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Outsourcing technology to China

Outsourcing to China – Risks and benefits

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A B S T R A C T

With the rewards of outsourcing technology to China come risks of loss or misappropriation of intellectual property (IP) rights and trade secrets. This article outlines the ways in which companies can balance benefits and risk by addressing: IP and technology transfer rights, the business and legal environment in China, contractual arrangements, preemptive legal protections, and understanding the rules relating to IP creation by employees or outsource suppliers. Once foreign firms understand the legal and practical issues addressed in this article, and how to navigate them, they can decide whether or not to move valuable projects to China.

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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 goods to China. It is only in the last two to three years, however, 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. Increasing numbers of companies are now bringing in high technology products to be manufactured in China. This is requiring greater research and development within China, much of which is 'outsourced', if not to completely independent companies, to related companies.

This has highlighted one of the great risks of such outsourcing arrangements – the risk of loss or misappropriation of intellectual property (IP) rights and trade secrets. This article will consider some of the legal and practical issues that need to be addressed by companies currently considering outsourcing to China the production of high

technology products, research and development and IT outsourcing.

1. Key legal issues

The Chinese legal system, while markedly improved over the past five years, still does not provide adequate protection to IP rights when high technology is being transferred to or developed in China. The key legal issues when considering outsourcing in China are:

- Understand the business and legal environment that the company will be operating in.
- Understand the available legal protection for IP rights, for example, it is essential to know to what extent patents and trade secrets are protectable.
- Understand the rules relating to transferring technology into China and limiting the risk from such transfer.
- Understand what the legal provisions are in relation to IP created by employees or outsource suppliers. This includes the right of employees under patent law to compensation for successful inventions that are implemented.
- Maintain the physical security of technology.

2. The business and legal environment

All companies entering the market in China are required to establish a legal entity under Chinese law. In recent years the main vehicle for this has been the wholly-owned foreign entity (WFOE). There are a number of advantages to setting up a captive WFOE – the foreign investor in a WFOE 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. Responsibility for the daily operations of a WFOE 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 IP perspective, the greatest risk in establishing a joint venture is the leaking of technology transferred and developed by the joint venture to the Chinese partner and its parent. This is particularly a great 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 them 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 the information to the entities above them. Naturally, as with WOFEs, there remains the risk that IP or trade secrets will leak or be misappropriated.

3. Legal protection

China has enacted IP laws that provide, on paper, the full protection one would expect in a Western country. China has patent,¹ trademark,² and copyright laws,³ as well as laws making the misappropriation of trade secrets both a civil and criminal wrong.⁴ 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. The key issues are:

- Civil procedure law puts a strong burden on plaintiffs to prove their case.⁵ There are no rules specifically shifting the burden of proof if a plaintiff makes out a prima facie

¹ Patent Law 1984 as amended on 1 July 2001 (“Patent Law”) and its Implementing Rules.

² Trademark Law of 1982 as amended on 27 October 2001 (“Trademark Law”) and its Implementing Rules.

³ Copyright Law of 1990 as amended on 27 October 2001 (“Copyright Law”) and its Implementing Rules

⁴ Article 10 of Unfair Competition Law of 1993.

⁵ Article 64 of Civil Procedure Law of 1991.

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.⁶ Without discovery, it can be extremely difficult to prove a case.
- Oral evidence is very rarely accepted in civil proceedings⁷ – oral evidence of misbehaviour by an employee will thus be very hard to use.

All companies in China thus operate in an environment where pre-emptive measures to protect IPRs 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.

4. Contractual outsourcing arrangements

The sometimes difficult to navigate PRC technology licensing regime can at times create additional hurdles for outsourcing projects. A foreign company should become familiar with the applicable limitations under the PRC technology licensing regime in order to protect its IP rights and to retain maximum ownership of deliverables and improvements.

Contracting in China essentially is not so different from contracting anywhere else in the world. There are a few main exceptions which are discussed below. English and/or Chinese are usually acceptable languages for PRC 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.⁸ Inconsistencies are interpreted in light of the objective of the contract.⁹

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 (though in practice 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 can have problems in preventing the theft of IP 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 be arbitrated.

⁶ *Ibid.*

⁷ Articles 63 and 70 of Civil Procedure Law of 1991 provide that the People’s Court has power to accept oral evidence but in practice they rarely accept or put weight in such evidence.

⁸ Article 125 of Contract Law of 1999.

⁹ *Ibid.*

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 the fact 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 seeking to slow down the grant of an injunction by insisting on obtaining evidence as to the availability of an injunction under the country whose law has been stated to be applicable.

5. Technology transfer and IP rights

China's laws, regulations and administrative practices often impose some significant restrictions on the terms on which technology can be licensed in 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 existing provisions and practices have been relaxed or eliminated.¹⁰

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 new PRC Technology Import-Export Management Regulations enacted on 1 January 2002, there is still some room for interference. These new technology regulations provide for classification of technology as 'prohibited', 'restricted' and 'permitted' for import-export purposes.¹¹ Prohibited

technology cannot be imported or exported; restricted technology can be imported¹² or exported only with approval¹³; and permitted technology can be imported or exported without approval but registration is required.¹⁴

The new technology regulations do contain an important improvement over the prior technology licensing regime in respect of the term of the licence. Under the new regulations, the term is no longer strictly limited to 10 years¹⁵ 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 licence¹⁶ and will avoid the need to licence only a current 'snapshot' of the existing technology with all improvements thereto being licensed under separate contracts subject to separate rolling 10-year licence terms.

Under the new 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 technology¹⁷ and the completeness and ability of the technology to achieve the stated objectives as well as relatively standard IP indemnity provisions.¹⁸

In practice, since the new regulations have been in place, the regime has proven to be relatively liberal. However, the regulations are not truly addressed to pure outsourcing services. The provisions were clearly not devised to address the situation that 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 their ownership of them. While the PRC regulations allow the licensee to make improvements unilaterally,¹⁹ the issue of ownership is typically addressed by requiring an assignment/licence grant back to the licensor.

New IP 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. Often a company's product is the result of the collaborative of a collaborated effort by many parties, and each of these parties may own some IP rights in their corresponding creations. It is vitally important that provisions are included in the original arrangement with these parties to ensure IP rights so created are retained.

¹⁰ The current legal regime governing technology transfer regime is set out in the PRC Technology Import-Export Management Regulations of 2002, which repealed the old PRC Regulations on Administration of Technology Acquisition Contracts of 1985 and the Implementation Rules of the Regulations on Administration of Technology Importation Acquisition of 1988.

¹¹ Articles 8 and 21 of Technology Import-Export Management Regulations of 2002. The classification of "prohibited", "restricted" and "permitted" technology is governed by Articles 16 and 17 of the PRC Foreign Trade Law of 1994 as amended in 2004.

¹² *Ibid.* Articles 9 and 32.

¹³ *Ibid.* Articles 10 and 33.

¹⁴ *Ibid.* Articles 17 and 39.

¹⁵ Article 8 of the repealed Regulations on Administration of Technology Acquisition Contracts of 1985 which provided that the relevant government authority could not approve any technology acquisition contract of a term exceeding 10 years. The current PRC Technology Import-Export Management Regulations of 2002 do not contain this restriction.

¹⁶ Article 27 of the PRC Technology Import-Export Management Regulations of 2002.

¹⁷ *Ibid.* Article 24.

¹⁸ *Ibid.* Article 25.

¹⁹ *Ibid.* Article 29(3).

6. IP created by business partners and employees

A company should take certain pre-emptive measures to ensure its IP 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 IP rights are, and ensure that they know what constitutes authorised and unauthorised use of those 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 rights and the controls in place aimed at protecting them. Audit rights can be an important means of ensuring that IP rights are 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.

7. Copyright

China is a signatory to the Berne Convention and as such, works generated by qualifying individuals will be protected by copyright.²⁰ Under Chinese law, the author or creator of an original work is the first owner of the copyright in the work.²¹ In the case of employee of a company who created the original work in the course of his or her general employment, the copyright in the work belongs to the employee while the company has the exclusive right of using the work within two years of the creation of the work.²² Where the employee was specifically assigned to create the work using the technology and resources provided by the company who supplied special assistance to the employee in support of the creation of the work, then the copyright in the work belongs to the company.²³ Because of these requirements in the copyright law, a company should ensure contracts with employees provide for assignment of copyright of all works created to the company to avoid possible disputes.

8. Commissioned works

Where a third party company is commissioned to undertake work (which in an outsourcing arrangement is likely to be the service provider) 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.²⁴ A written agreement with the commissioned

²⁰ Ibid. Article 2.

²¹ Ibid. Article 11.

²² Ibid. Article 16.

²³ Ibid. Article 16. Also Articles 11 and 12 of Implementation Rules of Copyright Law of 2002.

²⁴ Article 17 of Copyright Law.

party for assignment of copyright in its work should be reached prior to commencement of the business relationship.

9. Inventions created by employees

If a new invention is created by a Chinese employee in the course of the employee's employment, the invention may be protected by patent in China and the owner of the patent is the employer.²⁵ Chinese patent law provides, however, that the company needs to pay the employee an 'appropriate fee' for the new invention.²⁶ 'Appropriate fee' is not defined in the 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 in the case where a new invention has later become a huge success in the market. This has become a particular issue since an employee in Japan recently won a multi-million dollar award under similar provisions in Japan's patent law.

10. Applicant for inventions

For inventions made in China by a Chinese entity, Chinese patent law requires that patents be first filed in China unless the invention is assigned to a foreign entity.²⁷ Where a foreign company has established a WFOE or a joint venture in China, it will be regarded as a Chinese entity and hence the application must be first filed in China. Where there has been a true outsourcing of services to a Chinese inventor by a foreign entity which has not established any presence in China, the Chinese inventor is required to first file the patent application in China, unless the foreign entity obtains an assignment of the invention prior to the filing of the patent. This can cause problems because obtaining permission from the Chinese government for the assignment of an invention can often be time consuming.

11. 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 to making commercial decisions whether to proceed with a project. There remain risks with transferring technology and outsourcing to China, but there are also potentially great rewards. These potential rewards will drive more and more companies to outsource to China in areas involving high technology. The key to success will be proper management of the legal risks in doing so.

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²⁵ Article 6 of Patent Law.

²⁶ Ibid. Article 25.

²⁷ Ibid. Articles 20 and 10.