Technology Transfer to China: Thoughts on Trade-offs, IP/Know-how Protection and Related Risks

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Is Entering China a Feasible Option for Your Company?

Any company should consider its own resources, previous export or business experience abroad, and its long-term business strategy before taking into consideration to enter the China market.

Especially SMEs should – given their limited resources - not underestimate the impact of distance in respect to:

- **Cultural factors**: Relationship (guanxi) vs. transaction based business culture, language induced communication problems
- **Administrative factors**: Market access restrictions, high taxes, custom duties, and capital transfer restrictions
- **Economic factors**: “Home-biased” market, level of state involvement in various industries, corruption

**Q** How much risk can your company afford to take?
Technology Transfer as Entry Price

Foreign companies are keen to go to China for obvious reasons:
• entering a potentially huge market,
• low cost manufacturing,
• engaging in R&D activities,
• looking for investors and strategic partners, etc.

These opportunities induce foreign companies to ‘transfer’ their key technology and designs to their Chinese subsidiaries, joint-venture partners, or to independent Chinese companies.

Very often, foreign companies do not have a choice. Their potential Chinese partners will insist on getting access to their technology. This is mostly true for:
• Companies that do not have the resources to enter the Chinese markets on their own and/or can’t enter the Chinese market by relying on exporting products to China
• Companies that are looking for Chinese investors
Related Risks – Loss of Know-how/IP

The **trade-off** between pursuing business opportunities and transferring technology exposes foreign companies to significant risks:

- **Intellectual property rights**: Inadequate IPR protection is at the top of the list and continues to plague companies doing business in China.

- **Market access**: Many foreign companies fear that once their technology has been successfully transferred to a domestic Chinese partner firm, they will find themselves permanently shut out of the China market.

- **Legal effectiveness**: The absence of effective legal institutions is frequently raised as a challenge for firms operating in China. The World Bank’s Worldwide Governance Indicators Project has consistently ranked China in the forty-fifth percentile with respect to rule of law.

Companies transferring technology to China have to engage in actions that mitigate the risk of losing know-how or IP.
How to Protect Yourself

How can you protect your company?

• Choose the right partner
• Set up a structure that fits best to you purpose
• Draft contracts that protect your IP/know-how as much as possible
• Get professional advise
  Intellectual Property rights holders should understand how to protect their IP under Chinese law before entering the China market
Choosing the Right Partner

• It is important to take into account right from the start that part of the motivation for a Chinese company for doing business with a foreign company is to obtain access to new technology and know-how.

• Consequently, a first step to protect your IP in a technology transfer, is to make sure you choose the right partners.

• Essentially, the ideal partner should be complementary, but not well-positioned to compete directly with your business.
Choosing the Right Partner (2)

An educated decision on partnering asks for some in depth analysis:

• **Analyse your strengths:** What is it that makes your company competitive? What measures and IPRs are used or can be used to defend your competitiveness? Which IP assets or know-how can be transferred to third parties without losing competitiveness or market share in the mid- to long-term?

• **Analyse your competitors and the Chinese market:** Do you know who your competitors in China are? What are their strengths? What are their strategies?

• **Design your own policy for dealing with China:** Define your red line when trading off know-how/IP protection for operational efficiency or market opportunities and stick to this line.
Structure

1. **Licensing the technology to an unrelated Chinese company**
   This structure generally provides you with the least control over your IP, know-how but you have the option to use multiple Chinese suppliers and can use what is known as a ‘modular strategy.

2. **Setting up a JV**
   It is extremely important to define the roles of not just the JV, but also of your Chinese JV partner. For example, many companies keep critical design work or the manufacturing of critical components in a separate wholly-owned subsidiary or completely off-shore.

3. **Setting up a WFOE (Wholly Foreign-Owned Enterprise)**
   IP risk is less because you have the greatest amount of control over your wholly-owned subsidiary. Under this structure addressing IP risk often means focusing on reducing or preventing IP leakage by employees and/or business partners.

**Choice of structure is correlated to the amount of available resources**
Contracts

Foreign companies should enter into license agreements with their Chinese partners. Such contracts not only define each party's rights but should also ensure that the transferred technology is well defined and documented, which will help when later on ownership issues should come up.

Some topics to be aware of:

• **Improvements**: Since the Chinese party is permitted under Chinese law to make and use improvements, foreign companies have to think twice about what technology they are willing to bring to China as the Chinese party cannot be prevented from making improvements on this technology.

• **Confidentiality**: It is important to include strong confidentiality provisions in the technology transfer contract. Foreign companies often go to great lengths to protect their confidential information, trade secrets and know-how, including using key-card access, closed-circuit TV, virtual data rooms, and sophisticated document tracking measures.

• **Reverse engineering**: Reverse engineering is permitted under Chinese law and not considered as a theft of trade secrets. As a result, well-drafted technology transfer contracts should include a provision limiting or prohibiting the Chinese party from engaging in reverse engineering.
Case Study 1: EV Charging SA

EV Charging SA is a Swiss company providing cutting-edged technology for charging solutions for electric vehicles (EV). As most Swiss technology companies it has to realize the major part of its revenues abroad. The Chinese government is implementing policies to elevate the annual sales of EVs to 5 million as of 2021, which asks for huge investments into the charging infrastructure.

EV charging SA chose a Chinese partner with a track record of successful business cooperation with European companies that is interested to use a Swiss company as its entry point for competing in the European charging infrastructure market. Interests have been aligned by granting the Chinese partner an equity stake in Green Motion, comprehensive sourcing agreements, exclusivity clauses, and the definition of the roles of both parties.

Most of EV Charing SA’s IP is in the form of trade secrets and know-how. Main asset is a comprehensive software suite for network management. Transfer is limited to a need-to-know basis, strict documenting procedures are put into place to make sure that the transfer is fully documented. The main asset is only licensed but not transferred.

Key Lessons:
1. Conduct due diligence on potential partners, find complimentary partners
2. Structure the deal to minimize risks by granting mutual exclusivity, segregating roles and keeping crucial technology offshore
3. Make sure that the technology transfer is well documented
Case Study 2: Antibodies GmbH

Antibodies GmbH (Antibodies) is a German Biotech company that has successfully developed antibodies in the field of oncology. Some indications of its antibodies are of special interest for China. China has set up a comprehensive drug approval process that forces foreign companies to disclose their technology to a large extent.

Antibodies chose a Chinese partner company, whose key employees not only got a considerable part of their education in the US and Europe but have also successfully registered biotech compounds in China.

The deal has been structured by putting the assets needed for entering the Chinese market in a Joint Venture company located in Europe. Equity stakes of the Joint Venture company in Antibodies and the Chinese company shall align interests. The deal will be implemented in stages. Initially, only non-crucial know-how will be transferred from the JV company to China and manufacturing will remain in Europe. Upon reaching certain milestones further technology will be transferred and Chinese production facilities will be set up.

Antibodies’ IP is well protected by patents, which enables the company to a certain extend to prevent sales outside the agreed territory.

Key Lessons:
1. Register patents to your technology before bringing it to China
2. Structure the deal to minimize risks by putting crucial technology in a JV located offshore
3. Implement the technology transfer in stages. Impose penalties for sales outside the agreed territory
Summary

Foreign companies who do not think carefully about how to guard against IP/know-how risk when transferring technology to China may unwillingly suffer a loss of competitiveness and market share.

To protect your IP/know-how in a technology transfer it is important to make sure that you choose the right Chinese partners.

It is strictly recommended that companies use license agreements with their Chinese partners.

The IP risk associated with a particular technology transfer will vary depending on whether you are licensing to a Chinese company, setting up a JV, or setting up a WFOE. However, in all three of these situations, the goal is the same - to prevent your IP from being inadvertently leaked or intentionally misappropriated or misused by a related or unrelated Chinese party.

Be sure that entering the Chinese market is the right strategic option, you provide of the resources needed and that you can afford the related risks.
Thank you

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