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Avoiding IP Licensing Pitfalls in China

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Three years ago, a US pharmaceutical company entered into a joint-development agreement with a Chinese drug discovery company, based in Shanghai, to develop a diabetes drug for the US and Chinese markets. Under the agreement, the US company licensed certain trade secrets and patents to the Chinese company, and the Chinese company dedicated a team of experienced PhD chemists to the drug discovery process. The two companies also entered into a license agreement by which the Chinese company agreed to assign any and all improvements to the licensed intellectual property to its US counterpart. While, under the agreement, the Chinese company received compensation for the contract R&D work, no separate consideration was recited 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, which was a modification of its US counterpart's patented active ingredient for treating diabetes. Subsequently, the Chinese company filed a PCT application in China covering the composition and method of making this new molecule. When the US 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 United States, the US company could not sue the Chinese company in the United States to compel specific performance. On advice of Chinese counsel, the US company filed a breach of contract suit in Beijing. The first instance court, *i.e.*, the trial court, found that the new molecule had been discovered solely by the dedicated team of the Chinese company, which the US company did not dispute. Instead it relied on the assignment clause in the license agreement. The court, however, held that such an assignment was anti-competitive and therefore could not be enforced. Today, the Chinese company owns the patent application, and the US company has no right to it.

Unfortunately, this US company, like many others, lost valuable intellectual property because it failed to understand relevant Chinese laws. In this case, the US company could have avoided this unfortunate loss if the agreement had provided for separate compensation to the Chinese company for the improvements. The US company was effectively outmaneuvered by the Chinese Regulations on the Administration of Technology Import and Export (the Technology Regulations), which state that improvements to transferred technology belong to the improving party. Under the Chinese Supreme Court's Judicial Interpretation, a foreign licensor cannot require the Chinese licensee to assign the improvements or grant an exclusive license to use the improvements to the foreign transfer, unless the licensee receives compensation for the improvements. Otherwise, the relevant grant-back provision is considered anticompetitive and thus invalid.

IP licensing in China is fraught with traps for the unwary, as applicable Chinese laws, such as Contract Law, Patent Law, Unfair Competition Law, Foreign Trade Law, and Antitrust Law,[1] can differ from US law in important ways. Approaching technology agreements with a "US mindset" and boilerplate language common in US legal documents is likely to cause licensing problems in China. This article seeks to discuss some of the pitfalls and provide suggestions on how to avoid them.

Chinese Legal and Regulatory Framework

In order to understand the potential pitfalls in IP licensing transactions in China, it is necessary to discuss the legal and regulatory framework for technology transfer in and out of China. Applicable Chinese laws include, but are not limited to, contract law,

patent law, unfair competition law, foreign trade law, and antitrust law. The principal regulations covering technology transfer are the 2002 Regulations on Administration of Technology Imports and Exports promulgated by the State Council. In addition, the Chinese Supreme Court promulgated a Judicial Interpretation on Litigation Issues Relating to Technology Contract Disputes (the Judicial Interpretation), which went into effect on January 1, 2005. The Judicial Interpretation provides some guidance on how to interpret certain provisions of the Contract Law and the Technology Regulations.

Chinese Import and Export Control Regulations

Under the Technology Regulations, "import and export of technologies" is broadly defined to include acts of transfer from inside China to outside China, and vice versa, through trade, investment, or economic and technological collaboration. "Acts" includes transfer of rights to apply for patents, transfer of licenses for the implementation of patents, transfer of technical know-how, technical services, and other forms of technological transfer. In other words, technology import and export can include: patent assignment contracts, patent application assignment contracts, patent license contracts, know-how license or transfer contracts, computer software license contracts, technology service contracts, technology contracts, joint design contract, research contracts, joint-development and production contracts. Therefore, most technology transfers by US companies to China will be subject to the Technology Regulations of China.

The Technology Regulations classify technologies into three broad categories:

1. *Prohibited Technologies*—technologies that cannot be imported into or exported out of China;
2. *Restricted Technologies*—technologies that must be approved by the appropriate governmental authority prior to the import or export (including the relevant transfer agreement); and
3. *Permitted Technologies*—technologies that may be imported into or exported out of China without prior governmental approval.

With respect to Permitted Technologies, although the failure to register a transfer agreement does not affect the validity of the agreement, it may have other adverse consequences, such as, the inability of the Chinese licensor to receive royalty payment in foreign currencies.

China has issued the Catalogue of Technology of Which China Prohibits or Restricts the Import (First Batch) (the Technology Import Catalogue) and the Catalogue of Technology of Which China Prohibits or Restricts the Export (the Technology Export Catalogue). These catalogues list the technologies classified as prohibited or restricted technologies for import or export purposes, respectively. Any technology not within either the prohibited or the restricted category is, at present, considered permitted technology.

Foreign businesses investing in China should give early consideration to The Technology Export Catalogue. As will be discussed, Chinese law mandates that ownership of improvements to licensed technology, made by a Chinese licensee, belong to the Chinese licensee. The assignment or license by the Chinese licensee of such improvements, to the non-Chinese licensor, will be subject to China's export control regulations. In addition, foreign companies wishing to establish a research and development facility in China and implement the product of that research abroad will need to comply with China's export control regulations.

Common Mistakes in IP Licensing Practice

Failure to Comply with Mandatory Provisions of Chinese Law

When a foreign company transfers technology to China, the parties to the transfer agreement 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 law to be the governing law, they need not comply with any Chinese laws. In reality, if the agreement is to be enforced in China, certain provisions of Chinese law are mandatory. A foreign licensor should carefully structure its technology transfer agreement to make sure that the agreement complies with the mandatory provisions.

For example, Article 329 of Chinese Contract Law voids contracts that illegally monopolize technology, impede technological progress or infringe on another person's technology. The Technology Regulation provides that a technology import contract cannot contain provisions that allow, among other things, for:

1. Purchase of unnecessary technology, equipment, etc.;
2. Payment for expired or invalid patents;

3. Restrictions on the transferee/licensee's rights to improve technology or to use improved technology;
4. Restrictions on the transferee/licensee's rights to acquire similar or competing technology;
5. Unreasonable restrictions on equipment/material sources;
6. Unreasonable restrictions on production volumes, models, and sales price; or
7. Unreasonable restrictions on export channels for products made with transferred/licensed technology.

The Chinese Supreme Court's Judicial Interpretation specifies the unequal rights of parties relating to the exchange of improved technology to be included within the term "illegal monopoly of technology and impeding of technological progress." As defined, unequal rights include the following:

1. Limitations on further improvement of licensed technology;
2. Limitations on usage of improved technology;
3. Unfair exchange conditions on improved technology, such as grant-back of improved technology without compensation, non-reciprocal transfer of improved technology, or sole or joint ownership of improved technology without compensation;
4. Limitations on licensee's reasonable exploitation of licensed technology according to market demand, including unreasonable restriction on sales quantity, type, price, channel, and export;
5. Tie-ins; and
6. Prohibitions or restrictions on licensee's ability to challenge the validity of licensed intellectual property.

Furthermore, Chinese law limits a foreign licensor's ability to disclaim its liabilities in connection with the licensed technology. For example, Chinese law requires that the foreign licensor "guarantee" that the licensed technology is complete, correct, effective, and that it will reach the specified technological target. It must also "guarantee" that it is the legal owner of, or the party retaining rights to license the technology. If the Chinese licensee infringes upon another party's right by using the licensed technology pursuant to the license agreement, the licensor is required to bear the responsibility for such infringement.

Some of these mandatory provisions are counter-intuitive to Western practitioners. In fact, some of the prohibited terms are legal in the United States. As such, US companies often are tripped up by these inconsistencies and penalized under Chinese law for invalid contracts.

Invalid Contract

A technology contract is invalid if it includes terms that are contrary to the mandatory provisions of the law and regulations. Therefore, such technology contracts are invalid *ab initio* and cannot be enforced. If a technology contract is found to be invalid, the parties are discharged from performing the contract. If the performance is under way, it should be ceased. If a contract has been fully performed, courts will attempt to restore the parties to their pre-contract state (*i.e.*, as if the contract had never been entered into). The party at fault for rendering the contract invalid is liable for damages caused to the other faultless party.

Under Chinese law, technology contracts that are contrary to the mandatory provisions of laws and regulations are invalid; they could be void entirely, or unenforceable, with respect to the offending provisions. Invalid technology contracts include, for example: (1) contracts obtained by fraud; (2) contracts that cause infringement of a third party's IP rights; and (3) anticompetitive arrangements that illegally monopolize or impede technology progress.

As explained previously, there are numerous mandatory provisions within Chinese law that an IP licensing agreement must observe, in order to remain valid in China. If the mandatory provisions are not complied with, the licensing agreement can either be void in whole, or in part. When adjudicating an invalid technology transfer agreement, Chinese courts generally follow these three principles:

1. *Doctrine of Fault*—The party at fault for rendering the contact invalid is liable for the damages caused to the other party due to the invalidity of the contract and if both parties are at fault, each is responsible for their own loss;
2. *Restoration to Pre-Contract State*—Courts will attempt to restore the parties to their pre-contract state (*i.e.*, as if the contract had never been entered into) by requiring the licensee to cease practicing the licensed technology, to return all the technical data/information, samples and equipment to the licensor, and requiring the licensor to return paid royalties to the licensee; and
3. *Continued Obligation of Confidentiality*—Both parties are obliged to maintain confidentiality.

Therefore, failure to comply with mandatory provisions of Chinese laws in IP licensing agreements can have serious consequences for foreign licensors or licensees. If the foreign party is at fault for failure to do so, the foreign party would have to pay damages to the Chinese party and still would not receive benefits of the contract.

No Formation of a Contract

Often, a Chinese technology contract is not formed until one party fulfills the condition precedent for the formation of the contract. For example, 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 the 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 because the assignment contract is not formed.

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 of an arbitration award or court judgment in China can be difficult if the Chinese company does not have assets or operations in the foreign venue.

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. While the losing Chinese company theoretically cannot attack the award or judgment substantively in a Chinese court, it can challenge the procedural fairness of the award or judgment, which may introduce substantive issues "through the back door." In such a case, the foreign party may have to re-litigate the substantive issues on their merits, sometimes in a venue unfavorable to the foreign company. Because a Chinese court order is effective countrywide, 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 such as China International Economic and Trade Arbitration Commission in Beijing should be seriously considered and generally are preferred, when dealing with a Chinese company with no assets overseas.

Ownership of Improvements to Licensed Technology

In the United States, it is common for the licensor to require that the licensee grant ownership rights to the licensor without separate consideration. Chinese law in this area, however, is significantly different from its US counterpart.

The Technology Regulations provide that during the term of a technology import contract, ownership of improvements to transferred technology belongs to the improving party. Thus, if a Chinese licensee makes improvements to the technology licensed by a foreign licensor, the improvements belong to the Chinese licensee. Under the Judicial Interpretation, the foreign licensor cannot require the Chinese licensee to assign the improvements or grant an exclusive license to use the improvements to the foreign transferor without compensation. Unfortunately, there is no clear guidance as to what constitutes adequate or reasonable compensation. Therefore, a safer approach is to provide for some payment for any improvements in the contract. In addition to or in lieu of payment, one could consider the following options.

First, in a joint development, the parties could agree that the foreign licensor and the Chinese licensee are co-owners of all improvements to the licensed technology and structure cross licenses to accommodate each party's need to use the improvements. Alternative to co-ownership, parties could structure sole ownership according to products so long as the division of ownership is fair. In both scenarios, if the grant of rights is mutual or nearly mutual, additional payment may not be necessary. Second, if the improvement is solely developed by the Chinese licensee, the foreign licensor may wish to negotiate both a non-exclusive license to use the improvements in China and in countries where the foreign licensor does not conduct business, in addition to an exclusive license covering improvements in the jurisdictions where the foreign licensor conducts business. Additional payment may still be required, albeit the fees should be less than an outright ownership. Lastly, when the Chinese licensee grants the foreign licensor a right of first refusal with respect to the licensee's improvements, if the foreign licensor is interested in a specific improvement, the licensee will then assign the improvement to the licensor for a fee.

Concluding Remarks

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 US law. An understanding of these laws will help US practitioners avoid unfortunate, and unnecessary, outcomes. They are well-advised to do their homework and avoid the traps.

1. China promulgated its antitrust law on August 30, 2007, which will go into effect on August 1, 2008.

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