



China breaks new ground with Foreign Investment Law-related Intellectual Property (“IP”) reform

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What has happened?

In a recent move involving both the Chinese legislature (the National People's Congress or "NPC") and the executive branch (the State Council), China has overhauled two of its most important pieces of legislation governing inbound IP-related investments.

The first major change was the adoption of the new *Foreign Investment Law* ("FIL") on 15 March 2019 (full text in Chinese [here](#), English version available upon request). The new FIL will enter into force on 1 January 2020, and the existing legislation that has formed the backbone of Foreign Direct Investment ("FDI") regulation since the 1980s (currently scattered over three laws¹) will be repealed on the same day. This note will focus on IP-related developments under the FIL, while a separate note will cover the corporate law implications of the FIL, which can be viewed [here](#). In a development that clearly is related to one of the main bones of contention in the ongoing US-China trade talks, the new FIL contains certain explicit assurances in relation to IP protection for foreign investors, including in relation to alleged forced transfers of IP in order to gain market access rights.

The second major change linked to the passing of the FIL was the repeal, with immediate effect, of some of the most controversial and restrictive IP-related provisions of the *Technology Import and Export Administrative Regulations* ("TIER") and the *Sino-Foreign Equity Joint Venture Law Implementing Regulations* (the "EJV Implementing Regulations") by administrative decree issued by the State Council on 2 March 2019, and promulgated on 18 March 2019. This change is crucial to most cross-border transactions involving licenses and transfers of technology, and has been long-awaited by foreign investors who often saw it as a barrier to bringing their IP into China.

What does it mean?

IPR-related highlights of the new FIL

In the following provisions, the new FIL attempts to tackle some of the most thorny issues for foreign investors when deciding whether or not to transfer or license their intellectual property rights ("IPR") into China, i.e. forced technology transfers, misappropriation of IP, and cash being trapped in China due to its foreign exchange controls, the latter often driven by opaque policy concerns e.g. dividends and licensing fees payments made by Foreign Invested Enterprises ("FIEs") being delayed as they got caught up in wider concerns in China over capital flight and 'fake outbound' investment in offshore assets in China:

- **Formal prohibition of forced technology transfers:** Administrative organs and their employees are now expressly prohibited from forcing technology transfers through administrative measures. The FIL also provides that technological cooperations based on the principles of voluntariness and relevant rules of commerce is encouraged, and the conditions for technological cooperation are to be agreed by the parties on the basis of equality and fairness (Article 22 FIL); in short; leave it up to the parties to decide.
- **Assurance of IP protection:** Moreover, the FIL provides that the State shall protect the IPR of foreign investors and FIEs as well as the lawful rights and interests of IPR holders (Article 22 FIL). The FIL also provides that administrative organs and their employees must maintain the confidentiality of trade secrets, and sanctions, including potentially criminal sanctions, will be imposed should they unlawfully disclose trade secrets they learn in the course of performing their duties (Articles 23 and 39 FIL).

¹ The PRC Sino-Foreign Equity Joint Venture Law, the PRC Wholly Foreign-Owned Enterprise Law, and the PRC Sino-Foreign Cooperative Joint Venture Law.

- **Freedom to remit out:** another IP-related provision provides that capital contributions by, profits, return on investments, proceeds of asset disposals, IPR licensing royalties, indemnification or compensation amounts obtained in accordance with law, liquidation proceeds and the like can be freely remitted in or out of China, in either RMB or foreign exchange, in accordance with law. This has the effect of consolidating provisions scattered over various pieces of legislation and of confirming that outward or inward remittances can also be made in RMB as well as in foreign currency. It expressly overrules the position set out in Article 11 of the EJV Law which requires that: “Based on the currency specified in the Equity JV contract and in accordance with the *Foreign Exchange Administrative Regulations*, after performing their obligations stipulated by law and as set out in the agreements and contract, foreign parties may repatriate their share of the net profit, as well as their share of funds as well as other funds [allocated to them] upon the expiration or termination of the equity joint venture.” This gives foreign investors some comfort that their cash will not be trapped in China, but the qualifier “in accordance with law” weakens this by allowing for the possibility of rules restricting these transactions to be introduced. In theory at least, most if not all these things should already be happening anyway, so the question becomes whether this new provision actually changes anything.

The main changes under the TIER

State Council [Administrative Decree No. 709](#) does not repeal or replace the TIER. In fact, it only repeals three of its most controversial articles, and rephrases another. The articles that have been repealed contained a number of very controversial mandatory clauses and prohibitions on contractual provisions in technology import contracts (“**TICs**”). These

were intended to protect the Chinese technology importer from imbalanced contractual provisions, or unfair treatment by the foreign technology exporter, but harked back to an era when foreign licensors or transferors had a much stronger bargaining position and Chinese licenses were relatively weak and less able to defend themselves. They were widely seen as onerous, outdated and a barrier to trade.

The effect of the changes to the TIER is essentially as follows:

- a. a foreign technology exporter is no longer required under the TIER to indemnify the Chinese technology importer for infringement of third party IP caused by the use of the imported technology in China (former Article 24.3);
- b. improvements to the licensed technology no longer need to mandatorily belong to the party creating or inventing the improvement. This means that the IP owner can now validly stipulate that it shall own all improvements and secondary rights in return for consideration (i.e. not for free, as otherwise such agreement may be considered unenforceable under the *People's Republic of China Contract Law* effective 1 October 1999 (the “**Contract Law**”)) (former Article 27); this provision and former Article 29.3 discussed below were consistently a cause for concern for licensors, who may have viewed licensee “improvements” as undesirable “re-engineerings” and who wanted any improvements to belong to the licensor or the person who created the technology;
- c. The technology transfer may now be coupled or made subject to the tied in sales of additional products or services that are not strictly necessary for the technology transfer (e.g. buying raw materials, mandatory upkeep services, and so forth), provided that they are not obviously unreasonable (which may be considered unenforceable under the *Contract Law*) (former Article 29.1);

- d. The prohibition on charging royalties even after the expiry of the underlying IP right under the TIER is lifted (former Article 29.2);
- e. The prohibition under the TIER on restricting a technology importer from making improvements, or on using such improvements to the technology has been lifted (former Article 29.3);
- f. The prohibition under the TIER on restricting technology importers from obtaining competing technology or obtaining similar technology from another source has been lifted (former Article 29.4);
- g. The prohibition under the TIER on imposing unreasonable restrictions preventing a technology importer from sourcing raw materials, parts and components, products or equipment from other channels or sources has been lifted (former Article 29.5);
- h. The prohibition under the TIER on a foreign technology exporter from unreasonably restricting the quantity, variety, or sales price of the products the technology importer produces under the TIER has been lifted (former Article 29.6);
- i. The prohibition on a foreign technology exporter from unreasonably restricting the export markets of products manufactured using the imported technology under the TIER has been lifted (former Article 29.7).

Overall this is a positive evolution, removing TIER provisions that were consistently a sticking point in negotiations with Chinese licensee counterparties, however, there is an important caveat to make with these changes. The repeal of these articles of the TIER does not automatically mean that the envisaged clauses are now permitted in all circumstances and contexts. Many of the envisaged clauses may still be unenforceable or illegal under other legislation, such as under the *PRC Anti Monopoly Law* effective 1 August 2008 and

related legislation (e.g. especially if the technology exporter benefits from a dominant market position), or under China's stringent [IPR Overseas Transfer Measures](#) (e.g. for cross-licensing or cross-transfer arrangements) or under the *PRC Contract Law* (e.g. the [specific technology transfer Articles 342-355](#) and general violation of contract principles such as duress and so forth). For example, based on a judicial interpretation issued by the Supreme People's Court on Article 329 of the Contract Law (the "**SPC Interpretation**"), the restrictions discussed in (b), (c), and (e)-(i) of the preceding paragraph could still be considered as void and unenforceable under the Contract Law. Under Article 329 of the Contract Law, technological contracts that illegally monopolize technology, prevent technological advancement, or infringe on technological achievements of others are void. Query whether China will make corresponding amendments to those provisions to reflect the changes to the TIER. The SPC Interpretation still contains traps for the unwary: one example is that a no challenge to the validity of IPR clause could be seen as an unlawful monopolisation of technology, potentially voiding the contract. Unlike the TIER which only applies to cross-border TICs, the restrictions under the Contract Law as interpreted in the SPC Interpretation are equally applicable to domestic and cross-border technology contracts which are governed by Chinese law.

Another noteworthy element is that these measures amending the TIER were hidden away in an administrative decision targeting no less than 48 separate legislative provisions other than the TIER, and made effective immediately, without any transitional period. This means that any transaction involving a technology import closed after 18 March 2019 will automatically benefit from these changes. It is also possible that existing agreements may need to be renegotiated in the light of these more liberal rules.

Other IP related changes

State Council [Administrative Decree No. 709](#) also repealed Article 43 (3)-(4) of the EJV Law Implementing Regulations, which imposed the following requirements for technology transfer agreements entered into by Sino-foreign equity joint venture companies:

- a. The term of a technology transfer contract generally shall not exceed 10 years (former Article 43(3));
- b. The technology importer (i.e. the EJV company) has the right to continue to use the imported technology after expiration of the technology transfer agreement (former Article 43(4)).

These provisions have been criticized as essentially making a license more akin to an outright transfer, and hence forcing technology transfer in cases where the foreign investor has decided to license technology to its equity joint venture in China. The provisions no longer apply from 18 March 2019.

What happens now?

Both sets of legislative changes may have a profound impact on the IP aspects of foreign investment and technology licensing into China.

The issue with the FIL, which has been widely noted in commentaries, is that after all the detail was stripped out in the final draft submitted to the NPC for approval, it is long on principles (including on protection of IPR) and notably lacking in implementing details. Statements of intent are fine as far as they go, but the questions remain as to whether they will be backed up by implementing rules and enforcement at the local level.

In stark contrast to this, the changes to the TIER and the EJV Law Implementing Regulations will have an immediate and tangible impact on cross-border technology deals involving the licensing of technology to a

Chinese domestic capital entity or an FIE. The changes provide for more contractual freedom, and are, as such, welcome by the foreign investment community, if long overdue.

These legislative changes can not be seen in isolation, being intimately linked to the current trade tensions between China and a number of other nations. In particular, both the recently filed World Trade Organization ("**WTO**") complaints against China by both the [US](#) and the [EU](#) singled out, *inter alia*, the restrictive provisions in the TIER and the EJV Law Implementing Regulations, some of which have now been repealed. Moreover, forced technology transfers, which are now formally prohibited under the FIL, were one of three main alleged unfair trade practices listed in the USA Section 301 Report, which was the basis for the "301 tariffs" imposed on Chinese exports to the USA. Trade negotiations are, therefore, likely to be a driver of further changes in this area.

Next steps?

Overall, the takeaway from these recent developments is a positive one: embedding IPR-related protections and guarantees into the new FIL and giving greater autonomy to the parties when doing a transaction with an IPR licensing or transfer component by removing some of the more restrictive provisions of TIER is progress of a sort. However you could argue from the other side that the provisions added into the FIL and removed from TIER were long overdue, and only came about due to the intense pressure exerted on China in the WTO cases and the ongoing trade negotiations, rather than China 'seeing the light' and voluntarily making a move to bolster the FDI market. China may also have been influenced by the fact that it is experiencing the lowest growth rate in its economy since 1990. Burying such important developments as the changes to TIER amongst a mass of other legislative provisions does not, of

itself, demonstrate a willingness to be open and transparent.

The question is whether all this is enough to change the minds of the foreign investors who looked previously at China and decided to keep their "crown jewels" IP offshore because they could not get comfortable it would be adequately protected in China. While matters relating to IP protection in China have progressed enormously in recent years, with developments like specialized IP courts, we do not think we are quite there yet; that would imply a sea change in the mindset and approach of local authorities and courts to the protection of IP. It would mean a shifting away from the approach of the past which was to treat the Chinese licensee as a financially weaker party that needed to be protected from a dominant foreign licensor by means of legislation: it would mean a move to the new paradigm of licensor and licensee being seen as having roughly equal bargaining power and being able to defend themselves by using legal counsel of their own choosing and only agreeing to those provisions which they are willing to accept following a robust, but free contract negotiation, with legislation only coming into play in areas like anti-trust, where there is a need for public protection.

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