

Crossing borders

Janet Xiao and Can Cui explore tech transfer opportunities emerging from import rule changes in China

Chinese companies are eager to bring foreign innovative technologies to China, for example, through intellectual property (IP) acquisitions or licensing, research partnerships, and other collaborations. Despite the ever-escalating trade tensions between the US and China, cross-border technology transfers into China, especially in the life sciences area, have remained active.

Technology import into China is generally regulated by China's technology import and export regulations (TIER), effective from 1 January 2002. The scope of cross-border technology transfers regulated by TIER is very broad and covers assignments of patent rights or rights to apply for patents, patent licences, transfers of technology secrets, and technology services, among others. In March 2019, for the first time, China's State Council amended TIER by deleting several significant provisions related to technology import contracts.

Introduction of TIER

Pursuant to China's foreign trade law, TIER has adopted a catalog-based classification system to regulate cross-border technology transfers. In the context of technology import, China's Ministry of Commerce (MOFCOM) published two catalogues: one for prohibited technologies, and one for restricted technologies. Examples of prohibited technologies include vis-breaking technology for oil processing, nuclear fuel processing, and certain pesticide production technologies. Examples of restricted technologies include certain printing and dyeing technologies, automobile engine-production technologies, compound microbiological preparations, and agricultural transgenic-organism technologies. Most technologies are neither prohibited nor restricted.

There are some technologies that cannot be imported without a technology import licence issued by MOFCOM. Technologies that are neither prohibited nor restricted, referred to as permitted technologies, can be freely imported, subject to registration of the relevant contract with MOFCOM under TIER.

A technology-import licence can be obtained in two ways. The technology importer may file an application for technology import with MOFCOM while still negotiating a technology-import contract. MOFCOM will review and decide on whether to grant a preliminary licence for technology import, usually within 30 business days after receiving the application. After the contract is executed, the technology importer must then further submit a copy of the executed contract to MOFCOM to apply for the technology-import licence.

MOFCOM will review the contract and decide on whether to grant the licence, usually within 10 business days. Alternatively, the technology importer may wait until the contract is executed and submit an application for technology import together with a copy of the executed contract. MOFCOM will review the application package and decide on whether to grant a licence, usually within 40 business days after receiving the application package. In either process, the technology import contract is effective under TIER only as of the date the technology-import licence is issued.¹

Before the TIER Amendment, TIER imposed a number of requirements on technology-import contracts that favoured Chinese companies. These included requirements that:

- The foreign assignor or licensor (the transferor) guarantee that it was the lawful owner of the technology or otherwise had the right to assign or grant licence.
- The transferor assist the Chinese assignee or licensee (the transferee) in the event the transferee was charged for infringing the rights of a third party in using the imported technology pursuant to the technology-import contract.
- The transferor guarantee that the technology was complete, error-free, and effective and met the technology target agreed upon in the technology-import contract.
- The transferor indemnify the transferee for infringement of third parties' lawful interests in using the imported technology pursuant to the technology-import contract (the infringement indemnification).
- The transferor allocate ownership of improvements to the imported technology to the transferee (the improvement allocation); and
- Certain restrictive clauses in the technology import contract related to the transferee's use of the imported technology be prohibited (the prohibition of restrictions).

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TIER sets out certain criminal and administrative liabilities for various types of non-compliance with its requirements, including importing prohibited technologies, importing restricted technologies without a licence, exceeding the scope of the technology-import licence, and forging, altering, buying or selling technology-import licence or registration. Depending on the circumstances, MOFCOM may suspend or revoke the Chinese technology importer's licence to engage in foreign trade activities. Any technology-import licence or registration that was obtained by fraud or other illegal means may be revoked by MOFCOM, which may also revoke the Chinese importer's licence to engage in foreign trade activities.

Because the vast majority of technologies are permitted, in practice, non-compliance with TIER is usually not intentional but results from ignorance of the existence of TIER and its requirements. Although TIER does not expressly set out penalties applicable to cross border transfers of permitted technologies (with the exception of fraud), non-compliance may still result in adverse consequences. For example, in order to lawfully remit licence or service fees or other forms of revenue

share under a technology-import contract to the transferor, the transferee must present its bank with the corresponding technology-import licence or registration. Failure to comply with TIER requirements may also lead to loss of IP protection of unlawfully imported technology, loss of enforcement of contractual provisions inconsistent with TIER, and damaged reputation with the Chinese government.

Amendment implications

The amendment removed the requirements for the infringement indemnification, the improvement allocation, and the prohibition of restrictions, but left the rest of the requirements intact.

The previous infringement indemnification requirement obligated the transferor to indemnify the transferee for infringement of third parties' lawful interests, including IP rights, in using the imported technology pursuant to the technology-import contract. Removal of the infringement indemnification requirement now allows parties to negotiate indemnification provisions, such as the allocation and cap of indemnifications related to the transferee's infringement of third-party rights. The transferor should make sure that such provisions are indeed negotiated and included in the technology-import contract. This is because under China's contract law, the default situation without such provisions would still be for the transferor to indemnify the transferee.

The previous improvement allocation requirement provided for mandatory ownership of the improvements by the transferee. This has been a major deterrent to bringing technology to China because many technologies, especially life-sciences technologies, are early stage and require further developments before a product is commercialised. Having the transferee own all improvements of the technology may potentially eviscerate the fundamental IP rights of the transferor. Removal of the improvement allocation requirement now allows parties to allocate ownership over technology improvements through negotiations. For example, the parties may decide to co-own the improvements, or have the transferor own the improvements and then grant the transferee a licence. The transferor should make sure that such provisions are indeed negotiated and included in the technology-import contract, because, under China's contract law, the default situation without such provisions would still be for the transferee to own the improvements to the imported technology made by the transferee or on its behalf.

The amendment further removed the prohibition of certain restrictive clauses in technology-import contracts in connection with the transferee's use of the imported technology:

- Imposing conditions on the technology import, such as requiring the transferee to purchase unnecessary technologies, raw materials, products, equipment or services.
- Requiring the transferee to pay fees or assume certain obligations for using technologies, the patent term of which has expired or the patent of which has been declared as invalid.
- Restricting the transferee from improving the imported technology or using the improved technology.
- Restricting the transferee from obtaining from sources other than the transferor technologies similar to or competitive with the imported technology.
- Unreasonably restricting the channels or sources for the transferee to purchase raw materials, spare parts, products, or equipment.
- Unreasonably restricting the quantity, type, or price of the products of the transferee; and
- Unreasonably restricting the channels for the export of products produced by the transferee using the imported technology.

Although the removal of these clauses from TIER seems significant, one should bear in mind that other Chinese laws impose similar restrictions. For example, contracts may be invalid due to violation of the contract

law for unlawfully monopolising technologies or impeding technology advancement. The parties should carefully analyse the potential consequence of including restrictive clauses in the technology-import contract, taking into account all applicable Chinese laws, regulations, and judicial interpretations.

Summary

As the amendment removed certain TIER provisions that had been considered as imposing undue restrictions on companies bringing technology into China, it represents a positive step by China to improve its compliance with international treaties. Technology companies wishing to bring their technology to China should engage in the negotiation of the previously non-negotiable terms. Silence in the contract on the allocation of ownership of improvements and indemnification obligations will prejudice the transferor because the default positions under the applicable laws still favour the transferee. Moreover, notwithstanding the removal of the prohibition of restrictions from TIER, the parties should still be careful about imposing restrictions on the transferee because certain restrictions may run afoul of other applicable laws in China.

Technology companies in the US wishing to bring their technology to China should also be mindful about applicable technology export control by the US. The Export Control Reform Act required the US Commerce Department to identify "emerging" and "foundational" technologies on which export controls may be placed.

A notice seeking public comment issued by the Bureau of Industry and Security in November 2018 identified 27 technologies, including biotechnology, as "emerging" technologies. Instead of blanket controls over all areas of emerging technologies, the US government will likely employ a risk-based approach to identify key technologies that are deemed sensitive and for which the export should be controlled. Sensitive technologies likely include artificial intelligence and machine learning, augmented reality, autonomous vehicles, advanced battery technology, and "big data", nanobiology, synthetic biology, genomic and genetic engineering, and neurotechnology, to name a few.

If deemed sensitive, the technologies may be subject to unilateral US control, most likely requiring a technology-export licence. Technology companies should stay close to the legislative progress in both the US and China and be mindful about restrictions in both countries to ensure smooth cross-border transfers of valuable technologies.

Footnote

1. In the event of any material amendment to a technology-import contract after obtaining the technology-import licence, the technology importer is required under TIER to apply for a new licence. The termination of a technology-import contract shall also be recorded with MOFCOM.

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