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Traps for the unwary

IP licensing and technology transfer is subject to complex legislation, which foreign practitioners must understand if they want to avoid pitfalls, say **Benjamin Bai**, **Anthony Chen**, and **Marcus Woo** of Jones Day

Because applicable Chinese laws can differ from foreign law in important ways, IP licensing in China is fraught with traps for the unwary. Approaching technology agreements in China with the boilerplate language common in foreign legal documents is likely to breed problems down the road. But there are ways to avoid the pitfalls.

Legal and regulatory framework

IP licensing and other technology transfer agreements in China are governed by a plethora of Chinese laws, including but not limited to the Contract Law, Patent Law, Unfair Competition Law, Foreign Trade Law, and Antitrust Law (China promulgated its Antitrust Law on August 30 2007, which becomes effective on August 1 2008). 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, which took effect on January 1 2005.

Permitted, restricted, prohibited

Under the Technology Regulations, "import and export of technologies" is broadly defined to include acts of transfer of technologies through trade, investment or economic and technological cooperation, from inside China to outside China, and vice versa. Due to the breadth of the Technology Regulations in China, most technology transfers by foreign companies to China fall under their scope. 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 relevant governmental authority before import or export, and the relevant technology transfer agreement must be submitted to the relevant governmental authority.
3. Permitted technologies: technologies that can be imported into or exported out of China without prior governmental approval, but the parties need to register the technology transfer agreement with the relevant governmental authority. With respect to permitted technologies, though the failure to register a technology transfer agreement does not affect the validity of the agreement, other adverse consequences may result – the inability of the Chinese licensee to convert renminbi into foreign exchange to make royalty payments to the licensor, for example.

China periodically updates the *Technology Import Catalogue* (technology whose import China Restricts or Prohibits) and the *Technology Export Catalogue* (technology whose export China Restricts or Prohibits.) These catalogues list the technologies classified as prohibited or restricted technologies for import or export purposes, respectively. Technologies not expressly listed on either catalogue are considered as permitted.

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

Common mistakes

Failure to comply with Chinese law

When a foreign company transfers technology to China, the parties to the transfer agreement can generally

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choose the governing law, including foreign law, for the agreement. This freedom to choose has given many foreign companies the false impression that they don't need to worry about the restrictions of Chinese law if they have selected a foreign law to govern the agreement. 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 these mandatory provisions.

For example, Article 329 of the Chinese Contract Law voids a contract that illegally monopolizes technology, impedes technological progress or infringes on another person's technology. The Technology Regulations provide that a technology import contract cannot contain provisions that allow, among other things, for:

1. Purchase of unnecessary technology, equipment.
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.
7. Unreasonable restrictions on export channels for products made with transferred/licensed technology.

The 2005 Chinese Supreme Court's Judicial Interpretation specifies the following contractual terms as "illegal monopoly of technology and impeding of technological progress":

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; sole or joint ownership of improved technology without compensation.
4. Limitations on licensee's reasonable exploitation of licensed technology according to market demand, such as unreasonable restriction on sales quantity, type, price, channel, and export.
5. Tie-ins.
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 party with legal ownership of, or right to license, the technology. If the Chinese licensee infringes on another party's right by using the licensed technology pursuant to the license agreement, the licensor is required to bear responsibility for such infringement.

Under Article 55 of the Chinese Antitrust Law, the new law will be applied if a licensing contract eliminates or restricts market competition by abusing IP rights stipulated in the relevant IP laws and administrative regulations. While it is too early to determine precisely how the new Antitrust Law will be applied to licensing transactions, there is likelihood that Chinese licensees could start to take advantage of the new law to attack foreign licensors.

Invalid contract

A technology contract is invalid if it includes terms that are contrary to the mandatory provisions of the law and regulations. As such, invalid 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. Where a contract has been fully performed, courts will attempt to restore the parties to their pre-contract state (that is, 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 in their entirety or unenforceable with respect to the offending provisions. Invalid technology contracts include, for example, (i) contracts obtained by fraud, (ii) contracts that

Foreign IP practitioners would be well advised to do their homework

cause infringement of a third party's IP rights, and (iii) contracts that illegally monopolize or impede technology progress (that is, anticompetitive).

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 could be liable to pay damages to the Chinese party without receiving any of the benefits of the contract.

No registration, no 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 undertake this statutory requirement, the foreign company has no right to the patent because the assignment contract has not been formed.

Misunderstanding dispute provisions

Chinese law allows contracting parties to select a foreign jurisdiction 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

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Benjamin Bai is a partner in Jones Day's Houston and Beijing offices, where he focuses on global patent litigation and prosecution. In the US, he regularly counsels clients on enforcement strategies for their intellectual property and advises them on minimizing the risk of infringement. Bai advises clients on effective strategies for building a global patent portfolio to maximize its value. He also handles a range of patent infringement and trade secrets misappropriation cases in China for multinational companies. He is experienced in obtaining patents and trade marks for multinational companies in China and providing strategic advice on how to enforce their IP there. Bai also counsels Chinese clients on how to build a portfolio, enforce their patent rights and handle patent infringement suits overseas. Bai received a BSc in polymer chemistry from the University of Science and Technology of China, a PhD in chemistry from Rice University and a JD from the University of Texas. He is registered to practise before the USPTO and is licensed in Texas.

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Anthony Chen has 14 years' experience assisting hi-tech and biotech companies with their IP matters in the US and in China. His practice focuses on patent litigation and technology transfer. Since moving to China in 2004, Chen has assisted multinational companies with enforcement of their IP rights in civil actions and through criminal sanctions. Furthermore, he advises Shanghai government on the life science industry and IP matters. Chen received his JD from Harvard Law School and his Bachelor's degree in Cell Biology from the University of Science and Technology of China. He is a member of the California Bar and is admitted to practise before the US Patent and Trademark Office.

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Marcus Woo has more than 20 years of experience in New York and in Greater China. He has extensive experience in cross-border investment, mergers and acquisitions, joint ventures, technology licensing and transfers, government procurement, and general corporate and commercial matters. He has advised on issues relating to high-technology companies, including companies in telecommunications, electronics and digital media.

Woo has extensive experience in the representation of large foreign companies on transactions involving business formations, joint ventures and business structurings, mergers and acquisitions, and infrastructure equipment procurement. He has particular experience in the area of wireless telecommunications and has advised on legal and regulatory issues governing IP licensing, licensing of spectrum and radio frequency transmission equipment. He has also worked in the areas of transfer of technology and know-how.

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operations in the foreign venue, and the foreign company must then obtain recognition and enforcement of its foreign court judgment or arbitral award in China.

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 bring in 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 unfavourable to the foreign company.

Since a Chinese court order is effective nationwide, a foreign company is well served to choose in advance a Chinese court with a reputation for fair treatment of foreign litigants. As to arbitration, tribunals such as the China International Economic and Trade Arbitration Commission (CIETAC) should be seriously considered and generally are preferred when dealing with a Chinese company with no assets overseas.

Ownership of improvements

License agreements in the west often have grant back clauses for the licensor to gain ownership of improvement without separate consideration. Chinese law in this area is significantly different from many foreign laws however.

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 cash payment, the foreign licensor could consider in-kind consideration such as trading some other technologies for the improvements. The foreign licensor should identify all other forms of compensation, monetary or in-kind, in the entire transaction and recite them in the licensing contract to legitimize the ownership of the improvements.

Concluding Remarks

IP licensing in and out of China is subject to a myriad of Chinese laws, regulations, and judicial interpretations that significantly differ from foreign laws. An understanding of these laws will help IP practitioners avoid unfortunate – and unnecessary – outcomes. They would be well advised to do their homework if they want to avoid the many pitfalls and traps.