

Key IP Issues for Foreign Companies Doing Business in China

With one of the fastest growing economies and the largest population in the world, very few companies can resist the attraction of China as an investment destination. However, companies must pay special attention to the protection and enforcement regime in China of intellectual property (IP), often their most valuable asset. This Client Briefing provides an overview of the key IP issues for foreign companies doing business in China.

What you need to know

- When forming joint ventures with Chinese firms in order to establish local operations, a clear definition of rights to and contributions of IP rights as well as audit rights are critical;
- Companies should ensure timely procurement of patent protection in China, in particular as Chinese competitors do not shy away from securing such protection themselves;
- Particular attention must be paid to preventing theft of trade secrets and counterfeiting, the latter preferably in cooperation with local agencies;
- When concluding an IP licensing agreement with a Chinese-operating firm, Chinese law generally governs the agreement despite a different choice of law;
- Import and export of technology in and out of China is heavily regulated and many types of technologies cannot be imported or exported at all, or only under strict conditions.

IP risks associated with joint ventures

Local operations in China often take the form of joint ventures (JVs), due to foreign ownership restrictions, in order to take advantage of a local partner's superior distribution channels or local market knowledge, or to bid on government projects. However, this often involves the sharing of IP with the local partner.

- The JV documentation should:
 - Clearly define the background IP contributed by each party, as well as stipulate the ownership and usage of later developed modifications, improvements, and new IP;
 - Provide audit rights over production and research sites and invention and accounting records; and
 - Include safeguards to deter improper use and disclosure of IP as well as to cap IP infringement liabilities.

Key Issues

IP Issues in Forming Local Operations

IP Issues in Manufacturing and Distribution

IP Issues in Innovation

IP Issues in Licensing and Technology Transfer Agreements

Conclusion

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- Other things to note include:
 - When collaborating with entities previously owned by or affiliated with the Chinese government or a university, one should carefully review the IP chain of title for completeness and any joint ownership issue;
 - The Patent Law of the People's Republic of China ("PRC") states that **unless otherwise agreed upon, a joint owner can individually exploit or allow another to exploit a jointly owned patent** by means of a general license;
 - Consent by all joint owners is required for other ways of exploitation (Article 15); and
 - Agreements should be drafted to ensure that commercial use of any jointly developed IP can be exclusive and will not be blocked by such default veto power.

Manufacturing and Distribution

Foreign companies that manufacture and distribute products or services through local agents in China must consider the risks of parallel import, counterfeiting, and trade secret theft.

- **Parallel Import.** In China, **parallel import is not considered an act of patent infringement** (see PRC Patent Law, Article 69.1), but may be considered an act of trademark infringement under specific circumstances based on recent case law (see *Michelin Group v. Tan Guoqiang and Ou Can* (2009))
- **Counterfeiting.** This is a serious issue in China, despite government efforts such as the requirement of Good Manufacturing Practice (GMP) certification, a clamp down on false advertising, and criminal sanctions, including the 2007 execution of the former director of the State Food and Drug Administration (SFDA), Xiaoyu Zheng, convicted of taking bribes worth over RMB6 million (about US\$850,000) from eight companies, for approving an antibiotic blamed for at least 10 deaths, as well as approving other substandard medicines. While unusual, the harsh sentence reflects Beijing's desire to address corruption and ensure consumer safety.

Companies should coordinate enforcement tactics with local agencies, and contemplate anti-counterfeiting labelling tools and public education.

- **Theft of Trade Secrets.** To minimize this, companies should:
 - Monitor their physical parameters and cyber security;
 - Ask employees to sign confidentiality and non-competition agreements;
 - Track the career path of key employees and monitor IP filings by or naming such individuals.

It is not uncommon for the head of R&D of a Chinese company to also be affiliated with local universities or the government, or even a competitor. The Chinese legal system offers limited recourse in the event of trade secret infringement disputes. Thus, companies must take practical and pre-emptive steps to protect their trade secrets.

Patent strategy

It is essential that a foreign company has an IP strategy in China. Unfortunately, many foreign companies do not procure IP protection until it is too late. In the meantime, their Chinese counterparts, in a quest for higher profits, have created substantial IP and are not shy to exert their rights. Therefore, foreign companies should assess in advance the IP landscape of the target product by conducting clearance searches and address upfront any potential validity and infringement issues. Foreign companies considering conducting business in China should note that:

- Any patent applications to be extended into China should be drafted in such a way as to comply with the PRC Patent Law;
- Employers that intend to patent in China and exploit employee-generated inventions must consider the rights and remuneration granted under various Chinese laws:
 - See, for example, Rules 77 and 78 of the Implementing Regulations of the PRC Patent Law.
 - Also see Article 326 of the PRC Contract Law, which stipulates that when a service invention is transferred, the employee has the right of first refusal under the same conditions.

Licensing and Technology Transfer Agreements

The import and export of technology into and out of China is heavily regulated:

- Some foreign companies have the false impression that a transaction is exempted from Chinese law if a foreign governing law is selected.
- A foreign judgment or ruling can be applied for recognition in China under certain circumstances, but a Chinese court can and has refused to recognize judgments and rulings that contradict the basic principles of Chinese law or violate the national, social, and public interest of China.
- In order for an IP licensing or technology transfer agreement to be validly enforced in China, it must comply with China's Foreign Trade Law, Contract Law, Anti-Monopoly Law, and Patent Law, just to name a few.
- The *Regulations of the People's Republic of China on Administration of the Import and Export of Technology*, effective from January 1, 2002 ("Regulations"), is the main legal framework that regulates technology import and export in China, including patent transfer, assignment of patent application rights, patent licenses, assignment of trade secrets, provision of technical services, and other means of technology transfer:
 - In China, a technology can be classified as (i) a "prohibited" technology, which cannot be imported/exported; (ii) a "restricted" technology, which can be imported/exported only upon license approval; or (iii) an unrestricted technology, which can be freely imported/exported but the related contract must be registered with the relevant government authority. The government has published two catalogues that list technologies the import/export of which is prohibited or restricted; technologies not listed in the catalogues are freely tradable.
 - For a technology import contract, the Regulations prohibit the inclusion of restrictive clauses that (1) require the licensee to accept supplementary conditions that are not absolutely necessary for the import of the technology, including the purchase of unnecessary technology, raw material, product, equipment or service, or to pay exploitation fees or to undertake obligations for expired or revoked patents; (2) restrict the licensee's right to improve technology or use the improved technology, or right to acquire similar or competitive technology from other sources; (3) unduly restrict the licensee's right to purchase raw material, part, product or equipment from certain channels or sources, or the quantity, variety, or sales price of the products made by the licensee; or (4) unduly restrict the export channels of products made through the use of the technology.
 - The Regulations also require the licensor to be responsible for IP infringement due to use of the technology, as well as guarantee ownership or transfer right of the technology, and guarantee that the technology is complete, without error, effective and able to achieve the technological target agreed upon.
 - Furthermore, the Regulations stipulate that an improvement made to the technology belongs to the improving party; the foreign licensor cannot require the licensee to assign or license the improvement to the licensor without compensation. While these mandates may seem counterintuitive to foreigners, they are consistent with the Chinese government's intent to trade market access for domestic technological progress. In fact, the subsequent chapter governing technology export contracts do not contain any of these provisions.

Conclusion

The Chinese government has a strong interest in ensuring the sustainability of its economy. As such, Chinese laws can differ from foreign laws in many important aspects, and heavily influence how companies compete on the basis of IP in China. Failure to understand and install mechanisms that address IP concerns unique to China may well be detrimental.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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