

## Protecting your IP while Transferring Technology to China

Many European Companies are keen to come to China. While in the past, European companies came to China to take advantage of low-cost manufacturing for export, more recently, they have come to enter the Chinese domestic market, establish R&D, engage in cooperative development, take advantage of a skilled work force, establish suppliers, and develop longterm partnerships in China. In order to achieve this, they are often willing to ‘transfer’ their key technology and designs to Chinese subsidiaries of European firms, joint-venture (JV) partners, or Chinese manufacturing and service companies. One of the challenges facing European companies coming to China is devising creative solutions to minimize the risk to their intellectual property (IP) associated with such technology transfers.

A technology transfer happens in a number of different ways. European companies most commonly transfer their technology by licensing their patents, designs, software, trade secrets, and know-how. Ownership of the technology may be transferred, but this type of transfer is less common. A common misconception is that a technology transfer is limited to transfers of high technology. However, many European companies using contract manufacturing to manufacture low technology, consumer, or industrial products, for example based on product designs, must deal with many of the same risks to their IP as their high technology counterparts.

The Chinese government encourages the lawful and legitimate transfer of technology while at the same time supporting innovation by Chinese companies, otherwise known as ‘indigenous innovation’. Over the years, gaining market access in exchange for bringing foreign technology to China has been a successful bargain for many European companies. Unfortunately, some Chinese companies seeking to acquire foreign technology often obtain it from European companies either through inadvertent leakage of IP, or in breach of agreements or Chinese law. Protection of IP through courts and other avenues in China remains mixed as the legal system continues to develop. As a result, European companies who do not think carefully about how to guard against IP risk when transferring technology to China may unwillingly suffer a loss of competitiveness and market share as a result of losing their IP to Chinese competitors.

### Thinking of Transferring Technology? - The First Step

SMEs new to China or considering bringing technology to China should first check the Catalogue for Prohibited and Restricted Technology Imports (the ‘Technology Import Catalogue’), published by the Ministry of Science and Technology (MOST) and the Foreign Investment Catalogue, jointly published by the Ministry of Commerce (MOFCOM) and the National Development and Reform Commission (NDRC).

Technology imports in China are divided into ‘freely importable’, ‘restricted’, and ‘prohibited’ technology. Restricted and prohibited technologies are specifically enumerated in the Technology Import Catalogue, while technologies not listed in the Technology Import Catalogue are deemed freely importable. In most cases, technology is deemed freely importable, with only certain technologies

related to economic policy development or national security classified as restricted or prohibited. If technology will be later exported, SMEs also need to check the corresponding Catalogue for Prohibited and Restricted Technology Exports (the 'Technology Export Catalogue') and whether there are any relevant regulations in the destination country.

In addition, where the technology is to be brought into China via foreign direct investment (FDI) such as with the establishment of a joint-venture or wholly foreign-owned enterprise, it is important to consider the Foreign Investment Catalogue to determine what restrictions, if any, apply to the establishment of the Chinese entity. For example, the foreign investment in design and manufacturing of civil aircraft equipment is limited to JVs. For technology transfers in the form of a FDI, the permitted form of FDI will be critical in determining what contractual and non-contractual solutions you will need to protect SMEs' IP.

## **What Can Companies Do to Protect Themselves?**

### Picking the Right Partners

It is important to recognize at the outset that part of the motivation for the Chinese company in a technology transfer is obtaining foreign technology and know-how. This fact is not a secret and SMEs should not treat it like one. Consequently, as a first step to protecting IP in a technology transfer, it is important to make sure SMEs choose the right partners. Essentially, the ideal partner will be complementary, but not well-positioned to directly compete with European SMEs' business. However, in order to make an informed decision, SMEs need to take a closer look at your business as well as the potential Chinese partner by following these three-steps:

1. Analyse your strengths. What is it that makes the company competitive? What measures and IPRs are used or can be used to defend Company's competitiveness (e.g. trade secrets, patents, new applications for technology requiring know-how, etc.)? Which IP assets can be transferred to third parties without losing competitiveness or market share in the mid- to long-term?
2. Analyse your competitors and the Chinese market in which your company wishes to operate. Do you know who your competitors in China are? What are their strengths? What is their strategy? This analysis should also include potential and existing partners in China: are you aware of their specific objectives? Are they in a special situation which influences your cooperation? For example, State Owned Enterprises (SOEs) may be obliged to abide by local and State industry policy which requires them to gain more know-how transfer and R&D investment rather than maximising short-term profits.
3. Design your own procedures when dealing with China. They need to be practical, but also indicate where your company will draw the line when trading off IP protection for operational efficiency. Define your company's limits and vigorously defend your position.

### Structure

Once European SMEs have selected the right partner, structuring technology transfer is critical to effectively protecting IP assets. The IP risk associated with a particular technology transfer will vary depending on whether SMEs are licensing, setting up a JV, or setting up a WFOE. In all three of these situations, SMEs need to prevent their IP from being inadvertently leaked or intentionally misappropriated or misused by a related or unrelated Chinese party. However, each situation presents unique opportunities and challenges:

1. ***Licensing the technology to an unrelated Chinese company (such as in a contract manufacturing context).*** When licensing to unrelated Chinese companies such as in contract manufacturing, SMEs generally have the least control over their IP, but they have the option to use multiple Chinese suppliers and can use what is known as a ‘modular strategy’ which basically involves using different Chinese suppliers to source different components of SME’s product, so that no single Chinese supplier can make the product. In addition, phased implementation is often used to test out the Chinese partner before transferring additional technology. Both of these strategies are widely used by many European companies.
2. ***Setting up a Joint Venture.*** In the context of a JV, modular strategy and phased implementation is limited because typically business efficiency requires the JV to be able to deliver a completed product. In addition, there is the added challenge of transferring technology to the JV while preventing company’s IP from leaking to the Chinese JV partner. In such circumstances, it is important to be creative and to not let the deal get in the way of protecting company’s valuable IP. It is extremely important to define the roles of not just the JV, but also the Chinese JV partner. For example, many companies keep critical design work or the manufacturer of critical components in a separate wholly-owned subsidiary or completely off-shore. A Chinese JV partner with strong local contacts and sales networks can be structured as an authorised distributor of the JV’s products, but being otherwise limited in the activities of the JV.
3. ***Setting up a WFOE.*** If a WFOE structure is used, IP risk is less because European SMEs have the greatest amount of control over their wholly-owned subsidiary. In these structures, addressing IP risk often means focusing on reducing or preventing IP leakage by employees and business partners. For example, when establish an R&D centre, it is important to ensure that employee-inventors are properly remunerated and developed IP is routinely captured and managed, including filing patents and registering copyrights. Use of confidentiality agreements and non-compete agreements for certain employees who are intimately knowledgeable about the business and technology is strongly recommended.

## Contracts

In addition to structure, the other key to successfully protecting IP in technology transfers is to make sure the IP owner has all the relevant contracts in place and that they are airtight. It is recommended that companies use IP licenses with their Chinese partners; in addition to establishing each party’s rights, the IP license ensures that the technology transferred is documented in case issues arise later on. This is especially critical when the Chinese party is also contributing technology and IP becomes difficult to identify or differentiate.

**Improvements:** One of the most negotiated parts of the IP clauses of a technology transfer agreement is the provision for the creation of improvements and the ownership of improvements made by the Chinese party. This is because improvements to the transferred technology are often extremely valuable and form the basis for the cooperation. As a result, the foreign party typically wants to own all improvements to the technology made by the Chinese party. However, there are a couple of important points under Chinese law on improvements SMEs need to know:

1. Commissioned IP belongs to the commissioned party, unless the contract states the commissioning party owns the IP. This means that it is important that the contract states clearly what IP is to be developed and who will own it.
2. Improvements are owned by the party that makes the improvements and cannot be automatically 'granted-back' to the other party without some form of compensation or without reciprocation such as granting a license to the other party's improvements. This means that the typical automatic ownership of improvements being owned by the foreign party will be unenforceable.
3. A Chinese party cannot be restricted from making improvements to transferred technology and using the improvements. This means that a Chinese party can make improvements and any such restrictions will be unenforceable.

The implications of these three rules create many problems for European companies looking to transfer their technology to China. Since the Chinese party is permitted under Chinese law to make and use improvements, European companies have to think twice about what technology they are willing to bring to China and allow the Chinese party to improve on. It is important to discuss the technology transfer with an experienced lawyer who can help IP owners to come up with effective ways to structure the terms of the contract in order to address the development, ownership, and use of improvements.

**Confidentiality:** It is important to include strong confidentiality provisions in the technology transfer contract. European companies often go to great lengths to protect their confidential information, trade secrets and know-how, including using key-card access, closed-circuit TV, virtual data rooms, and sophisticated document tracking measures. While these measures may be expensive and difficult to administer, they should be seriously considered if critical IP is transferred.

**Reverse engineering:** In addition to dealing with the issues related to improvements to the technology, European companies must also think about reverse engineering, which is the acquisition of technology by taking apart and studying an existing product in the market. Reverse engineering is permitted under Chinese law and not considered a theft of trade secrets. As a result, well drafted technology transfer contracts should include a provision limiting or prohibiting the Chinese party from engaging in reverse engineering.

## Take-away Messages

- European SMEs who do not think carefully about how to guard against IP risk when transferring technology to China may unwillingly suffer a loss of competitiveness and market share.
- SMEs should refer to the Catalogue for Prohibited and Restricted Technology Imports (the 'Technology Import Catalogue') and the Foreign Investment Catalogue to make sure that they will be allowed to bring their technology to China.
- To protect IP in a technology transfer it is important to make sure SMEs choose the right partners at the outset. It is recommended that companies use IP licenses with their Chinese partners.
- The IP risk associated with a particular technology transfer will vary depending on whether the SME is licensing, setting up a JV, or setting up a WFOE. However, in all three of these situations, the goal is the same - to prevent IP from being inadvertently leaked or intentionally misappropriated or misused by a related or unrelated Chinese party.

China IPR SME Helpdesk Team

## CHINA IPR SME HELPDESK

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