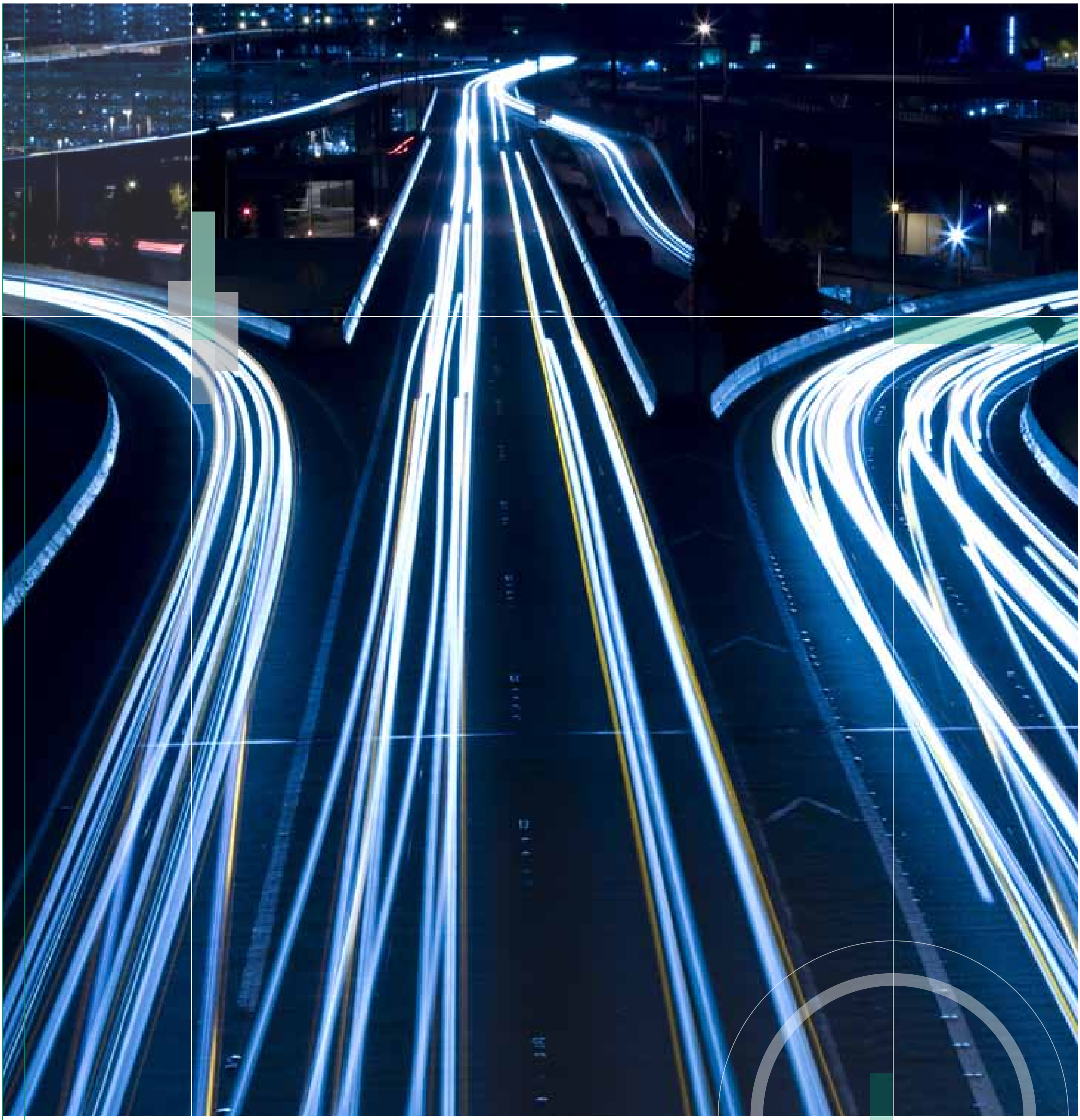

SECTOR PRIMERS — TECHNOLOGY

ORRICK

The Chinese government is aggressively encouraging domestic and foreign-invested companies to develop, co-develop and acquire various technologies viewed as critical to China's long-term global competitiveness. This policy change means that attractive opportunities are currently available for foreign companies in technology-oriented industries, including Internet, software development, information technology (IT), cloud computing, gaming and clean technology.

Despite these opportunities, serious challenges remain for international companies active in these fields. As counterfeiting and piracy issues are common in China and the enforcement of intellectual property rights (IPR) is selective, foreign investors must carefully weigh the risk of losing proprietary technology against the benefit of entering the China market. Certain practical measures can be implemented as part of a well-designed China strategy that enables a foreign technology investor to succeed at an acceptable level of risk.

This report provides a brief introduction to the state of the market for foreign technology companies doing business in China. Orrick has advised dozens of leading U.S., European and Asian technology companies in their China-related matters, and this report draws from our wealth of practical, on-the-ground experience in this dynamic industry sector.

MARKET ENTRY FOR TECHNOLOGY COMPANIES

China's legal regime presents a unique set of challenges for foreign technology investors. There are various ways to enter (or expand one's presence in) the China market, including direct product sales, investment through a corporate vehicle, and licensing or outsourcing arrangements with China subsidiaries or local business partners. Product sales into China are often subject to product registration or labeling requirements, compulsory product certification, import restrictions (e.g., data encryption products) or licensing requirements (e.g., information security products) and implied warranties.

There are two basic corporate vehicles suitable for use as a technology subsidiary in China, a Sino-foreign equity joint venture (EJV) and a wholly foreign-owned enterprise (WFOE). Each vehicle is subject to certain minimum capitalization requirements, as well as restrictions on its ability to incur debt, and its operating activities are strictly confined to a government-authorized scope of business. A foreign-invested partnership enterprise may offer an appealing alternative in certain investment scenarios. Foreign investors should carefully consider the relative advantages and disadvantages of each type of vehicle before investing.

Technology may be imported to China pursuant to a registration or approval procedure involving a "technology import contract." Technology imports include the following: an assignment or license of patents, technical secrets, software or other proprietary technology; the provision by a foreign supplier of technical services or consulting; and cooperative arrangements for design, research and development, co-development or co-production.

Additionally, foreign technology companies have recently been outsourcing certain functions to China. Common arrangements involving software development companies include contracts between a foreign company/foreign-invested enterprise (FIE) and a third-party service provider in China or between a foreign parent or affiliate and its China subsidiary.

INCENTIVES IN THE TECHNOLOGY SECTOR

China is pursuing an aggressive industrial policy that offers a wide range of significant preferences for foreign technology companies. There are many different types of incentives currently available, both at the national and local level, including location-based preferences and preferences based on the operating activities, industry sectors and qualifications of the entity involved. Tax incentives include reduced enterprise income tax (EIT) rates, value-added tax (VAT) and business tax refunds or exemptions, and accelerated expense deductions. Other incentives include industry-specific cash awards and subsidies, real estate and rental refunds as well as various incentives for qualified personnel.

R&D Center: A qualified research and development center (R&D Center) is eligible for a range of incentives under national and various local rules. An R&D Center may be established as an EJV or WFOE, or as an internal division or branch of an EJV or WFOE.

Advanced Technology Services Enterprise: A qualified advanced technology services enterprise must be located in a pilot outsourcing services city and operate in a preferred sector. It must also possess advanced technology or R&D capabilities, satisfy certain export quotas, employ a certain percentage of personnel with college degrees, derive a certain percentage of annual revenue from technology services and possess an international qualification certificate (such as an ISO quality service certification).

Software Enterprise: The principal business of a qualified software enterprise must involve the development or production of software products or services related to systems integration, applications or other IT, meet certain personnel, revenue and R&D expense thresholds, and have developed its own products or own the IPR to at least one of its products.

High and New Technology Enterprise: A qualified high and new technology enterprise must invest no less than US$2 million in R&D activities, own or possess exclusive rights to "core intellectual property," expend a certain percentage of revenue on R&D, engage a certain percentage of personnel in technology-related activities, and comply with certain tax and legal requirements.

FIE Established in Western Region: An FIE established in China's Western region may be eligible for various tax incentives, personnel incentives, rent refunds and land use grant fee subsidies and discounts, customs import duty exemptions, and industry-specific preferences offered under local government policies.

PROTECTING TECHNOLOGY IN CHINA

To maximize its ability to protect intellectual property rights in China, a foreign investor must identify the nature and scope of the proprietary technology that is best suited to the China market. Foreign technology companies may choose to either assign or license, but rigidly restrict access to, core technology or to assign or license less valuable proprietary technology that is sufficient to meet current market demand. Once the specific technology is identified, the relevant patents and trademarks (including Chinese language marks) should be registered in China, even if they are protected elsewhere.

Other measures for protecting proprietary technology include instituting vigorous security measures, training programs and localized confidentiality and IPR assignment agreements for staff and customers, public education programs on the benefits of genuine products, and careful vetting and monitoring of distributors.

China's Contract Law expressly prohibits a licensor from "monopolizing technology and impairing technological progress." The Supreme People's Court has interpreted this clause to prohibit a licensor from, among other things, inhibiting a licensee's ability to reverse engineer or make and use improvements to licensed technology. It is possible, however, to impose a series of affirmative and negative covenants on a licensee that temper these restrictions in exchange for payment of compensation to the licensee.

The "work-for-hire" doctrine is not recognized in China. By contrast, copyright in employee created work is held by the employee creator, while the employer holds certain usage rights. An employee and employer may expressly agree otherwise, before or after creation, and the employer is not required to provide separate consideration for the assignment.

Copyright protection in China is not conditioned upon registration, but registration can assist in demonstrating the validity and ownership of copyrights during a dispute. Registration may also be useful in supporting an application for incentives.

Finally, a foreign investor must consider an efficient means for resolving disputes. Foreign court judgments are seldom recognized or enforced in China and the court system is hampered by poor training, and both local protectionism and corruption have been frequently reported. Arbitration in China is available for an FIE, and arbitration in a foreign tribunal is available to a foreign contracting party, but a successful claimant seeking to enforce an arbitration award in China must file an action in a People's Court where the defendant's assets are located. Interim relief is available upon proving that the continuation of the alleged infringing conduct will cause "irreparable harm" to the interests of a proprietary rights holder.

ABOUT ORRICK

Orrick is an international law firm with more than 1,100 lawyers located in the major commercial centers of North America, Europe and Asia. Tracing its roots to 1863, over the years, Orrick has pursued a strategy of steady but measured growth to meet the needs of our clients for high-quality legal solutions wherever they do business. Our practices are balanced between high-stakes litigation and complex transactions, while emphasising proactive counseling and risk management. In recognition that our clients require both quality and value, the firm has led the legal industry by combining market-leading practice capabilities with client-service innovation.

Orrick's Greater China team of more than 100 lawyers and legal professionals offers clients one of the most comprehensive and experienced international law practices in the region.

With an unmatched 40-year track record advising regional and international clients on a broad range of China-related legal matters, our lawyers work from offices in Beijing, Hong Kong and Shanghai to provide clients with complete transactional and dispute resolution legal services in Greater China and the major markets around the world.

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