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## 1. Introduction to R&D

Many European SMEs may not consider that they conduct any R&D in China because they do not have a laboratory or research facility there, but in reality, a high proportion of these companies engage in activities which fall under at least one of the terms: research or development. Some examples of R&D might include an SME that enters into a contract with a local company to use their engineers to develop a prototype into a commercial product or application; or an SME that works with local researchers in a Chinese university to design a digital database that is to be accessible via the Internet to users in Europe.

Intellectual property (IP) is a critical consideration for European SMEs that come to China wishing to tap into the market potential for business growth, or the talent pool for technology development. When engaging in R&D in China, new intellectual property is being created, the rights to which need to be clearly defined from the outset to avoid disagreements later on.

This guide highlights some important issues to consider when researching and developing in China, and describes some strategies and techniques that could be useful. It is worth pointing out that the legal practices described here should be considered in the context of specific business models and specific methods of technology development.

## 2. Develop Your R&D Strategy

When addressing Intellectual Property Rights (IPR) issues related to R&D, people often quickly jump to questions of IPR ownership, licensing, enforcement etc. All of these issues are important. However, it is very helpful to examine the following questions before discussing legal structures with your counsel.

### 1) Where is your market in your current business model?

If you focus on the market in China, your business partners in China might want to ask a lot more from you, including sharing the ownership of IPR,

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in exchange for helping you develop the product and the market.

### 2) Who will be the inventors?

If the primary inventors are non-Chinese citizens, you will have much more leverage in deciding how to control the IPR. If however, the Chinese team is expected to make key contributions, IPR ownership will be a more sensitive issue when negotiating the terms of your agreement. To retain the innovators, you will need to include a sufficient amount of rewards and incentives for them as individuals if the ownership of the innovation will not be granted to them.

Additionally, you will need to consider the legal status of the Chinese individual inventors. If the inventor is an employee of another party, for example a researcher at a local university, the inventor may be under contractual duty to assign his/her IP rights to that employer. Ignoring the inventor's existing legal duties can cause serious problems.

### 3) Is the technology going to be useful for other areas?

Very often SMEs bring in a promising technology to develop applications or products to suit the Chinese market. People often focus on the IPR related to the particular applications or products which are being developed. However, the underlying technology may be useful for other sectors. Control over the IPR for the underlying technology, and the outcome of R&D, often have much greater stakes.

### 4) Are you willing to give away your IPR in exchange for equity?

The Chinese parties you are working with may be equally IPR conscientious. Are you willing to give away your IPR in exchange for shares, stock options or other equity interests in their enterprises in China?

The answers to this question may help you open up some doors to creative solutions in China.

### 5) What if your business fails in China?

IPR may be the only asset you are left with in the case of your business venture failing in China. For example, if your current business venture is closed down, can you securely use the IP you have developed somewhere else, or in other fields, or with other partners? Thinking about the worst case scenario will give you some insight as to your fall-back options.



## 3. Ownership of IP

IP ownership is less of an issue if you simply set up your own entity in China to conduct all R&D activities. You can choose to file patent applications under the name of the Chinese entity, or its affiliates outside China. Placing the IPR under an overseas entity may provide greater flexibilities to suit the future needs of your business operations and financing. However, companies increasingly apply for IPR under their

Chinese entities in order to qualify for the incentive plans offered by local Chinese governments.

If you rely on your business partner to some extent, IPR ownership may be more complicated. Some common choices can be seen below:

- Sole ownership of all the IPR by the European SME
- Sole ownership of all the IPR by the Chinese business partners
- Co-ownership, shared between the European SME and the Chinese business partner. Terms of the co-ownership can be largely defined by contracts.

The ownership issue can be sensitive between foreign SMEs and Chinese business partners. Excessive fighting over ownerships will produce risks for future business co-operation. It is therefore advisable to keep revisiting the business models you have in place, and to always sign mutually agreed contracts on ownership, licensing and other legal tools to support your shared business interests, so that ownership is clearly defined from the start. For example, if you realise that the software tool you have developed can be used for another business model, to which your Chinese business partner has no relation, you may need to carefully craft the agreement in a way that will allow you the freedom to use the technology in other fields. Failure to do this will likely lead to disputes in the future.

#### 4. IP Licensing

An IP licence is a contract to permit where, when, and how your IP can be used by another party, for free, for royalties, or in exchange for other services. In most R&D contracts, licensing is a key aspect. The greater leverage the business partner in China has in terms of knowledge about the market and execution ability, the more consideration is likely to be given to licensing

options.

In practice, licensing is probably one of the most important legal tools that SMEs often overlook. Part of the reason is that SMEs are not always confident about the effectiveness and enforceability of the contracts they enter into with Chinese partners. For example, people may be afraid of unfair court rulings and difficulties with the enforcement of judgments. While such considerations may be justified in some cases, SMEs should not overlook the importance of using contracts, as the lack of an agreement in writing will inevitably lead to disaster. IP licensing options should be well thought out prior to negotiations.



In China, common types of licences such as exclusive and non-exclusive licences are permitted. The laws and regulations are designed to give a large amount of autonomy for the parties to decide what to do with their IP licences. Parties can negotiate and reach a mutual agreement on the following key terms:

- **Territory of the licence:** Does the licence cover China or is it applicable worldwide? Is it better to have a licence that covers a certain specified geographical area in China?
- **Duration of the licence:** When does the licence expire? How should it be renewed? Can the licence be terminated under certain clearly-defined circumstances?

- **Licensed IP:** Are you only going to license your patents? What about copyrights and trade marks? How about less familiar types of IP such as graphic user interface, sensitive client information, special skills? Some innovations may not be fully protected by the patent, trade mark or copyright laws, but you may use the contract to protect yourself. To obtain more information about the protection of trade secrets, please refer to the Helpdesk guide for Protecting Trade Secrets in China and the Helpdesk guide to Using Contracts in China.
- **Licensed products covered by the licence:** You need to define clearly what types of products/ services are covered by the licence.
- **Royalties:** You can choose a lump-sum payment, running royalties, etc., or even operate royalty-free for a certain period of time and then start charging. Issues like tax and auditing should be addressed as well.



- **Limitations of the licence:** Do you have to give warranty or indemnify everything asked for by your Chinese partner? Think of ways to limit your exposure to liabilities.
- **Other key terms:** Every licence is different; do not imagine that one template can fit all your needs. Work with your counsel and think about your business interests, and come up with mutual agreements with your business partners.

**Important note:** In the context of joint IP development, keep in mind that Chinese laws do not allow foreign companies to retain ownership of improvements that are made by Chinese parties, unless the Chinese parties are being remunerated in some way for these inventions. This remuneration could be in the form of cash, shared profits, equity interest, or other types of property rights. Chinese laws also require the foreign company providing the technologies to authorise the quality and usefulness of the technologies, and to bear the liabilities if the technologies turn out to have infringed others' legal rights. Therefore, through discussions, European SMEs and their Chinese business partners should decide on fair and workable solutions before proceeding with a deal.

### 5. Building Valuable IP Portfolios

After European SMEs come to an agreement on ownership and licensing issues with Chinese partners, the real steps to developing a valuable IP portfolio require good discipline and good management. Due to budget constraints for most SMEs, it may not be entirely realistic to apply for and register all their inventions, and therefore scrutiny is required to figure out which are the 'must-file' patents. Always remember that it is extremely difficult to enforce your rights or prove ownership for inventions that are not patented.



Below is a check-list of essential actions to keep in mind:

- **Quality patent drafting:** The initial draft can be done in Chinese or a foreign language. You may even file an international application (PCT) from China if it is justifiable to do so from the cost and strategic perspectives. However, if the application needs to be translated, attention should be given to the quality of translation. If you need further information about how to register patents in China, please refer to the Helpdesk guide to Patent and Trade Mark Strategies.
- **Foreign filing licence:** If the invention is made in China, either by Chinese or European engineers, the filing of the invention for patents requires a foreign filing licence, which is given by the State Intellectual Property Office (SIPO). Very often foreign filing licences are granted quickly unless the technology relates to sensitive areas such as national security.
- **Filing entity:** If a Chinese entity, which is set up by a foreign SME, alone or jointly with a Chinese business partner, retains all the IPR ownership, the Chinese entity must file patent applications under its own name. The patents can later be transferred or licensed to the foreign SME. If a foreign SME manages to be the sole owner of all the technologies under the R&D activities, the SME may apply for the patents under its own name.
- **Transferring of patents after the filing:** The Chinese government has imposed restrictions on (or in certain instances has banned) the transfer of ownership of certain types of technologies to foreign companies or individuals. Such types of technologies mostly include unique innovations, or otherwise have significant long term effects on China's social, economic and technological interests. For example, prohibited technologies for export could include those related to the manufacture of traditional Chinese medicine, land surveying, breeding of livestock, encryption, and computer network security. If foreign SMEs believe that the technologies developed under their R&D activities in China are somehow sensitive, it is advisable to check the Catalogue of Export Restricted Technologies and the Catalogue of Export Prohibition Technologies. Please refer to the Helpdesk guide on Technology Transfer for more information.
- **IP other than patents:** Besides patents, copyrights and trade secrets can also be of high importance. IP ownership or licensing agreements should include detailed information on both copyrights and trade secrets. Regarding copyright, registration of the copyrighted works with authorities such as the National Copyright Administration is not required, but can be helpful as proof of these rights.
- **Recordal and registration for licences:** If IP licensing is adopted in R&D activities, registration and recordal requirements may be necessary under Chinese laws and regulations. Technology licences may need to be registered or recorded with local government authorities such as the Chinese Ministry of Commerce (MOFCOM) and the State Intellectual Property Office (SIPO) to comply with several legal requirements. If the licence has royalty payment clauses, the recordal and registrations are necessary under the foreign exchange control rules for the payments to be remitted through local Chinese banks to overseas bank account.
- **Employee remuneration rules:** If a European SME hires employees to conduct R&D and to contribute to inventions, it is important to note Chinese employee remuneration rules. These

rules are intended to ensure that inventors get fair returns and benefits from the patents they invent. The current rules allow the employer and employees to dictate how the employees are rewarded for their inventions. However, in the absence of an agreement between the employer and employee, default rules under the Chinese patent law will be implemented. For example, an inventor or ‘creator-employee’ may claim for 2% of the business profits annually derived from the invention or utility model patents he or she invented. It is also important to remember that if the remuneration agreed in the contract is too low (and therefore deemed ‘unreasonable’

under Chinese law) the term on the remuneration in the contract may be void and the employer will end up paying a higher amount in fees. In order to understand the definition of ‘reasonable’ reimbursement, reference may be made to the Chinese patent law, which requires, in the absence of other agreements, the employer to give a bonus of no less than RMB 3,000 to an employee who completes an invention patent, and RMB 1,000 to an employee who completes a utility model or a design patent. To obtain more information about contracts, please refer to the Helpdesk guide to Using Contracts in China.



## SME Case Study

A European SME has come up with a very unique algorithm and prototype software in the video searching field. The SME has identified a promising business partner in China with whom to conduct joint R&D. The purpose of the joint R&D is to launch a software product suitable for Chinese search engines. The Chinese business partner has an R&D team and impressive marketing capability in China. The Chinese business partner is offering equity in its current company in exchange for the IP rights to the future R&D. How should the IPR issues be handled?

### Advice

IP Ownership: The market potential and strength of the Chinese business partner are likely to make it difficult for the European SME to retain the full IPR ownership. A co-ownership of IP in China and full ownership of IP outside of China may be considered.

Licensing: The European SME should think about the potential applications of its algorithm and software in sectors other than search engines. The SME may consider the option of giving an exclusive licence to the Chinese business partners for the search engine sector, but retain the right to use the technologies for other business applications, e.g. security surveillance or traffic control systems. If the SME desires to have a licence given back from the Chinese business partners for those future improvements, the SME is advised to take into account the possibility that the joint-venture is terminated or fails in a situation like bankruptcy of the Chinese business partner. Under the bankruptcy law in China, a licence given by the bankrupted entity may be revoked without compensation.

IP Portfolio: The European SME should enter into a contract with the business partner to dictate how the patents are going to be filed, how to manage the non-patented technologies, source codes, etc. This will be critical in order to minimise the risk of disputes in the future.

## Take-Away Messages

- Your first step should be to review your business strategy, and ask yourself the following questions: who are you doing the deal with, what is the potential of your technologies under the R&D, what are the worst case scenarios?
- IP ownership and IP licensing are probably the most important considerations in structuring your R&D agreement. In particular, the licensing options may offer you a great deal of flexibility to fulfil the business interest for both sides and avoid potential conflicts between parties.
- To build and improve the quality of your IP, you need to manage several important aspects: patent drafting, foreign filing license, and employee remuneration etc., on an on-going basis.

*The China IPR SME Helpdesk provides free, confidential, business-focused advice relating to China IPR to European Small and Medium Enterprises (SMEs).*

**Helpdesk Enquiry Service:** Submit further questions to the Helpdesk via phone, email ([question@china-iprhelpdesk.eu](mailto:question@china-iprhelpdesk.eu)) or in person and receive free and confidential first-line advice within seven working days from a China IP expert.

**Training:** The Helpdesk arranges training on China IPR protection and enforcement across Europe and China, tailored to the needs of SMEs.

**Materials:** Helpdesk business-focused guides and training materials on China IPR issues are all downloadable from the online portal.

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