Licensing Prospects in PRC

'Pure' licensing not yet in China trade jargon; prospects for licensing appear bright

BY WILLIAM I. COLEMAN*

Transfer of technology is an increasingly important concept in analyzing present and future trade possibilities in China. The visions of massive sales of equipment and machinery, albeit high in technology content, have given way in stages to much greater concentration on the export of the technology component and increasingly to the exclusion of the material embodiment. Purchases of high-technology equipment in key sectors continues, but on a lesser scale than formerly envisaged and on a format that accords priority to development of indigenous production capabilities.

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Gu Ming, vice-minister in charge of the State Planning Commission, in July reported:

> *As our science and technology and machine-building skills are still rather backward, we have been importing mainly complete sets of equipment. This state of affairs must be changed. We must gradually change to importing mainly technologies (including the technology to manufacture key equipment), selectively purchasing key equipment and designing the engineering projects ourselves. We should not import complete plants if importing key equipment will solve the problem. If importing technology will solve the problem, we should not import equipment. Only in this way can we enhance our designing and manufacturing skills and constantly increase our ability to do things by ourselves. Of course, this requires a process, but that will be the direction of our thrust. Beijing Review*, July 27, 1979

In the new jargon of China trade, one hears repeatedly the words "counter trade", "compensation trade", "production buy-back and barter". The word "licensing" has not yet appeared in this new jargon. Even though licensing is a less talked about aspect of China trade, I believe, and will try to demonstrate, the prospects of licensing into China are very bright and embrace a broad cross-section of current commercial activity.

Licensing in industrialized countries generally implies the giving of consent by a licensor to a licensee to exploit a specific process or know-how (generally for manufacturing) in consideration for payments of royalties tied to production. This form of pure licensing involving a provision of technical expertise or know-how without accompanying production cooperation activities and equipment packages has not yet reached

significant levels in China. Until an industrial infrastructure adequate to support importation of pure technology is developed, pure licensing will remain relatively insignificant.

In assessing prospects for future licensing into China, I suggest a more comprehensive and simplistic view of defining licensing as "transfer of technology or know-how on agreed commercial terms" would be appropriate *(Guidelines for the Acquisition of Foreign Technology in Developing Countries With Special Reference to Technology License Agreements — United Nations Industrial Development Organization, 1973).*

The form of this transfer to China as to other developing countries involves more than the communication of a specific process. Because of the lack of an industrial infrastructure and a lower level of knowledge in manufacturing, transfer of technology to China may include provision of technical services and assistance, the supply of capital equipment and materials, and/or specific manufacturing processes and know-how.

The potential for high-technology Western countries willing to market their products and services aggressively in China remains very great. It is no secret that China intends to become an industrialized nation and that its target is achievement by the end of this century. It is also no secret that while China holds firmly to the policy of self-reliance, it has recognized the need to import technology if plans for industrialization are to succeed. Chairman Hua Guofeng, at the second session of the National People's Congress this past June, stated:

> *"We must rely mainly on tapping the potential of the large number of existing enterprises, renovating and transforming them and enabling them to reach or approach modern standards. There is no wavering on this point... While resolutely maintaining independence and self-reliance as our main premise, we must work hard to learn all that is worthwhile from foreign countries, selectively import advanced technology of which we are urgently in need, and not wall our country off from international exchanges. Both in the three-year period of economic readjustment and in subsequent years, we shall be taking energetic steps to develop foreign trade, expand*

*Executive Director, Canada-China Trade Council, Toronto, Ontario, Canada.

economic cooperation and technical exchange with foreign countries and employ various appropriate means, current in international practice, to absorb funds from abroad. This is a firm, important policy of our government. Cited in *Summary of World Broadcasts*, June 28, 1979

In 1978, China contracted a total of some U.S. $11.2 billion in imports. China's economic plan for 1979 foresees total imports, including both technology and commodities, rising 30% from 1978 and increasing to around $25 billion in 1982 and $35 billion in 1985. The implied annual growth rate in total imports is 16%. Since technology imports are increasingly to assume priority relative to commodities, the annual increase in the value of technology imports and concomitant licensing activity are expected to exceed 16% through 1985.

Assessing future prospects of licensing into China is not a matter of determining if licensing will occur but of examining variations of contract format consistent with China's fiscal and other requirements. A major task of Beijing's planners and foreign trade partners is to devise ways of importing technology into China with minimal outflow of foreign exchange. The success of future licensing will be in direct proportion to the effectiveness of such devices. They embrace many foreign commercial deals being implemented or negotiated in China today.

VARIATIONS OF LICENSING AGREEMENTS

Joint ventures

Traditionally, the inflow of technology to developing countries has been in the form of direct foreign investment. Nationalistic sentiment has until recently blocked such a route to China. However, as most of you may know, on July 8, 1979, China introduced a Law on Joint Ventures Using Chinese and Foreign Investment. This joint-venture law has been described as an "enabling act" permitting foreign persons to incorporate into joint ventures with Chinese enterprises. The purpose of the joint-venture law is to expand international economic cooperation and technological exchange between the PRC and foreign commercial entities.

The law specifically contemplates the transfer to China of technology by a foreign joint-venture partner. Article V provides that "each party to a joint venture may contribute cash, capital goods, industrial property rights," etc. as its investment in the venture. The law provides for the right of foreign companies and their employees in China to repatriate net after-tax income in accordance with the Foreign Exchange Regulations. The latter, not yet in place, are expected to be promulgated in upcoming months. Companies that bring "up-to-date technology by world standards" into China will qualify for full or partial tax rebate during the first two or three years of operating profit.

The law appears to open the way for foreign management of enterprises within China. Senior managerial positions, including seats on the board of directors of joint-equity companies and positions as general manager and assistant-general manager in the case of factories, will be filled by both Chinese and foreign partners. Each joint-equity company will have a chairman appointed by the Chinese. Such an appointment could assure ultimate Chinese control in important decisions of the company and company activity consistent with China's national interests. The law states that minimum foreign equity participation will be 25%. No maximum holding for the foreign investor has been defined and the Chinese have indicated that in some ventures the interest could be as high as 100%.

Normal Limit

Normally, however, overseas investors would be limited to less than 50% equity. Profits, risks and losses are to be shared in proportion to each side's investment. Gross profit will be subject to Chinese income tax, although there is no income tax law presently in force. Foreign partners who reinvest their profit in China may apply for rebates of taxes already paid on the profit. Marketing rights to the venture's product both in the Chinese market and in the international market is to be a subject for contract negotiation. Two organizations are being established to handle foreign investment in China: a Foreign Investment Control Commission which possesses sole authority to approve or disapprove joint-venture proposals, and the China International Trust Investment Company to coordinate the use of foreign investment and technology.

The joint-venture law is not a document dealing in detail with all potential problem areas in commercial dealings between a foreign partner and a Chinese trade entity. Publication of the law has resulted in extensive debate on rights and privileges due to potential foreign participants. In areas not adequately covered by the joint-trade-venture law, foreign firms are advised to insist that detailed provisions be provided in the text of the contract establishing a joint venture. Only in cases where Chinese law specifically provides for contrary action would the provision of the contract not be valid. Also, where a provision does contravene Chinese law, the problem would be identified prior to the creation of the joint-equity company at the time of review by the Foreign Investment Control Commission.

Some four days after the release of the joint-venture law, a seminar was held in Hong Kong to examine the law and its implications for foreign investors. The sole speaker providing interpretation of the law was Miss Liu Yiuchu (Dorothy Liu), legal advisor to the Bank of China, China Resources Company and other Chinese organizations. Miss Liu spoke on the broad policies which had given rise to the introduction of the code and to the principles which the code enshrined. Following her general comments, she fielded questions from some 600 businessmen in attendance. An edited transcript of Miss Liu's remarks has been prepared by the Hong Kong Chamber of Commerce, the host of the seminar, and is available through our council's offices in Toronto for those interested. The transcript provides some useful insights into the spirit and letter of the law.

Industrial Cooperation

Industrial cooperation, which has been utilized by the Eastern European countries in their trade with the West, is gaining growing acceptance in China. Industrial cooperation is viewed in Eastern Europe as a vehicle for importation of western technology. The same motive underlies its use in China.

There is no universally accepted definition of industrial cooperation arrangement. Drawing from a paper submitted by Carl H. McMillan *East European Economies Post-Helsinki*, a compendium of papers submitted to the Joint Economic Committee of the Congress of the United States, August 25, 1977), I would include as industrial cooperation arrangements the following:

1. Counter Trade — Sale of plant, equipment and/or technology with provision for complete or partial payment in resulting or other products.

2. Sub-Contracting — Contractual agreement for provision of production services for a short term and on the basis of existing capabilities, but often to design specifications furnished by the contractor. Some or all components are also frequently supplied by the contractor.

Production Contracting — Contractual agreement for production on a continuing basis to partner specifications of intermediate or final goods to be incorporated into the partner's product or to be marketed by him. In contrast to subcontracting, production contracting usually is on the basis of a partially transferred production capability, in the form of capital equipment and/or technology.

3. Co-Production — Mutual agreement to narrow specialization and exchange components so that each partner may produce and market the same end product in his respective market area. Usually on the basis of some shared technology.

4. Product Specialization — Mutual agreement to narrow the range of end products used by each partner and then to exchange them so that each commands a full line in his respective market area. In contrast to cooperative sourcing, product specialization involves adjustment in existing product lines.

5. Co-Marketing — Agreement to divide market areas for some product(s) and/or to assume responsibilities for marketing and servicing each other's product(s) in respective areas. Joint marketing in third markets may be included.

6. Project Cooperation — Joint tendering for development projects in third countries.

7. Joint Research and Development — Joint planning and coordinated implementation of research and development programs with provision for joint commercial rights to all product or process technology developed under the agreement.

So far, China has used a combination of the first three types of industrial cooperation arrangements listed above. Different names, however, have been applied.

1. Compensation Trade. This may also be called counter trade and is the most frequently touted new format of China trade. Under this arrangement a foreigner sells capital equipment and/or technology to China in consideration for payment by resultant or other products. Reported sales using this arrangement in 1978-1979 include sales by Itoman; Prestige Sportswear; Marubeni and Hoko Fishing Company; Dunbee-Comber-Mark; and Container Transport International.

2. Processing. This arrangement may be classified as subcontracting or production contracting and involves processing for fee, materials provided by the foreign partner. Alternatively, the foreigner may provide samples, designs and specifications and China may supply the materials and the production process. China would charge both for the materials and the processing service. Such arrangements have been most commonly used in industrial ventures in China by Hong Kong garment and electronics companies.

3. Co-Production. Under such an arrangement, both the foreign and Chinese partners supply portions of the component parts to be assembled. The foreign partner has the exclusive right to distribution of output. China receives an assembly fee and/or reimbursement for the Chinese parts plus probably a share of the profits from the sale of the assembled product.

There has been no reported case of other industrial cooperation arrangements. However, it is clear that China is interested in the East European industrial cooperation arrangements and Chinese versions of the same can be expected.

In a meeting with the Mining Equipment Delegation from the National Council for U.S. China Trade held on May 4, 1979 in Peking, Vice-Premier Kang Shien, head of China's State Economic Commission, made the following remarks:

> *We would be very glad to learn from your experience with respect to how you renovated your equipment and technology of the '40s and '50s to transform it into equipment and technology for the '70s.*
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> *There is one question I would like to discuss very much. One of your companies should select one particular factory in China and take that factory as a target. For example, help the factory's production and renovate the factory. Have "cooperative production". Help renovate outmoded machinery and introduce advanced technology, working together to increase production and improve technology. Concentrate on a few products at first, and later, with improved technology and equipment, have cooperative production.*
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> *Take that factory to cooperate with one of your factories. That factory can produce power shovels using your technology or blueprints. By producing together – combining our factory with your factory — gradually production will be increased. Eventually, we will be able to make a whole set of equipment.*
>
> *This method is good for both sides — cooperative production which is mutually beneficial. It is a way to introduce technology from you. We must change the present way of doing things.*
>
> *In the past we bought whole plants — complete sets of equipment from the U.S. and Japan. In that way, we did not learn the technology. Now, we are very interested in cooperative production . . .*
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> *I want to again return to the subject of cooperative production. Again, this means that we save money. If we buy complete sets of equipment, we would spend a lot. If we encourage cooperative production we can do more things with less money. We will develop mining and the ferrous metal industry in a big way. If we do not have this as a basis, we cannot realize the four modernizations.*
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> *We want you to think of some way that we can save money — for our mutual benefit — so we can do more with less money.* China Business Review, July-August 1979

Conventional Financing

Despite a policy of self-reliance and fiscal conservatism, China appears increasingly prepared to use credit in financing its export programs. The Chinese joint venture and cooperative undertakings with Western firms will, in line with Chinese preference, usually involve no foreign exchange outflow from China. In some cases, however, for example when repayment is over an extended period of time or where there is no product output, China will need to look to conventional financing packages. The role to be played by foreign financing is to be small relative to China's total developmental costs.

Many estimates have been made of the cost of China's development program through 1985. As noted, annual growth in imports is projected through 1985 at 16%. Exports this year are likely to rise some 15% to $11 billion and to expand at an average annual rate of 20% through 1985, rising to $18 billion in 1982 and approximately $33 billion in 1985. Based on these forecasts, China's 1978 trade deficit of $1.2 billion is expected to widen to $6.8 billion in 1982 and narrow to approximately $2 billion in 1985. The German Institute for Economic Research estimates China's cumulative deficit in the period should reach approximately $32 billion. Such a cumulative deficit could result in an estimated short-term borrowing requirement of $6.5 billion and long-term needs (five years or more) or around $17 billion. China's borrowing on international markets is projected to reach its highest level between 1979 and 1982.

The German Institute's estimates represent a high assessment among opinions of similar institutions elsewhere in the world. The China Business Review (May-June 1979) estimates a trade balance (F.O.B.) for the period at $17.4 billion; the Far Eastern Economic Review (August 17, 1979) estimates total borrowings for the period of approximately $20 billion; the Japan External Trade Organization (China Newsletter, July 1979) projects a trade surplus of $5 billion.

Regardless of which set of estimates one uses, and obviously markedly differing assumptions underlie the different figures profferred above, several general observations can be made. First, compared with the total developmental costs of the period ($400-$450 billion) foreign capital will play a relatively tiny part over the next six years. Although small in size and thus not likely to result in serious administrative problems for China, the funds will be channeled largely into technologically-advanced sectors and thus should have a vital catalytic impact. Second, it is generally accepted that China's financing difficulties will peak over the next three years and the need for external financial assistance will thus be greatest during that period. Third, the reservoir of funds that China will be able to draw on from external sources is more than adequate to meet any needs the Chinese may have during the period under consideration. As of this June, publicized world extension of credit to China exceeded $21 billion, including $2 billion extended by the Canadian Export Development Corporation (formally signed on August 21) and publicized lines of credit extended by two Canadian banks totalling $105 million.

LAWS AND REGULATIONS GOVERNING FOREIGN COMMERCIAL ACTIVITIES IN CHINA

I shall now deal briefly with some aspects of the legal framework within which commercial activity in China is taking place. In this section, as indeed in the previous sections, I shall draw heavily on information supplied to me by Stitt, Baker & McKenzie of Toronto. The firm, which is a member of our Trade Council, was extremely generous in supplying counseling and background information.

Patents

China does not have legislation for the protection of patent rights and is not a member of the Paris Convention for the Protection of Industrial Property. There is a history of legislation dealing with patents. The most current development was in December of 1978 when "Regulations or Rewards for Inventions in the People's Republic of China" was promulgated. The following articles are of central importance:

Article IX: All inventions belong to the State. All units throughout the country (including units enforcing the system of collective ownership) may make use of inventions as needed.

Article XII: Overseas Chinese residing in foreign countries and foreigners may report their inventions to the State Scientific Commission. They will be examined and approved for rewards according to this regulation.

China has, however, more recently recognized the need to grant patent protection, at least to foreign investors. China has sent observers to the World Industrial Property Organization and is studying and preparing legislation for patent protection. The recently concluded Sino-U.S. Trade Agreement provides insight into current Chinese views on patent protection. The agreement provides in Article VI, Paragraph 3, "both contracting parties agree that each party shall seek, under its laws and with due regard to international practice, to ensure to legal or natural persons of the other party protection of patents and trademarks equivalent to the patent and trademark protection correspondingly accorded by the other party."

Until China does enact legislation granting patent rights, patented and unpatented know-how are protected in China only by contractual arrangements.

Trademarks

The governing legislation on trademarks is the Regulations Governing Trademarks and Implementing Rules Governing Trademarks promulgated on April 10, 1963, and April 25, 1963, respectively. Article XII of the regulations provides that where registration of a trademark is sought by any foreign enterprise, the following two conditions must be met:

1. An agreement on reciprocal registration of trademarks has been previously concluded between the People's Republic of China and the home country of the applicant.

2. The trademark under application for registration has already been registered in the name of the applicant in his home country.

Canada is one of the countries that have bilateral agreements with China on reciprocal registration of trademarks.

While the regulations provide that similar trademarks may not be registered by different enterprises for the same commodity, there is no provision that registration confers the right to exclusive use and there is no provision for action against infringement.

Copyright

China has not promulgated copyright legislation. Again, the Sino-U.S. trade agreement provides an indication of changes to come. Section 5 of Article IV provides that "both contracting parties agree that each party shall take appropriate measures, under its laws and regulations and with due regard to international practice, to ensure to legal or natural persons of the other party protection of copyrights equivalent to the copyright protection correspondingly accorded to the other party."

Tax

China does not have a comprehensive tax code. The Tax Bureau of the Ministry of Finance presently administers three principal types of taxes, two of which affect foreign businesses. There are the Industrial and Commercial Consolidated Tax and the Industrial and Commercial Income Tax.

The Industrial and Commercial Consolidated Tax is a gross receipts or sales tax imposed at each level of production (with no credit for tax previously paid on the same goods) and at the retail level.

The Industrial and Commercial Income Tax is imposed on non-state enterprises engaged in industrial and commercial activities in China. It is levied on net income after deducting costs of production, all necessary expenses and the amount of consolidated tax paid. Under the legislation presently in effect, the highest income tax rate representing the peak of a graduated scale and including surtax is 55%.

There is no statute providing for tax exemption for foreign enterprises but practice appears to have been uniform in exempting all foreign investments to date. According to Eugene Theroux of Baker McKenzie, Chicago, all foreign enterprises in practice are exempt from the consolidated tax and income tax. According to Mr. Theroux, a taxing statute is currently under preparation and is expected to specify how taxes will be imposed; to reduce tax levies to a 30-40% range; and to introduce a scheme for tax exemptions.

Personal tax

China is also expected to introduce personal income tax, at least on foreign residents in China. Article XI of the joint-venture law provides that "wages, salaries or other legitimate income earned by a foreign employee of a joint venture will be subject to personal income tax."

Naturally, those planning to license into China must consider the forthcoming tax code in formulating their business structures. Prior to formalization of a tax code, the foreign businessman should ensure that taxation liability is clearly defined in terms of the contract setting up the business venture.

China is in process of preparing four major pieces of legislation affecting foreign company operations in China. No schedule for announcement has been given but reports are that all are being accorded concentrated attention. Other than the tax laws mentioned above, they are in the fields of: company law, foreign exchange law and industrial property law. There is differing opinion on when the latter may be expected. The most recent report from one very close to China's lawmakers, however, is that all four are being given high priority treatment and that promulgation of at least some is expected this fall.

THE PROSPECT AND CHALLENGE

In macro terms, the business potential held open to us by China is enormous. Canadian exports to China have been and remain overwhelmingly natural resource-based although there has been over the last 12 months an encouraging trend of increased exports of high-technology-manufactured product and service. I refer, *inter alia*, to sales of aircraft and geophysical equipment ($7 million), computer software ($69 million), contracts for purchase of 100 35-ton and 10 100-ton trucks and for offshore petroleum related seismic survey work. Of greater interest presently are the multihundred million-dollar trade negotiations under way between China and such Canadian companies as Northern Telecom, Hydro Quebec, Massey-Ferguson and CIPM (Canadian International Project Management) engineering consultants. All of these negotiations will involve one or more of the licensing activities described earlier in this paper.

It bears repeating that, at this time, pure licensing of technology involving periodic payment of royalties or other user fees is, at most, uncommon in China. I am unaware of any such arrangement. The monetary return for technology transfer typically is included in each negotiated contract price. A good example in Canada has been the sale of geophysical survey equipment by Scintrex of Toronto. In its dealings with China, technology transfer is accomplished by provision of technology in export product and an arrangement for Chinese technicians to observe production procedures on site in Canada. Scintrex fully expects its product to be copied and has agreed to compensation for its industrial property solely in the negotiated product price. Earlier discussions with China on protection of Scintrex technology have achieved little.

Joint-Business Venture

In May, Mr. Sun Daguan, Director General of the National Bureau of Geology, proposed to Dr. Digby McLaren Director General of the Geological Survey of Canada, Energy Mines and Resources, a joint-business venture to use Canadian technology to manufacture exploration equipment in China. The proposal, as understood by the writer, does not include the concept of ongoing user fee for know-how. It does, however, propose transfer of Canadian technology to China. Mr. Sun's proposal in essence was: China possesses an inexpensive and adaptable labor force; Canada possesses know-how; China and Canada should collaborate in a joint-business venture to produce exploration equipment. China will guarantee a large domestic market for the product and proposes joint marketing to other world markets.

Technology transfer is also the central issue in negotiations presently under way for most, if not all, of the major Chinese contracts presently sought by Canadian companies. Hydro Quebec International, a principal bidder for hydroelectric construction and project management contracts in China, is presently training 29 Chinese technicians at various facilities in Quebec. All training and living expenses are being contributed, without obligation, as up-front costs, in the quest for the greater prize of a major contract.

Licensing activity in China to date, on the basis of present evidence, can still only be considered in the context of technology transfer in consideration for payment. The prospect of pure licensing agreements can perhaps be found in the language of statements issuing from Peking and in interpretation of the regulations promulgated and receiving preview discussion. One cannot but say, however, that the jury is still out as to when or perhaps even if "pure licensing" agreements will be accepted in China.