows a foreign licensor to select a foreign venue for dispute resolution, be it arbitration or litigation. However, while a judgment from a foreign court is effective against a Chinese company that has assets or operations in the foreign venue, enforcement in China can be difficult if the Chinese company does not have assets or operations in the foreign venue.

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To enforce the award or judgment in such a case, the winning foreign company must apply to a Chinese court that has jurisdiction over the losing Chinese company. The choice of court can be important. A foreign company is well served to choose in advance a Chinese court that is likely to be neutral or favorable to it for litigation. Large cities, such as Beijing and Shanghai, are more favorable to foreign litigators than smaller cities. As to arbitration, venues like the China International Economic and Trade Arbitration Commission in Beijing should be seriously considered and sometimes are generally preferred when dealing with a Chinese company with no assets overseas.

Inclusion of prohibited terms. The Technology Regulations provide that a technology import contract cannot contain provisions that allow, among other things, for:

- Purchase of unnecessary technology, equipment, or payment for expired or invalid patents;
- Restrictions on the transferee/licensee's rights to improve technology or to use improved technology;
- Restrictions on the transferee/licensee's rights to acquire similar or competing technology;
- Unreasonable restrictions on production volumes and sales price; and
- Unreasonable restrictions on export channels.

The Chinese Supreme Court's Judicial Interpretation specifies that the unequal rights of parties relating to the exchange of improved technology is included within the concept of "illegal monopoly of technology and impeding of technological progress." Such unequal rights can include the following:

- Limitations on improvement and usage of improved technology;
- Unfair exchange conditions on im-proved technology, such as grant-back of improved technology without compensation;
- Tie-ins; and
- Prohibitions or restrictions on a licensee's ability to challenge the validity of licensed IP.

Furthermore, Chinese law requires that the foreign licensor "guarantee" that the licensed technology is complete, correct, and effective, and that it will reach the specified technological target. The licensor is responsible if the Chinese licensee infringes upon another party's right by using the licensed technology.

No formation of a contract. Article 10 of the Chinese Patent Law states that if a Chinese company assigns one of its Chinese patents to a foreign company, the written assignment does not become effective until such assignment has been approved and registered by the State Intellectual Property Office of China. If the Chinese company fails to go through this statutory requirement, the foreign company has no right to the patent.

If any of a long list of provisions winds up in a technology import agreement, **the contract won't be enforceable in court.** Among the forbidden practices: limitations on the use of improved technology.

In summary, IP licensing in and out of China is subject to a myriad of Chinese laws, regulations, and judicial interpretations that significantly differ from U.S. law. These differences can increase transaction costs and even become traps for the unwary. A cost-benefit analysis should be made as to whether to license IP in and out of China. Only then can U.S. legal practitioners and their clients avoid unfortunate outcomes. ■

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