Technology Transfer Agreements With China

Table of Contents

1. Introduction

It is undeniable that in the past three decades expanding trade and foreign direct investments (FDI) have contributed to the Chinese economic miracle, in which importing and exploitation of foreign advanced technology plays a significant role. Aiming to progress Chinese indigenous innovation capabilities and break its reliance on foreign technology, in particular on core technologies in important fields, the Chinese government officially unveiled the indigenous innovation plan which is a massive and complicated plan to turn the Chinese economy into a technology powerhouse by 2020 and global leader by 2050.

The Chinese government stimulates domestic innovation through incentives for companies (and employees) to innovate locally and to import and absorb foreign state-of-the-art technologies. The policy aims to increase high value-added production in China and decrease the use of energy inefficient and polluting technologies. In the ideal case, imported technology and indigenous innovation should be able to positively correlate. In reality, Chinese firms have an impressive ability in absorbing and re-innovating inventions and technologies. Former "Shanzhai" companies - producers of copied products - have developed into innovative companies with globally available products.

In 2015, the Chinese government launched "Made in China 2025" ("MIC 2025"), a state-led industrial policy that seeks to make China dominant in global high-tech manufacturing. However, with the 2018 Negative List and enactment of Foreign Investment Law and most recently the substantive amendments made to Technology Import and Export Regulations ("TIER") , the Chinese government has conveyed the message to foreign companies that the introduction of foreign technology into China is still promising in spite of the MIC 2025 and the indigenous innovation policy in general.

These dynamics create opportunities for European SMEs to exploit their technology in the Chinese market. At the same time, it poses substantial risks if these technology transfers are not well structured and documented. In brief the pros and cons are:

Opportunities

- Access to China's domestic market;
- Financial and tax incentives and subsidies, in particular with respect to China's "encouraged" industry sectors;
- Reputational/relational benefit with central, provincial and local governments as technology transfer is a way to demonstrate commitment to China.

Risks

- The Chinese recipient of the technology can exploit the technology beyond the agreed scope of the technology transfer agreement;
- Know-how can be disclosed to third parties;
- Employees of the transferee that have access to the technology can seek employment with a competitor or establish a new competing company;
- The Chinese partner can refuse to perform audit and information disclosure obligations, leading to lower royalty payments;
  If technology is successfully absorbed by the Chinese party, the transferor is permanently shut out of the Chinese market.

CASE STUDY

Goldwind's development (wind turbine manufacturing)

Goldwind is one of China's largest wind-turbine manufactures. It owes much of its success to government supportive policies and transfer of technology from foreign companies, including financial support.

In 1989 a Danish wind-turbine manufacturer partnered with Goldwind and transferred its technology to construct 150 Kw wind turbines. In 1996 a German supplier transferred technology as part of China's National Key Technology & Research Program. Another Germany supplier licensed 750Kw wind-turbine technology to Goldwind in 2001.

In 2005 the National Reform and Development Commission required that 70% of wind turbines should be produced domestically in order to qualify for government tender projects (this restriction is abolished since November 2009). This therefore induced foreign manufacturers to start producing locally in China.

No foreign wind-turbine manufacturer has to date won a concession tender. Foreign companies that supported Goldwind have not gained substantial presence in China. Sharing technology and producing locally will therefore not automatically open doors to the Chinese market, in particular not in economic sectors that are dependent on government procurement

Foreign companies deciding to transfer technology to China should be fully aware of the regulations covering technology transfers and the application of China's legal framework.

2. Technology transfer definition

Under Chinese law, "technology transfer" shall include the transfer of both ownership right and the exploitation or usage rights of the followings:

- Patents: a patent application or a patent registered with the Chinese Patent Office of National Intellectual Property Administration ("CNIPA"). This can be an invention patent, an utility model or a design patent;
- Plant variety right: right granted to plants that are artificially-bred varieties of plants or developed from known wild plants which possess the characteristics of novelty, distinctiveness, consistency and stability;
- Know-how: technical information unknown to the public, of commercial value and protected by confidentiality measures by the right holder.

According to Article 22 of the Interpretation of the Supreme People's Court on Issues relating to Applicable Laws for Trial of Cases involving Technical Contracts Disputes, the following agreements will be characterised as "technology transfer agreements" under Article 342 of Contract Law of the People's Republic of China ("Contract Law"):

- agreement on assignment of patent rights;
- agreement on assignment of patent application rights;
- agreement on licence of patent;
- agreement on assignment of know-how;
- agreement on licence of know-how;
- agreements on sales of special equipment and materials in relation to the exploitation of technology, or agreements on technical consulting, and technical services thereof;
- agreements on joint venture under which a party subscribes to the equity by contribution of technology but does not participate in management of the joint venture entity and where the parties agree in the form of a capital protection clause that the joint venture entity or the other party shall pay transfer fee or licence fee to the party contributing the technology.

In addition to the above statutory classification, in practice, the following contracts are also covered by the Chinese technology import and export regulations:

- assignment of computer software (source code);
- computer software licence;
- licence or assignment of trademarks involving licensed patents or know-how;
- technology consulting;
- technical services;
- cooperative design;
- cooperative research;
- cooperative development;
- other agreements of similar nature.

3. Prohibited, restricted and free technology import & export

According to Administrative Measures of Ministry of Commerce on Import Banned and Import Restricted Technology, China has divided foreign related technologies transfers into three categories:

- Prohibited technologies;
- Restricted technologies; and
- Non-restricted technologies.

Due to consideration of national security, social public benefits, personal health protection and environment protection, trade with technology classified as prohibited from import to or export from China shall be avoided, while the restricted technologies can be imported to or exported from China with the acquisition of licence from relevant governmental authorities. Technologies are listed in the Catalogue of Technologies Prohibited and Restricted from Import and Catalogue of Technologies Prohibited and Restricted from Export ("Catalogues") which are publically available and regularly updated. It is important to consult these Catalogues before initiating technology transfer.

Currently, the effective version of Catalogue of Technologies Prohibited and Restricted from Import is the 2007 edition ("2007 Import Edition"). The Ministry of Commerce ("MOFCOM") published an amendment to the 2007 Import Edition for public opinion in July 2018 ("2018 Import Edition").

The effective version of Catalogue of Technologies Prohibited and Restricted from Export is the 2008 edition ("2008 Export Edition"). MOFCOM published an amendment to the 2008 Export Edition for public opinion in July 2018 ("2018 Export Edition").

The Catalogues can be found on the following website of MOFCOM (available in Chinese only):

Source: http://fms.mofcom.gov.cn/article/a/ae/201807/20180702768684.shtml

The numbering in the Catalogues is systematic: the first two digits represent the year, the second two digits represent the classification, the last two digits represent the technology name, and the letter at the end represents the control level, where "J " signifies import is prohibited and "X" signifies import is restricted.

On the other hand, China's demand for sophisticated technology, advanced equipment and key components is on the rise. It is encouraged to import such technologies from abroad. In April 2017, the National Development and Reform Commission ("NDRC"), MOFCOM, the People's Bank of China and the Ministry of Foreign Affairs of China jointly issued Guiding Opinions on Further Guiding and Standardizing the

Direction of Foreign Investment which states that investment cooperation with overseas high-tech companies shall be encouraged.

Besides, the 2017 Edition of Catalogue of Technologies and Products Encouraged to be Imported (draft for comments) has increased the listed number of technologies and products, expanded the scope of introduction, and raised the standard of some listed technology.

Moreover, in the perspective of foreign direct investments (FDI), the 2018 Edition of Special Administrative Measures for Foreign Investment Access (Negative List), compared to the previous version released in 2017, has removed the restriction on the foreign ownership percentage applicable to the manufacturing sectors including automobile, shipbuilding and aircraft, with the aim to achieve general liberalization of manufacturing with foreign involvement in the aforesaid sectors. Furthermore, according to the Negative List, the foreign investors are allowed to establish a wholly-owned entity in China to engage in breeding and seed production of crops (with the exception of wheat and maize). It deserves to mention that the 2019 Negative List has also been newly rolled out and effective as of 30 June 2019, which further opens up foreign investments into sectors and industries with respects to domestic shipment agencies, gas and pipelines in cities, value-added telecommunication, and the exploration and development of petroleum and natural gas.

It is believed that the major reason for China to encourage foreign investment to technology related industry and encourage advanced technologies to be imported is related to its ambition of achieving the "indigenous innovation" goal.

Another most recent development is that on 15 March 2019, the Chinese legislature National People's Congress passed the final draft of Foreign Investment Law, marking a new milestone of foreign investment regulatory regime in China. Related to technology transfer in the context of investment, the Foreign Investment Law explicitly stipulates that the state encourages the Sino-foreign technology cooperation based on the free will of parties and business rules, and forced technology transfer through administrative measures is prohibited.

Several examples of each category for technology import and export are set out as below.

3.1. Import

3.1.1. Prohibited:

Number	Category	Technology
182601J	Chemical Materials	Pesticide production technology
183102J	Manufacture & Processing of Ferrous Metals	Second-hand equipment and technology for production and rolling of iron and steel
183209J	Manufacture & Processing of Non-Ferrous Metals	Gold extracting through amalgamation processing
183601J	Manufacturing Transport Equipment	Gasoline engines with output per litre of less than 50KW / Diesel engines with output per litre less than 40KW
183803J	Manufacture of Electronic Machinery & Equipment	Battery manufacturing technology containing mercury, alkali and manganese
183804J	Manufacture of Electronic Machinery & Equipment	Cooling technology using CFC as cooling agents

Compared to 2007 Import Edition, 2018 Import Edition removes the "Process for medicine with cork and wax packaging (052701J)" from the list, which will make the total number of prohibited technologies for import reduce from 39 to 38 if the 2018 Import Edition is passed.

3.1.2. Restricted:

Number	Category	Technology
181401X	Manufacture of Foods	Genetic engineering technology for ferment production
182607X	Manufacturing of Chemicals	Paint production technology
183506X	Manufacture of Special Purpose Machinery	Feedstuff extrusion and expansion equipment and technology
183609X	Manufacture of Special Purpose Machinery	Plastic mould design and manufacturing technology
183601X	Manufacture of Transport Equipment	Technology for vehicle engines (output per litre less than 30KW and size more than 3 litres)
183804X	Manufacture of Electronic Machinery & Equipment	Generator manufacturing technology
186601X	Banking	Anti-counterfeiting technology and process for printing RMB

2018 Import Edition replaces "Electrolysis process technology of 350kA prebaked aluminium electrolysis cell (053303X)" in 2007 Import Edition with "Electrolysis process technology of 600kA prebaked aluminium electrolysis cell (183203X)", and adds "Fruit and vegetable preservation technology (180201X)" to the list, which will make the total number of restricted technologies for import increase from 87 to 88 if the 2018 Import Edition is passed.

3.2. Export

3.2.1. Prohibited:

Number	Category	Technology
180301J	Animal Husbandry	First level animal husbandry variety breeding technology
183501J	Special Purpose Equipment Manufacturing	Bead tea & flat tea processing technology
183901J	Communication, Computer & Electronic Equipment Manufacturing	Integrated circuit manufacturing techniques
188401J	Hygiene	Traditional Chinese Medicine (TCM) medical technology

Compared to 2008 Export Edition, 2018 Export Edition removes "Lonic type rare earth ore mining technology(050901J)", "Caffeine manufacturing techniques (052701J)", "Riboflavin (VB2) production process (052702J)" and "Chemical synthesis and semi-synthetic drug production technology (052705J) " from

the list. It also moves "Non-ferrous metallurgy technology (053301J)"and "Rare earth refining, processing and utilization technology (053302J)" from prohibited catalogue to restricted catalogue, which will make the total number of restricted technologies for export reduce from 33 to 27 if the 2018 Export Edition is passed.

3.2.2. Restricted:

Number	Category	Technology
180201X	Forestry	Forest tree germplasm resources and breeding technology
180301X	Animal Husbandry	Second level animal husbandry varieties breeding technology
182604X	Chemical Raw Material	Dye production technology
183002X	Non-Mtal Mineral	Fireproof material production technology
185002X	Architecture	Building environmental control technology

On the basis of 2008 Export Edition, 2018 Export Edition adds many new technologies to the restricted catalogue, including "Gene manipulation technology (180105X)", "Animal endemic breeding technique (180302X)", "3D printing technology (183406X)", "Large-scale high-speed wind tunnel design and construction technology (183505X)", etc. which will make the total number of restricted technologies for export increased from 118 to 142 if the 2018 Export Edition is passed.

3.3. Encouraged

Encouraged technologies are not found in the Import / Export prohibited and restricted catalogue but in the Catalogue of Technologies and Products Encouraged to be Imported.

Currently, the list in effect is 2016 Edition of Catalogue of Technologies and Products Encouraged to be Imported ("2016 Encouraged List"). NDRC has also announced an amendment to the 2016 Encouraged List for public opinions in November 2017 ("2017 Encouraged List").

The above-mentioned update signified Chinese government's stronger encouragement of importing sophisticated technology, advanced equipment and key components. Compared with the 2016 Encouraged List, in terms of quantity, the listed number of technologies encouraged to be imported in the 2017 Encouraged List has increased by six. In terms of industry, the 2017 Encouraged List increased introduction of high-end equipment and key components for spinning machines and LNG carriers and increased emphasis on automotive, aircraft and satellite manufacturing, as well as engines and solar buildings area. Besides, the standards of certain technology, e.g. the integrated circuit, are set higher than in the 2016 Encouraged List. The update also signified that the Chinese government had paid more attention to sustainable development, such as increasing the emphasis on biotechnology and green energy-efficient buildings, e.g. add transgenic animal mammary gland generator technology.

Both versions can be found on the website of NDRC:

- http://www.ndrc.gov.cn/fzgggz/gyfz/gyfz/201611/t20161110_826213.html (2016 Edition)
- http://www.ndrc.gov.cn/zwfwzx/tztg/201711/t20171123_867550.html (2017 Edition, not effective)

中华人民共和国国家发展和改革委员会
National Development and Reform Commission

热门搜索：产业结

首页 > 发展改革工作 > 产业发展 > 工业发展

国家发展改革委 财政部 商务部关于印发
鼓励进口技术和产品目录（2016年版）的通知

发改产业〔2016〕1982号

各省、自治区、直辖市及计划单列市发展改革委、财政厅（局）、商务主管部门，新疆生产建设兵团发展改革委、财务局、商务局：

为积极扩大先进技术、关键装备及零部件进口，鼓励企业引进消化吸收再创新，更好的发挥进口贴息政策在培育产业竞争新优势上的积极作用，现印发《鼓励进口技术和产品目录（2016年版）》，自发布之日起实施，并将根据执行情况和实际需要，适时对目录进行调整。

《国家发展改革委、财政部、商务部关于发布鼓励进口技术和产品目录（2015年版）的通知》（发改产业〔2015〕1541号）同时废止。

附件：鼓励进口技术和产品目录（2016年版）

国家发展改革委
财　政　部
商　务　部
2016年9月9日

Encouraged technologies can be subject to specific policy benefits, such as access to loans and interest discounts, premium subsidies, allocation of land for production and other (local) benefits. For example, companies who imported the encouraged technologies, when meeting specified conditions (the total price shall not be less than 1 million USD etc.), may apply for the interest subsidies (in RMB). The amount will be determined through multiplying the total price of the imported encouraged technologies by the latest benchmark loan rate issued by the People's Bank of China.

According to 2017 Encouraged List, examples include:

Number	Technology
A19	Portable computer design and manufacturing technology
A21	High speed mobile data communication technology
A22	Software technology based on an open resource
A58	Design and manufacturing of large tractor (above 147kW) and implements, self-propelled grain combines (above 110kW) silage harvester, tomato harvester, self-propelled sugarcane, cotton harvester (above 74wK)
A67	Design and manufacturing of microchip components
A140	Manufacturing and technology of a high speed labelling machine (above 72,000 bottles / hour)
A168	Complete device manufacturing technology of construction of waste treatment and recycling processing
C7	Biomass fired and gasification power generation technology
C11	Development and manufacturing of new-energy vehicle's parts

4. Import licence or registration of the technology transfer agreement

The agreements covering the technology transfer need to comply with certain standards and licence requirements to mainly ensure that the transfer price or royalties can be remitted overseas smoothly. In this chapter the applicable authorities are first set out followed by the applicable licence requirements.

4.1. Authorities involved in technology transfer agreements

National Intellectual Property Administration, PRC (CNIPA)

国家知识产权局
NATIONAL INTELLECTUAL PROPERTY ADMINISTRATION,PRC

- Registers Chinese Patents and patent applications
- Registers Chinese Patent transfers and patent licensing
- Make decisions on application for compulsory licensing
- Supervises patent infringement

Ministry of Science & Technology (MOST)

中华人民共和国科学技术部
Ministry of Science and Technology of the People's Republic of China

- Publishes the "Catalogue of Technology of Which China Prohibits or Restricts the Export"
- Responsible for the coordination of National High-tech R&D Programs

Ministry of Commerce (MOFCOM)

中华人民共和国商务部
MINISTRY OF COMMERCE OF THE PEOPLE'S REPUBLIC OF CHINA

- Publishes the "Catalogue of Technology of Which China Prohibits or Restricts the Import"
- Publishes the "Catalogue of Technologies and Products Encouraged to be Imported";
- (Local) MOFCOM is in charge of issuing technology import and export licences and the registration of non-restricted technology import and export agreements

National Development and Reform Commission (NDRC)

中华人民共和国国家发展和改革委员会
National Development and Reform Commission

- Publishes the Foreign Investment Catalogue
- Formulates strategies, plans and major policies for the development of high-tech industries and advance of industrial technologies

State Administration for Market Regulation (SAMR)

国家市场监督管理总局
State Administration for Market Regulation

- Enforces laws with respect to trade secret and trademark protection
- Maintains the Chinese company registered

4.2. Import/Export Licence Requirements

To import technology into China, an importer shall include the import of technology and technology transfer in its scope of business as registered with SAMR. In addition, it shall be registered as a foreign trade operator with MOFCOM.

Depending on whether the technology is "restricted" or "non-restricted", specific licences are required and different procedures are to be followed to regularize the transfer.

A. Transfer of restricted-import technology	**B. Transfer of non-restricted technology**
1) Submit the application for a technology import licence with local MOFCOM; 2) Local MOFCOM will examine the technology within 10 working days; 3) If the technology can be transferred, the importer can get a "Proposal for Technology Import Licence"; 4) Technology importer can sign the technology transfer agreement with the foreign party; 5) Technology importer shall submit the letter of intent, a duplicate of the technology transfer agreement and documentation of the legal status of the contract parties to local MOFCOM; 6) Local MOFCOM will examine the authenticity of the technology transfer agreement and grant a technology import licence within 30 working days; and 7) The technology transfer agreement becomes only valid after the technology import licence has been issued by local MOFCOM.	1) Technology importer can sign the technology transfer agreement with the foreign party; and 2) The technology transfer agreement becomes valid without government approval.
• The technology transfer agreement should be registered with local MOFCOM within 60 days. • If the transferred technology is a patent, the parties involved should go to CNIPA to get patent licence record-filing or change the information of the patent owner.	

A Chinese exporter of restricted technology should follow procedure A (step 2 will then take 30 days and step 6 will take 15 days). A technology export licence is granted by local MOFCOM.

The following information and documentation must be filed online at MOFCOM:

- http://jsjcknew.fwmys.mofcom.gov.cn

- an application for registration of the technology import or export agreement;

- a copy of the technology import or export technology transfer agreement; and
- documentation of the legal status of the contract parties.

Thereafter hardcopies should be sent to local MOFCOM. Local MOFCOM will register the technology transfer agreement and issue a registration certificate within three working days.

5. Technology Agreement

In this chapter, we will discuss the key issues to be taken into account during the negotiation of a technology transfer agreement with the Chinese transferee from the perspective of Chinese law and practice.

5.1. Chinese Contract Party

Before entering into a technology transfer agreement, it is important to check the legal status of the Chinese partner, its reputation and qualifications. A search in the register of SAMR can reveal valuable information on the registered capital, the permitted scope of business, the shareholder(s), and the legal representative of the potential partner/technology transferee. The credibility of a company can be investigated on www.creditchina.gov.cn, and its reputation could also be revealed in communications by customers, suppliers, and consumers on Chinese Internet pages.

Does the Chinese partner have international trading rights? This qualification should be incorporated in the business licence available at SAMR. The Chinese partner shall also be recorded with MOFCOM as a foreign trade operator, and such a record is available at the information platform of MOFCOM http://iecms.mofcom.gov.cn.

5.2. Importance of Clear Contract Terms

It is compulsorily required by Chinese law to form a technology transfer agreement in writing form. According to Article 324 of Contract Law, in principle the parties involved in a technology transfer agreement shall agree on the terms and conditions at their free will. As guidance, the same article also provides a list of terms which in general shall be included in a technology contract and such terms relevant to a technology transfer agreement are listed in the table below.

Contract Terms
• The content, scope and the requirements of the subject matter of the contract; • Performance plans and schedules, the performance period, location and region, and methods of performance; • The confidentiality of technical information and data; • Liability for risks; • Measures to allocate the ownership of, and the benefits to be derived from, the technical results; • The standards for and the method of inspection and acceptance; • Payment, remuneration or royalty and the method of payment; • The method of calculating penalties for breach of contract or compensatory damages; • The method of dispute resolution; and explanation of terms and technical phrases.

However, in case of any dispute between the parties over the terms of the contract, Chinese courts will follow the general rules on the interpretation of contract stipulated by Contract Law (semantic interpretation, systemic interpretation, contract aim-based interpretation, good faith interpretation etc.) and exercise its discretion to decide their respective rights and obligations of the parties. To enhance the certainty and predictability, the foreign technology transferor should negotiate the relevant terms and condition (the above list of items can be taken as reference) as specific as possible and aim to incorporate the clear, straightforward and unambiguous terms in a written agreement.

5.3. Validity and Consequences

According to Article 329 of Contract Law, a technology contract shall be invalid if it may have the effect of illegally monopolising technology and impairing technological advancement or if it infringes the technical achievements of other parties. To provide further guidance to judicial practice, the Supreme People's Court of the People's Republic China ("SPC") in its Interpretation of the Supreme People's Court on Issues relating to Applicable Laws for Trial of Dispute Cases involving Technical Contracts provides a seemingly exhaustive list of restrictive conducts which shall be regarded by the courts to constitute "illegally monopolising technology and/or impairing technological advancement". In practice, Chinese courts will adopt a reasonable approach to determine, on a case-by-case, basis whether any allegedly restrictive conduct really falls under the list below and will lead to monopolising technology and/or impairing technological advancement.

Restrictive Terms Triggering Review of Validity

- Restriction of a party concerned from carrying out new research and development on the technical basis of the subject matter of the contract or restriction of its use of improved technology or unequal conditions for exchange of improved technology between both parties, including request for one party to provide its own improved technology to the other party free of charge or unreciprocal transfer to the other party, exclusive possession or sharing of intellectual property of the improved technology without compensation;
- Restriction of one party from obtaining from other sources a technology which is similar or competitive to that of the technology provider;
- Obstructing the implementation of the subject matter technology by one party in a reasonable way in accordance with market needs, including obvious unreasonable restriction in terms of quantity, variety, price, sales channel and export market on implementation of the subject matter technology by the assignee of the technology to manufacture products or provide services;
- Imposing on the assignee of the technology conditions which are not essential for the implementation of technology, including purchase of non-essential technologies, raw materials, products, facilities, services and takeover of non-essential personnel;
- Unreasonable restriction of the channel or source of technology for purchase of raw materials, parts, products or facilities by the assignee of the technology; or
- Prohibition of valid objection by the assignee of the technology on the validity of the intellectual property of the subject matter technology or imposing conditions on raising of such objection.

Contracts that are invalid or have been revoked possess no legal binding force *ab initio*, the purpose of which is to restore the parties to their original status before the contract was made. To be more specific, after a contract has been declared invalid or revoked, all property obtained by reason of the said contract shall be returned. In case the property cannot be returned or there is no need to return it, compensation shall be paid on the basis of the depreciated value of such property. The survival of confidentiality obligation will normally be supported by the courts.

In principle, Chinese courts acknowledge the partial validity clause as the Contract Law provides the same principle. Where a contract is invalid in part, but the invalidity of the said part does not affect the validity of the other parts of the contract, then these other parts will still be valid. In judicial practice, even the inclusion of any prohibited restrictive conducts as list above is deemed to monopoly technology or impair technical advancement and thereby invalid, it will normally not lead to invalidation of the entire technology transfer agreement.

A party that is at fault is liable to compensate the other party for its resulting losses. If both parties are at fault, each party shall bear the relevant liability respectively.

CASE STUDY

Invalid Technology Transfer Agreement and Consequences

Zhejiang Kelexi Power Equipment Co., Ltd., v. Wu Xiuhai (2017)

In the contract signed by Kelexi Company and Wu Xiuhai, Article 8 stipulates that Wu Xiuhai shall not conduct production or operation of similar products of Kelexin Company. It is not allowed to engage in the development of other technologies in other competitive companies of the same type of business, or to manufacture or operate similar products or engage in similar businesses. The scope of the restrictions includes the production, sales and after-sales service of vacuum pumps, blowers and other products produced by Kelexin Company; the geographical scope of the restrictions is all areas where Kelexi Company sells products.

Higher People's Court of Zhejiang supported the judgment of the court of first instance that this part of the contract was invalid. According to the court, the restrictions on scope of business and geographical scope is too broad and unclear, and obviously hinders Wu Xiuhai from implementing the technology involved in a reasonable way. Unreasonably restricting Wu Xiuhai's new research and development on the basis of the technology involved, and also limiting the technology for its use, it should be regarded as "impairment of technological progress" in Article 329 of the Contract Law.

3.4. Contract Term

As relative to technology transfer agreement in relation to ownership right where the performance of contract shall be completed upon transfer, a technology agreement in relation to use right (a licence agreement) shall always be included with a contract term (licence term) . The term of a technology licence agreement shall not exceed the term of the patent, utility model, design model, or plant variety right hereof.

With respect to restricted technology, the starting date shall not be earlier as the date of the import or export licence granted by local MOFCOM.

5.4. Definition of Transferred Technology

If the transferred technology is not well described, the technology cannot be identified in the event of a dispute on the scope and use of the transfer thereof. In addition, any claim of breach of confidentiality obligations by the transferee will strand as the transferor has the burden of proof to demonstrate which confidential technology has been wrongfully disclosed. If a technology transfer agreement makes reference to a patent, the contract shall clearly state the name of the invention/creation, the patent applicant and the patentee, the application date, application number, the patent number and the duration of the patent right.

It is important to keep detailed records on the specifications of the technology transferred by the transferor, the time of transfer, and the representative of the transferee.

5.5. Purpose of Contract

Pursuant to Article 349 of Contract Law, the transferor under a technology transfer agreement shall guarantee that it is itself the legal owner of all the technology supplied, and shall guarantee that all the technology supplied is complete, without defects, effective, and is capable of achieving the agreed objectives.

The purpose of a technology transfer agreement is essential, as in judicial practice, it is an important factor to be considered by the courts to decide whether the transferor has performed its obligation under the agreement, and whether there exists one of the statutory termination ground, i.e. "frustrating the purpose of contract" .

Therefore, it is advisable to explicitly include the agreed purpose/objectives of technology transfer in the agreement, and clear and plain language shall be used to define such purpose/objective to the extent possible. Moreover, the conditions to be fulfilled by the transferee for the purpose of achieving such objectives shall also be specified in the agreement.

CASE STUDY
Purpose of Contract

Shaanxi Tianbao Soybean Food Technology Research Institute v. FenzhouYuyuan Local Products Co., Ltd. (2016)

On May 5, 2006, two parties signed a Patent Licence Contract. Tianbao Company licensed Yuyuan Company using the patented technology of "walnut lactic acid bacteria beverage and its preparation method" and was responsible for the teaching. In June 2007, Yuyuan Company sent the samples of its beverages to the Shanxi Provincial Food Quality Supervision and Inspection Center for inspection and the report stated that all the beverages produced by the patented technology were all qualified. On June 7, 2007, the trial production was sent to local hotels for free tasting. Due to problems as unstable tastes and the precipitation it could not be sold.

Yuyuan Company believes that Tianbao has not fulfilled all the obligations and the technology involved cannot produce qualified products. Tianbao Company believes that it has fulfilled its contractual obligations. Yuyuan Company sued to terminate their agreement and asked Tianbao to pay back the royalty of 500,000 yuan, and pay the compensation for the purchase of equipment of 1,237,900 yuan.

The Supreme People's Court rejected all claims of Yuyuan Company. It pointed out that whether it is possible to produce a product that conforms to the contract is not the same problem as whether the product can be marketed, whether it is marketable or not, and whether it has profit margins. In contracts involving industrial industrialization, if there is no clear agreement, product commercialization should not be considered as contractual purposes.

5.6. Confidentiality

According to art 26 of the Technology Import & Export Regulations, the assignee and licence shall keep secret know-how confidential during the validity of the technology transfer agreement. The parties can freely negotiate confidentiality obligations and if explicitly agreed in writing between the parties, the confidentiality obligation can last beyond the term of the technology transfer agreement.

The confidentiality obligation should also be incorporated in the employment agreements of the employees that have access to the technology.

Any confidentiality obligation does not extend to information publicly disclosed without the fault of the assignee or licence during the validity of the technology transfer agreement. This information can be freely used by the transferee and other parties.

5.7. Payment for Technology / Royalties

Payment for technology can be in the form of a fixed lump sum payment or a running royalty or a combination of the two. Lump sum payments are usually adopted in cases where the know-how can be fully and completely transferred and absorbed within a specified period of time.

There are no mandatory requirements for the calculation methods of royalty, depending on the difficulty and expenses of research and development, profits estimation, and technology type, etc. In practice, parties to technology transfer agreement may agree to calculate a royalty according to a fixed percentage of the product

price, or any increase in output or profits. Under these circumstances, the parties shall agree in the agreement on measures to inspect and audit the relevant accounts.

In the legal proceedings, in case of a technology transfer agreement which does not include the price or royalty or such clause is not specific and clear, the court will determine the price or royalty in accordance with the research and development cost of the relevant technology, advanced features, the extent of conversion and application, rights and interest and responsibilities of the parties concerned and the economic benefits of the technology.

When a transaction involves a licence for a group of patents, it should be specified in the agreement that in situation where certain part of the patents is invalid or expires whether the royalty should be reduced or left unchanged. Negotiations should base on whether an invalid or expired intellectual property has a material impact on the transaction.

The outbound remittance of a royalty by the Chinese licence to the foreign licensor will have certain tax implications which we will elaborate on below. The technology agreement should clearly stipulate whether or not the total amount of fees as agreed should be the net amount or not, i.e. whether such amount excludes any taxes to be withheld by the Chinese party or not.

5.8. Ownership of Improvements to Transferred Technology by the Transferee

As mentioned above, pursuant to Article 329 of Contract Law and the further clarifications made by SPC about the said article, Chinese law prevents a technology transferor from prohibiting or restricting the transferee from making further improvements to the transferred technology, as such restriction may be deemed to be illegally monopolising technology and/or stalling future innovation. Hence such contractual restrictions would likely be held invalid and unenforceable in China.

With the right of transferee to make further improvements to the transferred technology protected by Chinese law, it is a key point to negotiate the ownership of such improvements in technology transfer agreements. The original inflexible rule on the statutory requirement of ownership of any improvements being vested with the party making such improvements (Article 27 of TIER) has been abolished as of 18 March 2019. The current legal base should only be Article 354 of the Contract Law which states that parties to a technical transfer agreement can stipulate the method of sharing “improved technology” in accordance with the principle of mutual benefits. If not clearly agreed between the parties and such issue cannot be determined by reference to the provisions of Article 61 of Contract Law (i.e. by reference to relevant provisions of the contract or business practice), the subsequent improvements obtained by one party may not be shared with the other party.

In light of the above, the default position is that the original ownership of improvements made by a Chinese transferee will be vested with the Chinese transferee. The parties may contractually agree that the Chinese transferee shall assign its original ownership to the foreign transferor, conditional upon the inclusion of fair and reasonable consideration for the assignment of such improvements in the technology transfer agreement.

The assignment of improved technologies in the field of layout of integrated circuit designs, computer software or the plant variety right may be subject to the national security review. On18 March 2018, the State Council (the Chinese central government) promulgated the Working Measures for Foreign Transfer of Intellectual Property Rights (Trial) to tighten the control over the transfer of technologies in the aforesaid areas from Chinese parties to foreign parties. The aforesaid “transfer” refers to change of the right holder (ownership transfer), change of the actual controller (transfer the majority share in the right holder entity) and

exclusive licence. The review by the Chinese government will focus on the impact of the foreign transfer of technologies on China's national security and the capabilities of innovation and development for the core and key technologies in the aforesaid strategic areas.

In case the ownership of the improvements will be vested with the Chinese transferee, to enable the foreign transferor to use improved technologies made by the Chinese transferee, it is advisable to negotiate and include a grant-back licence clause in the agreement. Similar to the assignment of ownership of the improvements as discussed above, in order to avoid the invalidity and in enforceability of such grant-back licence clause, the licence shall not be agreed to be granted on a royalty-free basis.

Lastly, the agreement can include a provision that such improvements should be immediately brought to the attention of the transferor.

5.9. Employee Improvements

It is important that the employees of the transferee that have access to the transferred technology have clauses in their employment contracts determining the ownership of improvements to the transferred technology invented / created by the employees (so called "service-inventions").

5.10. Monitoring

The transferor is well advised to include monitoring provisions in the technology transfer agreements stating that the transferor can monitor and inspect the transferee's use of the technology.

5.11. Warranty & Indemnification

The warranty requirements provided by Chinese law for a foreign transferor can be referred to Article 24 of TIER and Article 329 of Contract Law as discussed in the section "Purpose of Contract" above.

According to Article 24 of TIER, the assigner or licensor of a contract of import of technologies shall guarantee that it is the lawful owner of the said technologies or the rightful transferor or licensor thereof, and therefore has the right to assign or license the technologies. In addition, according to Article 25 of TIER, the technology should be warranted to be complete, error-free, valid and capable of accomplishing contracted technical objectives.

The controversial Paragraph 3 of the original Article 24 regarding the indemnification obligation of foreign technology transferor from which the parties cannot derogate by agreement has been abolished in the amendment effective as of 18 March 2019. The existing Article 24 states that, if an assignee of a technology import contract who uses technology provided by the assignor in accordance with the provisions of such contract is accused by a third party of infringing the legal rights, the assignee shall immediately notify the assignor and upon the receipt of such notification, the assignor shall assist the assignee in removing any obstacles. By comparison, the controversial Paragraph 3 which has been abolished indicated that, under such circumstances, the assignor shall bear responsibility towards the aforesaid third party. In light of the forgoing rule, TIER used to impose the indemnity risk on the foreign transferor.

Article 353 of Contract Law provides for the similar rule: where the transferee infringes the lawful rights and interests of a third party in the course of exploiting a patent or using technical secrets as agreed by the parties, the liability shall be borne by the transferor. However, the said Article 353 also gives parties autonomy to deviate from such rule, which means parties may agree on such indemnification obligation at their free will, including imposing the indemnity risk on the Chinese transferee.

By deleting the controversial Paragraph 3 of the original Article 24 of TIER, the provisions in the TIER and in the Contract Law on this issue are consistent with each other, meaning the assignee and the assignor are free to agree which party will bear the indemnity risk towards the third party under that circumstance.

5.12. Compulsory Licensing

Under strict conditions a compulsory licence for an invention patent or utility model can be granted by CNIPA upon a party's request. We are not aware of any compulsory licences granted to date.

5.13. Termination

Article 27of TIER states that upon the expiry of the technology import agreement, the transferor and the transferee of the relevant technologies may consult with each other on the continued exploitation of the technologies following the principle of fairness and reasonableness.

The Chinese transferee might claim its business has become dependent upon the licenced technology and insist it is reasonable to continue usage against a reasonable fee (without being provided technology updates). Alternatively, the Chinese party might have patented improvements to the transferred technology. In these examples a simple termination of a technology licence agreement without a clear contractual exit arrangement can lead to serious complications and disputes between the parties when the technology transfer agreement is terminated.

5.14. Governing Law &Dispute Settlement

According to the choice of law rules under Chinese law, parties to a technology transfer agreement are free to choose the governing law. However, as a Sino-foreign joint venture agreement shall be compulsorily governed by Chinese law, the terms and conditions in respect of the technology transfer contained therein or a technology transfer agreement attached thereto should also be governed by Chinese law. As for a stand-alone technology transfer agreement, the parties may agree on foreign law to be the governing law to the agreement, but when the dispute arising from such agreement is heard by Chinese courts, Chinese courts will still apply the mandatory rules of Chinese law to the extent relevant.

A possible way to circumvent those mandatory rules are that in addition to the choice of foreign law, parties to a technology transfer agreement agree to submit the disputes arising therefrom to arbitration outside China. Chinese courts shall recognize and enforce the resulting arbitral awards based on New York Convention, and non-compliance of Chinese mandatory rule such as those stipulated in TIER shall not be a valid ground to set aside such arbitral award unless such non-compliance is also deemed to contradict with public policy of China. However, although public policy violation is an exception to the recognition and enforcement of foreign arbitral awards, like most major arbitral jurisdictions, Chinese courts define public policy narrowly and apply it exceptionally. In practice, it is almost unlikely that Chinese courts will deem the violation of TIER to meet the threshold of "public policy".

However, there is a drawback of foreign arbitration. When disputes emerge from the licence agreement, the licence will often refuse to provide its books and records for the licensor's inspection to prevent the licensor from obtaining evidence of any potential claims. When more serious breaches are committed, communication between the parties may even breakdown completely. Chinese Courts have the power to grant injunctions as an interim measure in legal proceedings. However, under the current rules and practice, such an interim measure issued by a foreign-seated arbitral tribunal cannot be enforced in China. It, nevertheless, deserves to mention that mainland China is going to open a door to interim measures issued by Hong Kong seated arbitral tribunal upon the effectiveness of "the Arrangement Concerning Mutual Assistance in Court-ordered Interim

Measures in Aid of Arbitral Proceedings by the Courts of the Mainland and of the Hong Kong Special Administrative Region" (the "Arrangement") concluded between Chinese Supreme People's Court and the Government of Hong Kong in April 2019. In general, from the perspective of availability and enforceability of interim measures, it is preferable to choose the competent Chinese court as the forum for dispute resolution, but a Hong Kong arbitral tribunal can be an advisable option if the Arrangements come into effect with relevant local laws in place for clarification.

If the parties to a foreign-related contracts or disputes choose a local Chinese court as dispute resolution forum by agreement, the court chosen shall have actual connection to the disputes such as the court in place of defendant's domicile, signing place of the contract or place of performance of contract.

In the past 5 years, China has been establishing a system of specialized IP adjudication. In November and December of 2014, 3 specialized IP courts were formed in Beijing, Shanghai, and Guangzhou which are the leading metropolises and high-tech hubs of China. From 2017, 18 specialized IP tribunals were successively set up. On 1 January 2019, an IP-specialized (appellate) tribunal within SPC began its operation which hears appeals in civil and administrative cases of technology-related intellectual property disputes nationwide.

Another practical alternative is to choose a domestic arbitration institute in China which is experienced in handling cases with an international component. In practice, the China International Economic and Trade Arbitration Commission (CIETAC) in Beijing is the most frequent option under such category. The model clause for CIETAC arbitration can be found at ***http://www.cietac.org/index.cms***. Although domestic arbitral institute like CIETAC has no power to grant interim measures such as an injunction according to Chinese Arbitration law, it can forward such application by the parties to the local competent court for decision and enforcement.

5.15. Special Consideration for SMEs with a Dominant Market Position

For a SME with a dominant position in its relevant market, certain clauses shall be avoided also from the perspective of anti-trust laws in China. Otherwise, it will be subject to administrative punishment.

Article 10 of the Regulation on Prohibiting the Abuse of Intellectual Property Rights to Preclude or Restrict Competition released by the State Administration of Industry and Commerce (the predecessor of SAMR) particularly stipulates several conditions violating anti-trust law which partly overlap with the restrictive conducts stipulated by Article 329 of Contract Law.

> *"A business that has a dominant market position shall not, without any justification, attach the following unreasonable restrictions to preclude or restrict competition in the course of exercising intellectual property rights:*
> *(1) Requiring the transaction counterparty to exclusively grant back the technologies improved by the latter.*
> *(2) Prohibiting the transaction counterparty from questioning the validity of its intellectual property rights.*
> *(3) Restricting the transaction counterparty from using competing products or technologies without infringing upon any intellectual property rights after the licensing agreement expires.*
> *(4) Continuing to exercise any intellectual property rights with an expired term of protection or determined as invalid.*
> *(5) Prohibiting the transaction counterparty from trading with any third party.*
> *(6) Requiring the transaction counterparty to attach any other unreasonable restriction."*

CASE STUDY

NDRC's decision against Qualcomm (2015)

In the NDRC's decision against Qualcomm released in February 2015, a fine of 6.088 billion Yuan ($975 million), or 8% of Qualcomm's 2013 revenue in China was imposed. NDRC concluded that Qualcomm had a dominant market position in the market for licensing standard-essential patents (SEPs) involving CDMA, WCDMA, and LTE, and that it abused its dominance by:

(1) Charging royalties on expired patents; requiring the licences to agree with free grant-back;

(2) Carrying out a tied sale of SEPs and non-SEPs without justification;

(3) Applying unreasonable conditions for sales of baseband chips, including waiving the right to challenge the agreement.

6. Tax Implications

Under the Chinese tax regime, income generated from the technology transfer by foreign transferors, either via the transfer of ownership (i.e. capital gains) or use right (i.e. royalties), may be subject to income tax, valued-added tax (VAT), stamp tax and custom duty.

6.1. Income Tax (Withholding tax)

For foreign transferors as non-tax residents, their China-sourced income may be subject to Chinese income tax. In the case of the foreign transferor involved being a non-resident corporate entity, Chinese Income Tax at a rate of 10% shall apply to income both derived from capital gains and royalties. The aforesaid income tax generated may be further subject to reduction or exemption as given to income of capital gains and royalties under double taxation treaties between China and the country where the transferor is tax resident. For example, under the Double Taxation Treaty between China and the Netherlands, capital gains derived from the transfer of technology ownership is not taxable in the country where the transferor is not a tax resident and, tax rate applicable to limited types of royalties is reduced to 6%.

Income tax shall be withheld by the transferee who remits the fund overseas acting as the withholding agent. According to the tax rules, the tax base shall be the gross amount remitted after the deduction of VAT (as introduced below) .

6.2. Value-added Tax (VAT) and Local Surcharges

As of 1 May 2016, when the VAT reform program was completed and rolled out nationwide to all sectors, business tax (BT) originally levied has been effectively and entirely replaced by VAT, and excluded from the Chinese tax regime. According to Provisional Regulations of the People's Republic of China on Value-added Tax (2017 Revision), technology transfer will be deemed as sales of intangible assets and subject to 6% VAT.

Additionally, there are local surcharges payable by the foreign transferors and calculated based on the VAT amount payable. This is a peculiar of the Chinese tax system. The local surcharges in cities like Beijing, Shanghai, and Guangzhou is in total 12% of the VAT payable which include7% for local urban infrastructure, 3% for state education and 2% for local education.

Under the current tax rules in China, VAT exemption is only available to the domestic transferors, and there are no tax benefits related to VAT and surcharges as given to foreign transferors in technology transactions. Both the VAT and local surcharges payable shall be withheld by the Chinese transferee before making the outbound payment. It is therefore recommended to clearly stipulate a net transfer price exclusive of VAT in the agreement to the benefit of the foreign transferor.

6.3. Stamp Tax

According to the relevant stamp duty regulations, any enterprises or individuals that enter into technology transfer agreements, including foreign transferors entering into such agreements with Chinese counter party, shall be subject to stamp tax amounting to 0.03% or 0.05% of the relevant total contract value payable by each contracting party. Currently the stamp duty levied on contracts related to the transfer of patent application right and the transfer of both ownership and use right of non-patented technology is at the rate of 0.03%, while the stamp duty levied on the contracts/certificates that record the transfer of both ownership and use right of patented technology is at the rate of 0.05%.

6.4. Customs Duty

In an international technology transfer transaction, customs duty borne by the Chinese transferee will arise under the circumstances where there is importation of physical goods (e.g. technical equipment or products) and 1) the transfer price or royalties paid are related to such imported goods, or 2) payment of the transfer price or royalties shall constitute a requirement for the sales of such imported goods within China.

Under condition 1) listed above, the transfer price or royalties payable in relation to patent or know-how shall be deemed to be related to the imported goods if such imported goods:

a) contain such patent or know-how; or
b) are manufactured by such patent method or know-how; or
c) are specifically designed or manufactured for the exploitation of such patent or know-how.

Under condition 2) listed above, payment of the transfer price or royalties shall be deemed as a requirement for the sales of imported goods within China at the circumstances where the buyer cannot acquire the imported goods without paying the transfer price or royalties, or where the transaction of such imported goods cannot be concluded according to the terms of the contract if the buyer does not pay the transfer price or royalties.

In the event that there is importation of goods involved in a technology transfer transaction which is deemed related to or dependent on the payment of transfer price or royalties, such transfer price or royalties will be added into the calculation of dutiable values of the imported goods.

In practice, the customs offices determine the dutiable values of goods requested for import based on self-declaration and supplementary declaration by the company according to the facts. According to the No.58 Announcement of General Administration of Customs effective as of 1 May 2019,[1] If there exist any royalty payments that are related to the imported goods, or constitute a requirement for the sales of such imported goods within China, the import company is required to:

- declare the royalties indicated as "incidentals" at the time of applying for customs release of the goods if such a royalty payment has been made before the custom release;
- declare the royalties within 30 days after the payment of royalties each time the royalties payment occurs after the customs release of the goods.

In addition, when the customs offices deem the self-declaration suspicious, it has right to request supplementary declaration by the company for further explanation and documentation submission. Moreover, it is worthy of note that the customs offices have the right to conduct verification and inspection within three years after customs release. If by any chance the declaration by the company is declared untrue or inaccurate by the customs office, in addition to paying up the outstanding, an accrued penalty will be further imposed.

It is understandable that calculating the royalties into the dutiable value of the equipment or products imported to China may be a main concern of the foreign licensor /seller, which will increase the costs of the products

[1]Announcement on Issues concerning Royalty Filing Formalities for Tax Purpose (Announcement [2019] No.58 of the General Administration of Customs) (in Chinese available at: http://www.customs.gov.cn/customs/302249/302266/302269/2360229/index.html)

and may thus affect their competitiveness in China. However, utmost importance should be given to regulatory compliance in this respect to avoid any administrative or even criminal penalties and bad record with the customs offices.

It is advised to carefully assess in advance whether the royalties payable in relation to the technology in full or in part will be deemed "related to" the products to be exported to China or constituting a requirement for the sales of such imported goods within China based on the conditions as listed and explained above. Considering the strict regulatory supervision and monitoring of customs offices, it is recommended to engage in effective consultation and communication with the competent customs offices before the licence agreement is concluded, and, to the extent practical, clearly set out in the licence agreement the royalties payments which are related and not related to the imported equipment or products. This is conductive to reducing or avoiding the suspicion by the customs office later on during the customs release or inspection process.

Also, it is vital to ensure that clear and complete documentations are retained properly in case of any customs inspection or questioning. All the original documentation including the agreements, invoices, payment receipts, and custom declaration documents, are suggested to be kept in archives and retained properly, which shall serve as proof and evidence in case of any inspection and verification by the customs offices.

CASE STUDY

Reply of the General Administration of Customs on the taxation of royalties paid by Baoding Tianwei Wind Power Blade Co., Ltd.

According to the "Measures of the PRC Customs on Determination of Dutiable Value for Imports and Exports", the royalties related to imported goods which constitute the conditions for the sale of the goods to the territory of the People's Republic of China shall be included in the dutiable value of such goods. You asked the Baoding Tianwei Wind Power Blade Co., Ltd. (hereinafter referred to as Tianwei Company) to introduce the wind turbine blade production technology from Germany AERODYN Company and paid the technology licence fee, but the blade processing equipment such as CNC machining milling machine introduced by Tianwei Company is an equipment for general use purpose, not specifically designed or manufactured for the purpose of implementing patents or know-how. The procurement of the above processing equipment was carried out through international tendering and was not controlled by the licensor of the blade production technology. Therefore, it shall not be deemed that the technology licensing fee paid by Tianwei for the introduction of the wind turbine blade production technology is related to the imported equipment including imported CNC machining and milling machines. The payment of the technology licence fee does not constitute the condition for the above equipment to be sold to the territory of the People's Republic of China.

In summary, agree with your opinion, the royalty paid by Tianwei for the introduction of wind turbine blade production technology shall not be included in the dutiable value of CNC milling machine and other equipment imported by Tainwei.

7. Reverse Engineering & Unfair Competition

7.1. Infringing Trade Secret as Unfair Competition

Chinese law determines unfair competition according to Article 9 of the Anti-Unfair Competition Law, which states that:

"A business shall not commit the following acts of infringing trade secrets:

1) Acquiring a trade secret from the right holder by theft, bribery, fraud, coercion, or any other illicit means.
2) Disclosing, using, or allowing another person to use a trade secret acquired from the right holder by any means as specified in the preceding subparagraph.
3) Disclosing, using, or allowing another person to use a trade secret under its control in violation of an agreement or the requirements of the right holder for confidentiality of trade secrets.
4) Instigate, induce or assist others to violate confidentiality obligation or to violate a rights holder's requirements on keeping confidentiality of trade secrets, so as to disclose, use or allow others to use the trade secrets of the rights holder."

Trade secret means technology or business information unknown to the public and of a commercial value for which the right holder has taken corresponding confidentiality measures.

7.2. Reverse Engineering as Defense

Trade secrets obtained by reverse engineering of imported technology by Chinese parties may not be perceived as unfair. As provided in the Interpretation of the Supreme People's Court on Some Issues Concerning the Application of Law in the Trial of Civil Cases Involving Unfair Competition (2007), the trade secrets obtained through reverse engineering, same as through independent development and research, shall not constitute an infringement upon trade secrets prescribed in the Anti-unfair Competition Law.

In the judicial practice in China, if reverse engineering as a non-infringement defence of trade secrets, special attention shall be paid to the following points:

- Reverse engineering defences must be based on the legitimacy of behaviours. This requires companies strictly abide the "clean room procedures" rules, which means persons who are relate to/ aware of the trade secret or had access to or were involved in the development process should never be, individually and jointly, involved in the reverse engineering.
- Objects of reverse engineering anatomy and analysis must be obtained by legal and public means, such as purchase, transfer, and donation.
- The implementer of the reverse engineering must hold no obligation to keep the trade secret as confidential. This obligation generally derives from legal provisions or contractual agreements. It is also believed that two parties cannot conduct reverse engineer if there is any implied confidentiality obligation arising from their trust relationship.

8. Transfer in ODM Agreement

Original Development Manufacturing (ODM) has become very common in China, especially for foreign companies without sufficient resources to turn their concepts into concrete items. Under the ODM model in cross-border trade, a Chinese local company is commissioned by a foreign company to both design/develop and manufacture a product which is specified and eventually branded by such foreign company. In general, the Chinese ODM companies are in charge of R&D, product testing, and manufacturing.

Under the traditional ODM model, the foreign commissioner may simply have and provide no more than a bare outline for the new product and the Chinese ODM company shall be responsible for undertaking the whole design and development. However, currently, the most common form of ODM for foreign companies has developed into a co-development form. Under the current co-development form, the foreign commissioner and the Chinese ODM company will both contribute the pre-existing IP respectively-owned by each other ("Background IP") into the development of the new products as funded and commissioned by the foreign commissioner. And new technological achievements embedded in the new products ("Foreground IP") will normally be generated based on and in the course of the ODM project. In this sense, it is of high importance to give careful considerations as to the IP ownership allocation, and protection in the ODM agreement with your Chinese party.

8.1. Identification, Ownership and Access Rights of Background IP

Under the ODM commission, it is typically expected to retain ownership of the Background IP that you own and share, while being able to access and exploit Background IP of the ODM company as incorporated into the product so developed. As such, it is vital, in the very beginning, to clearly identify in writing the Background IP, whether patented or non-patented, of both parties in the ODM agreement.

Practically, it is suggested to agree and list all Background IP both parties intend to use and share as specific and detailed as possible, which are typically set out on and incorporated into the agreement as an annex. This is for the purpose of avoiding potential disputes and ambiguities in the future by clear delineation of the Background IP of both parties, and the Foreground IP generated in the course of the ODM project in the very beginning.

Following the clear identification of the Background IP, in order to retain ownership of the Background IP, the followings shall be explicatively included in the agreement:

- an acknowledgment that ownership of the Background IP remains with the current owner (or with the foreign commissioner)
- precluding any assignment or indication of assignment of the ownership over the Background IP (of the foreign commissioner) to the other party in respect of and during the performance of the agreement

In addition, access right to the Background IP is another major consideration for the purpose of the ODM project. On one hand, the ODM company requires access right to the Background IP of the foreign commissioner for the purpose of executing the project (e.g. production, research and development), and on the other hand, the foreign commissioner requires access right to the Background IP of the ODM company in order to exploit the product after the project is completed. In your interests as foreign commissioners, it is recommended to carefully limit the scope of access right to your background IP granted to the ODM Company, and meanwhile ensure your access rights to the Background IP of the ODM company free of any encumbrances and restrictions.

Specifically, with regard to the licence of your Background IP to the ODM company, it is preferred to be stipulated in the agreement as follows:

- the licence granted is non-exclusive
- permitted use under the licence granted shall be limited solely to the extent necessary to perform its obligations under the agreement
- prohibiting or restricting sublicence to any third party by the ODM company.

As for the Background IP of the ODM Company, although it would be ideal to obtain its full ownership, most of the ODM companies are rarely willing to give it away. Nevertheless, in order to fully exploit the product developed without any obstacles, the Background IP of the ODM company licensed to you should be ensured in the agreement at least:

- the permitted use thereunder shall legally enable and ensure your use, production, and commercial development of the product developed;
- the Background IP shall be warranted free and clear of any encumbrances including but not limited to any charges, liens, claims. And the ODM Company shall warrant it should be directly liable if any third party claims arise.

8.2. Ownership Allocation of Foreground IP

The ownership of the Foreground IP is a very vital point to be determined and specified in the agreement, which is normally generated based on your Background IP and with your investments. However, if you wish to retain the ownership of the Foreground IP, it must be explicitly laid down in the agreement. Otherwise the operation of default rules under relevant Chinese laws will be more in favour of the developer if there is no agreement between parties in this regard.

Under relevant provisions of Chinese Patent Law and Contract Law governing the contracts of commissioned technology development, unless otherwise agreed by both parties, the patent application right to the technological achievements shall be attributed, by default rules, to the developer who creates such technological achievements, and such party shall become the patent right holder if the application is approved. However, the commissioner shall have the right to exploit the patent royalty-free. In addition, the commissioner shall have the right of first refusal under same conditions if the developer decides to transfer the patent application right. In comparison, if the parties prefer to protect the technological achievements in the form of know-how (trade secrets), but there is no agreement or supplementary agreement reached between parties as to the allocation of ownership, both parties enjoy the right to use and transfer such know-how by default rules.

In view of the above, it would be in your best interests to agree on and set out the favourable ownership allocation of Foreground IP in the agreement at the very beginning. In practice, the arrangement of ownership allocation may be either sole ownership or joint ownership depending on the negotiations with the ODM Company.

For your best position, it is for sure sole ownership of the Foreground IP rested with you. To this end, agreement of unconditionally waiving and transferring the ownership or all rights of the Foreground IP by the ODM Company to you shall be clearly laid down. However, the said arrangement is on the condition that the development is generated by virtue of your investments. Otherwise such agreement may be deemed as illegally monopolizing technology and ruled invalid by the court as mentioned above.

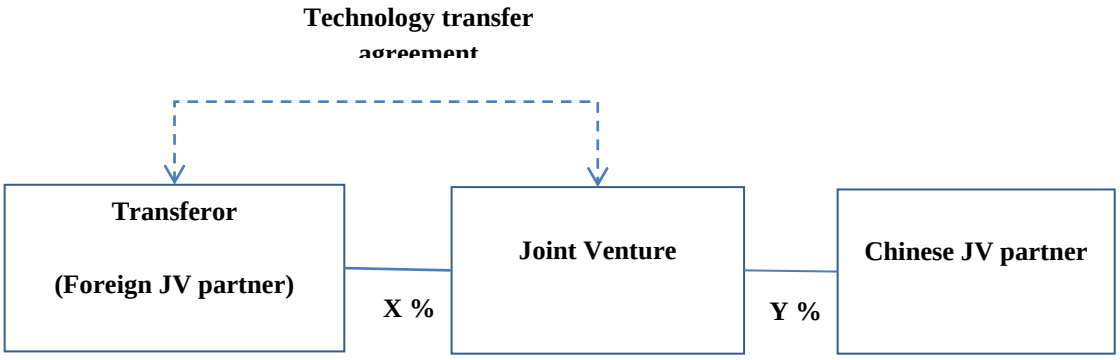
At the circumstance where the ODM Company is at a dominant position with regard to the ownership of the Foreground IP, joint ownership is another arrangement parties may consider. As dependent on further consultation and agreement by the ODM Company, this arrangement, however, will cause restrictions to your future use and commercial exploitation of the Foreground IP/product. Therefore, joint ownership is generally not an advised option. If joint ownership is determined, terms with regard to the exploitation, compensation, assignment, licence should be clearly and carefully stipulated. Alternatively, it would be recommended to retain the sole ownership and grant a limited licence to the ODM Company as a concession.

8.3. Non-disclosure and Confidentiality

IP protection should be considered as soon as you start entering into discussion with the ODM company with regard to your patent and know-how. A non-disclosure agreement (NDA) is recommended to sign with the ODM Company. In addition, confidentiality clause is suggested to insert in the ODM agreement.

9. Technology Transfer as Joint Venture Investment

A foreign investor is permitted to set up a foreign-invested enterprise (FIE) through contribution in the form of IP rights of technology as long as such IP rights can be both valuated and transferable in accordance with law. In the joint venture setups (JV) with Chinese parties which engage in hi-tech business or with demand of hi-tech, it is quite common for foreign investors to contribute or be requested to contribute in the form of IP rights of technology, which operation can be seen as follows:



However, under the above setup, if not properly arranged, disputes over IP rights associated with the technology contributed will generally arise during and after the termination of JV. Practically, for the purpose of protecting IP rights of your technology contributed into the JV, the following points should be considered and arranged properly:

- Contribution of IP rights of technology to the JV in the form of licence for use is preferred over the form of assignment of ownership. Chinese law does not explicitly exclude the form of capital contribution by use right of technology, which only provides the conditions that define a permitted form of IP rights contribution, i.e. valuable in currency and transferable in accordance with law. Contribution in the form of granting the use right of technology appears to meet with the said conditions considering it is acknowledged and permitted by Chinese law to transfer the use right of technology by way of concluding a licence agreement. Local rules and policies in Shenzhen, Guangdong Province and Suzhou, Jiangsu Province explicitly encourage the capital contribution in the form of use right of technology, both patent and know-how. Furthermore, there are existing guidelines and third-party assets valuation companies available for valuation of licence for use of technology.

  In practice, there are cases of such form contribution that show successful registration with the local SAMR. However, whether contribution in the form of licence for use of technology is viable for each individual case depends highly on the decision of specific SAMR local branches which might hold different views on the interpretation of current laws and regulations mainly with concern over the capital maintenance resulted from the depreciation and termination of the licence contributed. Therefore, it is advised to consult with the local SAMR branch before adopting this form of contribution. Depending on the circumstances, the types of licence for use granted with respects to the technology can be non-exclusive, sole or exclusive, all of which shall be valued and assessed by a third party assets evaluation company engaged. Compared with ownership transfer, granting a licence allows the IP ownership right of the technology retained by the foreign investor. Thus, you can have

more control over the technology contributed in case any illegal use and licence or sublicence arises. Moreover, when the JV is terminated, to withdraw the use right of the technology (termination of licence) will normally have less obstacles and complexity than retrieving the ownership back (ownership transaction).

- Clearly lay down veto right in the JV agreement and articles of association. Since the Chinese party most of the time demands control over the JV, in most cases, the foreign party will be a minority in the JV. Therefore, it is vital to allow the foreign party to have veto rights with respect to many corporate resolutions especially those with regard to your technology contributed.

- Sign confidentiality agreements with your Chinese partner, and relevant personnel. At circumstances where the technology contributed by the foreign party is know-how, it is not uncommon to happen that the Chinese partner or relevant personnel with access to the technology secretly copy/clone its technical data and information, and disclose them to a third party for patent registration or register patent itself after termination of the JV. As such, before entering into the JV agreement, it is highly important to conclude confidentiality agreements with both Chinese partner and relevant personnel, in which obligations of keeping the technology data and information confidential without disclosing to any third party, and acknowledging foreign party's sole ownership of the technology, and corresponding liabilities for breach shall be clearly and strictly stipulated.

- Clearly stipulate the exit mechanism in JV agreement and articles of association. After the termination of the JV or if for any reasons the foreign investor would like to exit the JV, revoking the licence contributed should be of vital concerns for the foreign investor. However, since the licence contributed is closely attached with the equity interest in the JV, an exit mechanism determined and agreed on in the JV agreement and articles of association is very important. To that end, the parties may choose to dissolve and liquidate the JV, or to permit the foreign shareholder to withdraw from the JV by reducing the registered capital of the JV if it is preferred to continue.

10. Business Recommendations

10.1. On Strategy:

- *Understand the short-term priorities of the Chinese government and the transferee and their long term goals;*
- *Make a clear long-term risk analysis with respect to the technology transfer for the business of the company. Which technology can be licensed, which technology should stay in-house? Is the technology to be transferred outdated in a few years and replaced by new technology of the transferors due to continued innovation of the transferor; and*
- *Check the most up-to-date prohibited, restricted and encouraged technology catalogues.*

10.2. With respect to the Chinese partner:

- *Do a brief due diligence on legal status, business scope and reputation; and*
- *Take a step by step approach. Check out first whether the Chinese counterpart is abiding its obligations before transferring substantial and business sensitive technologies.*

10.3. Regarding the cooperation terms:

- *Make a detailed technology transfer protocol. Each transfer of the technology part should be documented and described in detail, acknowledged and signed-off by both parties;*
- *Negotiate an agreement with the Chinese importer that is compliant with Chinese laws and regulations and build in adequate audit and disclosure obligations;*
- *Make sure there is an obligation that improvements to the transferred technology by the transferee should be immediately disclosed to the transferor;*
- *Insist on adequate human resource policies at the transferee to protect the secrecy of the technology;*
- *Make the transferee agree in writing that the transferred technology and resulting products thereof cannot be exported abroad; and*
- *Deal in detail with terminations terms.*