IP issues in outsourcing to China

There are a number of legal and practical issues that need to be addressed by companies currently considering the manufacture of high technology products, research and development, and IT outsourcing in China

By **Douglas Clark** and **Gabriela Kennedy**, Lovells, Shanghai and Hong Kong

China has been at the forefront of providing outsourcing services for more than 30 years, to such a degree that it is now taken for granted that Western companies will outsource the manufacture of a wide range of consumer and consumer electronics goods to the country. Yet, while it almost dominates the global market of the outsourcing of the manufacture of consumer goods, it is only in the last two to three years that attention has focused on China's capabilities in relation to research and development and IT outsourcing.

Many foreign companies, such as Microsoft, Motorola, Texas Instruments, HP and IBM, have already set up research and development facilities in China. Hong Kong and Shanghai Bank has hosted back office systems in China since the mid-1990s. As with India in the early days of its outsourcing business, international companies look tentatively at outsourcing to China. However, more and more companies are now bringing in high-technology products to manufacture there. This is requiring greater research and development within China, much of which is outsourced, if not to completely independent companies, then to related companies.

There is a high degree of risk loss of or misappropriation of IP and trade secrets in such outsourcing.

Essential elements to protecting IP when outsourcing

The Chinese legal system, while markedly improved over the past five years, still does not provide adequate protection to intellectual property rights when high technology is being transferred to, or developed in, China. Of particular concern is that the legal system is not adequately able to prevent the misappropriation of intellectual property and trade secrets by business partners or employees. All legal steps should be taken to protect IP and trade secrets. In order to protect IP fully, it is necessary to have in place practical measures to reduce the risks of the misappropriation. There are two essential elements to do this successfully:

- Build in protections to legal documents and physical security.
- Have proper supervisory measures in place.

As far as possible, reliance should be made on building in to systems and processes appropriate protections. Supervisory measures are subject to human frailties and can only be relied upon as a back-up.

If you take, for example, contracts protecting trade secrets, a built-in structure would mean that employee/supplier contracts have general terms acknowledging trade secrets and confidentiality obligations (general contract). A supervised structure, on the other hand, would see work and supply being monitored and specific contracts signed on an as-needed basis (specific contract)

There are strengths and weaknesses in each of these approaches. With a general contract, there is no need to have suppliers or employees sign contracts on a regular basis – something that in practice can be difficult to do. However, because the contract is not specific as to what is a trade secret, it can be difficult to enforce in court. With a specific contract, it is possible to state what the specific trade secret is, so making court enforcement less problematic. However, generally speaking, people forget to request

Key legal issues when outsourcing in China

1. Understand the business and legal environment that the company will be operating in.
2. Understand the legal protection for intellectual property rights that is available. It is essential to know what protection the law does provide. For example, it is essential to know to what extent patents and trade secrets are protectable.
3. Understand the rules relating to transferring technology into China and limiting the risk from such transfer.
4. Understand what the legal provisions are in relation to IP created by employees or outsource suppliers. This includes the right of employees under the Patent Law to compensation for successful inventions that are implemented. Identify and obtain protection for IP created during the transaction.
5. Assess and ensure the physical security of technology.

specific contracts or, if requested, the other party "forgets" to sign, unless there is some reason for them to do so.

In fact, a combination of both types of contract is best, provided that built-in reminders to update what is considered a trade secret are put in place when the transferring party has negotiating leverage (for example, on renewal of a supply agreement; promotion or pay rise).

Another example relates to physical access controls. A built in structure will mean that there will be, say, access gates requiring each person entering and exiting to use a security card. Supervision would mean having a security guard checking access. Again, both approaches have plus and minus points. With access gates, it is a strength that a company does not have to rely on an individual to stop or monitor people and records; while the need to ensure access controls are in working order could be seen as a weakness. Security guards, by contrast, can spot irregular behaviour and are able to investigate it on the spot; but they may not check because of face or laziness, and so on.

The business and legal environment

All companies entering the market in China to do business are required to establish a legal entity under Chinese law to do so. In recent years the main vehicle for this has been wholly owned foreign entities (WOFES). There are a number of advantages to setting up a captive WOFE: the foreign investor in a WOFE does not need to negotiate with a Chinese enterprise matters such as the scope of operation, number of workers, percentage of exports and changes in control or ownership of the business; and responsibility for the daily operations of a WOFE lies solely with its own management. This provides its foreign parent with greater control over its day-to-day operations and makes it easier to protect IP rights as they are transferred and created. The greatest IP risk in these circumstances is the leakage of IP or trade secrets to competitors or the misappropriation of trade secrets by employees.

Nevertheless, in some industries it is legally necessary to establish a joint venture. For commercial reasons, it may also sometimes be necessary to establish a joint venture, for example where it has been agreed to conduct research and development with a Chinese party for the purpose of developing new products for the Chinese market.

From an intellectual property perspective, the greatest risk in establishing a joint venture is the leaking of technology transferred and developed by the JV to the Chinese partner and its parent. This is a particularly big risk if the Chinese joint venture partner is a state-owned enterprise (SOE). SOEs remain under the control of the ministry in the industry in which they work. If any part of the government above an SOE requires it to share technology that has been transferred as part of a joint venture, then there is a great likelihood that the Chinese party will pass this information over. Naturally, as with WOFEs, there remains the risk that IP or trade secrets will leak or be misappropriated.

Legal protection for IP

China's has enacted intellectual property laws that provide, on paper, the full protection one would expect in a Western country. China has patent, trademark and copyright laws, as well as laws making the misappropriation of trade secrets both a civil and criminal wrong.

The key issue in China is the enforcement of laws. In particular, Chinese civil procedure law makes it very difficult to protect high-technology patents and trade secrets. For example:

- The civil procedure law puts a strong burden on a plaintiff to prove its case. There are no rules specifically shifting the burden of proof if a plaintiff makes out a *prima facie* case. This can make it very difficult to prove that a high-technology patent has been infringed or a trade secret has been misappropriated.
- There is no discovery in civil proceedings. Parties are only required to submit evidence that assists their case. Without discovery, it can also be extremely difficult to prove a case.
- Oral evidence is very rarely accepted in civil proceedings; oral evidence of misbehaviour by an employee will thus be very hard to use.

All companies in China are therefore operating in an environment where pre-emptive measures to protect intellectual property are essential. Once a case gets to court, it is very difficult to rely on inferences or oral evidence and the company should assume that only documentary evidence will be accepted. This means that, as far as possible, all transactions must be clearly and properly documented.

Entering into outsourcing arrangements

The sometimes difficult to navigate Chinese technology licensing regime can create additional hurdles for outsourcing projects taking place in China. A foreign company should become familiar with the applicable limitations under the technology licensing regime in order to protect its IP interests and

to retain maximum ownership of deliverables and improvements.

Contracting in China is essentially not so different from contracting anywhere else in the world. There are a few main exceptions, which are discussed at high level below.

English and/or Chinese are usually acceptable languages for contracts (except for the contracts required to be approved by the Chinese authorities, where Chinese should be the language used or governing). In cases where both languages are equally effective, the presumption is that words and sentences in both language versions have the same meanings. Inconsistencies are interpreted in light of the objective of the contract.

It is not possible to enforce foreign court judgments in China. However, China is a member of the 1958 New York Convention on the Enforcement of Arbitration Awards. Hence foreign arbitration awards are technically enforceable in China (as a practical matter enforcement is difficult, time consuming and often subject to local protectionism).

Parties will for this reason often include an arbitration clause in contracts. However, this on its own can rarely prevent the theft of intellectual property rights or trade secrets. Often the only real remedy available is an injunction. In order to be effective, an injunction must be granted by a court where the defendant (or its assets) is located. An arbitration clause could prevent a party obtaining an injunction, as the defendant would apply for a stay of proceedings on the basis that any issues should arbitrated.

Where arbitration is the preferred method of dispute resolution, it is therefore recommended that a clause be included in contracts that provides that, notwithstanding the agreement to arbitrate, the parties agree that, in addition to any recourse to arbitration, the transferring party may seek a temporary or permanent injunction from a court or other authority with competent jurisdiction, including administrative authorities.

In addition, because the agreement will have a choice of law clause, it is often best to specify that, notwithstanding that the agreement is governed by the law of a certain country, a court or authority hearing an application for injunctive relief may apply the law of the jurisdiction where the court or other authority is located in determining whether to grant the injunction. This will assist in avoiding delaying tactics by a defendant.

Technology transfers and IP rights

China's laws, regulations and administrative practices often impose some significant restrictions on the terms on which technology can be licensed into China. While the regime has been liberalised in recent years, there are still a number of restrictions that transferors of technology must be aware of.

For example, where existing software is to be developed and supported under the outsourcing service arrangements, the customer will need to consider carefully the terms on which source code and related technical materials are licensed to the service provider.

Historically, technology transfer rules and regulations imposed certain onerous limitations on the contents of technology transfer contracts and required centralised government approvals. This approval/registration regime has been streamlined post-WTO, to the effect that many of the previously more onerous provisions and practices have been relaxed or eliminated.

While China has agreed as part of its WTO market access undertakings to eliminate most intrusive approval practices, as well as the licence term limitations, unfortunately, under the Technology Import-Export Management Regulations issued on 10th December 2001 (New Technology Regulations), there is still some room for interference.

The New Technology Regulations provide for classification of technology as prohibited, restricted and permitted for import-export purposes. Prohibited technology cannot be imported or exported; restricted technology can be imported or exported only with approval; and permitted technology can be imported or exported without approval but registration is required.

The New Technology Regulations do contain an important improvement over the prior regime in respect of the term of the licence. Under the New Technology Regulations, the term is no longer strictly limited to 10 years and at the expiration of the licence term the licensee no longer has the automatic right to continue to use the licensed technology on a royalty-free basis. This permits evergreen licence arrangements covering continuously updated technology within the scope of the licence and will avoid the need to license only a current snapshot of the existing technology with all improvements thereto being licensed under separate contracts subject to separate rolling 10-year terms.

Under the New Technology Regulations, as under the prior licensing regime, the technology import licence contract is to include basic warranties regarding the rights of the licensee to the subject technology and the completeness and ability of the technology to achieve the stated objectives, as well as relatively standard IP indemnity provisions.

In addition, the technology licence import

contract is not to include any of the following: provisions (which represent some improvement in some but not all areas):

- Improper tie-in arrangements, including requiring the purchase by the licensee of unnecessary technology, raw materials, products, equipment or services.
- Requirements that the licensee pays royalties or assumes other obligations in respect of expired or invalid patents.
- Limitations on the licensee's ability to make improvements or use such improvements; and the intellectual property rights to such improvements made by the licensee are to vest in the licensee.
- Restrictions on the licensee's right to obtain other similar or competing technology.
- Unreasonable restrictions on the source of the licensee's raw materials, components, products or equipment.
- Unreasonable restriction of the licensee's production volumes, product types or sales prices.
- Unreasonable limitations relating to the export sales channels of products manufactured using the licensed technology.

In practice, since the New Technology Regulations have been in place, the regime has proved to be relatively liberal. However, the regulations are not truly addressed to pure outsourcing services. The provisions were clearly not devised to address the situations where materials were licensed solely to enable the Chinese entity to provide maintenance and support as opposed to other forms of exploitation. From a practical point of view, the main issue for such agreements relates to improvements and the ownership of them. While the PRC regulations allow the licensee to make improvements unilaterally, the issue of ownership is typically addressed by requiring an assignment/licence grant back to the licensor.

New intellectual property rights come into existence regularly in the course of a company's business. These newly created rights should be properly protected as soon as they arise. A company's product is often the result of efforts from many parties, and each of these parties may own some intellectual property rights in their corresponding creations. It is vitally important that provisions be included in the original arrangement with these parties to ensure intellectual property rights so created are retained.

IP created by business partners/employees

A company should take certain pre-emptive measures to ensure its intellectual property rights are well protected when working with a Chinese business partner and Chinese employees.

It is important to ensure that Chinese business partners and employees are aware of how important intellectual property rights are and to ensure that they know what constitutes authorised and unauthorised use of the intellectual property rights.

Obviously appropriate contractual provisions can be included in the contract but it is also advisable to reinforce the provisions from time to time by reminding the business partner of its obligations and auditing the use of licensed IP and the controls in place aimed at protecting critical IP. Audit rights can be an important means of ensuring that IP is protected.

Contractually, all rights should be assigned in writing back to the outsourcer or employer. Contractual provisions should also be in place to ensure that a business partner has taken all steps to obtain assignments in writing from their suppliers and employees.

Under China's copyright law and patent law, this is generally the case; however, it is best to have a written agreement confirming this.

Copyright

China is a signatory to the Berne Convention and, as such, works generated by qualifying individuals will be protected by copyright. Under Chinese law, the author or creator of an original work is the first owner of the copyright in the work, save in the case of employees of a company who created the original work in the course of their employment, in which case the copyright of the work belongs to the company. A company should nevertheless ensure that contracts with employees provide for assignment of copyright of all works created to the company to avoid possible disputes.

Commissioned works

Where a third-party company (which in an outsourcing arrangement is likely to be the service provider) is commissioned to undertake work, the Chinese Copyright Law provides that, short of prior arrangement, the copyright in these commissioned works belongs to the commissioned party, that is, the third party company. A written agreement with the commissioned party for assignment of copyright in its work should be reached prior to commencement of the business relationship.

Inventions created by employees

If a new invention is created by a Chinese employee in the course of his employment, the invention may be protected by patent in China

and the owner of the patent is the employer. The Chinese Patent Law provides, however, that the company needs to pay the employee an "appropriate fee" for the new invention. Appropriate fee is not defined in the Patent Law. It is important that a fee arrangement is made with all employees at the commencement of employment to avoid any disputes on the issue of what constitutes an appropriate fee, particularly where a new invention later becomes a huge success in the market.

Applicant for inventions

For inventions made in China, the Chinese patent law requires that patents be filed in the name of a Chinese entity unless permission has been obtained in advance for assignment of the invention to a foreign applicant. Where a foreign company has established a WOFE in China, this does not raise a major issue, as the applicant can be the WOFE. Where a JV has been established, or there has been a true outsourcing of services and no entity has been established in China, this can cause problems because obtaining permission for assignment of an invention can often be time consuming.

Conclusion

The transfer of technology to China as part of investment and outsourcing projects continues apace. A thorough understanding of the risks of the transfer of high technology and the limits of the Chinese legal system is essential and when making commercial decisions about whether to proceed with a project. There remain risks with transferring technology and outsourcing to China, yet there are also potentially great rewards. These will drive more and more companies to outsource to China in areas involving high technology. The key to success when they do so will be proper management of the legal risks.

Lovells
Suite 1107, Shanghai Kerry Centre,
1515 Nanjing West Road, Shanghai
200040, People's Republic of China
Tel: +86 21 6279 3155
Fax: +86 21 6279 2695

www.lovells.com

Douglas Clark
Partner
douglas.clark@lovells.com

Douglas Clark is a partner in the intellectual property department of international law firm Lovells and managing partner of the firm's Shanghai office. He was based in Hong Kong until 2000 and moved to Shanghai in that year.

He has practised IP law in China and Hong Kong since 1993 and is experienced in all aspects of intellectual property work. He has handled over 1,000 patent, trademark, copyright and passing off/unfair competition cases in mainland China and Hong Kong, including pharmaceutical, computer software and telecommunications-related patent and copyright cases. He has also coordinated regional brand protection programmes covering Asia. His non-contentious experience includes advising on patent licensing technology transfer, and conducting patent and other intellectual property audits as part of investment projects.

Douglas speaks fluent Mandarin and Japanese. He studied law at a postgraduate level at Fudan University in Shanghai in the late 1980s.

Lovells
23rd Floor, Cheung Kong Center,
2 Queen's Road, Central, Hong Kong
Tel: +852 2219 0888
Fax: +852 2219 0222

www.lovells.com

Gabriela Kennedy
Partner
Gabriela.kennedy@lovells.com

Gabriela Kennedy has worked in the intellectual property department of Lovells Hong Kong since 1994. She is qualified as a solicitor in Hong Kong and in England and Wales.

She has handled all aspects of intellectual property work including enforcement, licensing and registration work. She has handled a number of high-profile cases including a copyright infringement claim that went to the Court of Appeal in 1997. Her IP practice includes pan-Asian enforcement of IPRs and licensing (in particular patent licensing). In recent years, her IP practice has concentrated on the management and enforcement of intellectual property rights in the information society with particular emphasis on the protection of databases and protection of copyright online.

Gabriela is widely recognised as an outstanding practitioner and is named in legal directories, including Asia Pacific Legal 500 *as a leading individual and* Asia Law & Practice *as a leading lawyer in intellectual property practice.*