

# Negotiating License Agreements in PRC

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*A how-to look at negotiating technology licenses and joint ventures in China*

## THE LEGAL SYSTEM

In the late 1970s, business people and lawyers were faced with a situation in which China essentially had no legal system. As a result, each contract established its own legal system. Moreover, visitors to China in the late 1970s and early 1980s were confronted with the notion that the Chinese do not like laws and lawyers.

To some extent that latter notion still prevails, at least in conversations of Chinese with American business people. Yet, this is a potential trap for the unwary. In the last 20 years the Chinese have created a legal system from scratch. And, in many respects Americans who believe that they no longer need the guidance of tax, banking, and legal experts may be encountering it not because of the accelerated pace of such new legislation and regulation. Among the new laws adopted in just the last 10 years are the following:

- An economic contract law.
- A foreign contract law.
- A joint venture law and implementing regulations.
- An individual and joint venture income tax law and implementing regulations.
- Regulations regarding the registration of joint ventures.
- Foreign exchange control regulations.
- Regulations governing permanent representative offices in the PRC.
- Complete regulations on doing business in special economic zones, including labor and wage manage-

ment, land management, technology imports and many other subjects.

- Antitrust law.
- Import/export regulations.
- A patent law.
- A trademark law.
- Regulations governing administration.
- Insurance regulations.
- Advertising regulations.
- Regulations on the administration of technology import contracts.

## THE LEGAL RULES FOR TECHNOLOGY TRANSFER

The new regulations on technology transfer adopted on January 28, 1988, apply literally to all technology transfers, whether in a patent license, know-how license or even in a technical services contract. In general, these contracts have to be approved by the Ministry of Foreign Economic Relations and Trade in the relevant province or municipality. Indeed, the Chinese party will already have been required to submit a feasibility study and get approval before even entering into final negotiations with you.

## LEGAL REQUIREMENTS IN TECHNOLOGY TRANSFER CONTRACTS

### Required Terms

The following nine items must appear in a technology transfer contract:

1. The title of the contract.
2. Contents, scope and requirements of the technology.
3. Criteria, time limit and measures for assessing the efficacy of the technology and which party is liable if the technology does not meet the specifications.

4. Inventory and confidentiality provisions.
5. Provisions on ownership of improvements to the technology.
6. A detailed breakdown of the terms of payment.
7. Measures of damage for breach of contract.
8. Method of resolving disputes.
9. Definitions of technical terms.

### Warranties

In addition to those required terms, you are required to warrant the following items to the Chinese party:

1. The documentation supplied is complete, accurate, effective and capable of achieving the results specified in the contract.
2. The delivery times will be observed.
3. That you are the legal owner of the technology and have the legal right to transfer it. There is also a requirement for indemnification of the Chinese party, if it is used for infringement.

### Term of Contract

A technology import contract will not be approved for a term longer than 10 years without an extremely strong showing for why such longer term is necessary.

### Restrictions

The following matters will ordinarily be deleted from a technology contract:

1. Restrictions on the ownership of improved technology.
2. Regional restrictions on export (some exclusion sales agency/distributor contracts are approved).
3. Restrictions on the use of the

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technology after expiration of the contract.

4. Terms of equipment, materials or parts.

### Source

A foreign supplier must pay the Chinese 8% withholding tax. This cannot be offset to the Chinese party.

### Effect of the Approval Certificate

It is often necessary to have the approval certificate in order to obtain bank guarantees, letters of credit, customs clearances and for tax payments.

### A STEP-BY-STEP APPROACH TO THE CONTRACT

#### Technical Information

The first aim for concern in any contract, whether it be a license agreement, a sale of equipment or a joint venture, involves the technological documentation to be delivered to the party in the PRC. It is critically important to specify the actual documents that will be supplied to avoid any possibility for confusion later on. The PRC party will normally ask that you guarantee that the technical information supplied will be "up-to-date and will enable them to manufacture qualified product simply by using the documents." I advise clients against making open-ended commitments of this type and instead to indicate that the technical documentation supplied is "the same documentation used by the Seller in the United States and the Seller is able, by using this documentation in its U.S. plants, to produce product that meets specifications." This may seem like a small matter; however, it is important because often you are not able to control whether or not proper raw materials or production procedures are being used and by guaranteeing that your technical documentation will allow the purchaser to produce quality product, you are in effect guaranteeing their raw materials and production processes.

#### Technical Assistance

Technical assistance in your experts going to the PRC and their ex-

perts coming to the United States. The first and most important item is to put a limit on the amount of time you have to spend there and they get to spend here, expressed in person-days. Also, the matter of who pays for such assistance and for travel and living expenses should be clearly specified. As a practical matter, my experience in the PRC leads me to conclude that what American firms consider a reasonable amount of technical assistance for a project almost never is enough to satisfy the PRC party. The hierarchical structure in the Chinese system and the fact that everyone is reporting through more or less a rigid chain-of-command, often leads the PRC party to demand more assistance than may be necessary, to insure that they have protected their flanks. Also, the effect of the cultural revolution on managers' more conservative evaluation of the amount of assistance required cannot be underestimated.

Another matter that never seems important at the negotiation stage is the actual arrangements for your expert in the PRC. If your experts have to spend long periods of time in the PRC, the success or failure of the project will depend on their ability to adapt and work properly. Since Americans take for granted amenities that are considered luxuries in other societies, you may not assume that sending an expert to a somewhat more rural location in the PRC will be the same as sending that expert to somewhere in the U.S. Mountain things like transportation to the town the factory, access to tele facilities, the quality of the accommodations, the ability to access recreational facilities, medical facilities and other similar matters need to be covered in any agreement where the commitment of technical assistance is substantial and long term.

#### Guarantee for Equipment and Product

Nowhere is the need for protection greater than in contract guarantees. When a government official signs a contract for millions of PRC dollars, he/she must be sure the factory will actually produce product that meets specifications. Sometimes, when a sale is made in the

PRC, the natural tendency is to overkill what the product can do. Before drafting the agreement one should avoid that natural sales urge. Resist the guarantee of output of individual pieces of equipment beyond what your technical personnel say is possible to accomplish under the most adverse conditions. Remember you are going to be operating in an area that may not be like the U.S., as far as reliability of electrical supplies and other utilities is concerned. Second, the final product to be produced is subject to the vagaries of raw materials, production processes and perhaps climatological conditions that may be greatly different than those that affect your processes here in the United States. Finally, there are all matters over which you have very little control.

I recommend to clients dealing in the PRC that they specify very carefully the actual numbers that each piece of equipment should achieve in order to pass the equipment test. As far as the resulting product is concerned, there should be only one product test after the project is completed, and that one that has been successfully completed, so further guarantees should be made with respect to the continuing quality of the product.

#### Delivery Date

Negotiators in the PRC will often insist on specific delivery dates for equipment and final production items. Usually penalties are assigned for failure to meet these dates. Many western companies when first dealing with the PRC assume that these penalties will not be enforced, and indeed many PRC negotiators will treat the penalties cavalierly during the negotiating process. However, penalties are and will be enforced. When you are agreeing to a delivery date with a penalty attached for late delivery, there is a very real possibility that, if you do not make that date you will have to pay the penalty. In agreeing to penalties, the penalties are often expressed as a percentage. It is critical to understand accurately against what that percentage is taken. Normally, PRC negotiators attempt to have the percentage

applied to the contract price. This is the price for the entire contract and profits are made higher precisely in the event of a problem. I prefer to have this profit limited to the actual price of equipment for which the late delivery applies.

#### Practical Advice on Delays

At this point I want to make a small digression to cover a matter which I think is a problem endemic to all government-controlled economies, not just the PRC. You must expect and plan for delays on the part of the other side. You must draft your contracts to protect yourself against those delays.

These delays occur for a variety of factors. The hierarchical bureaucratic structure in the PRC is an inevitable cause of delay at every stage. The lack of resources, financial and otherwise, cause in some cases monumental delays. I am familiar with one project in which the delay due to lack of financial resources on a license agreement lasted for more than five years. There are also delays that result at custom points. I am familiar with a situation in which critical pieces of equipment sat for many months in the receiving port due to a failure of customs agents to clear the machines. Moreover, delays because of unavailability of materials are not uncommon.

#### Payment Problems

Payment provisions in contracts with the PRC are of critical importance. The delays common to project completion also happen in payments. In this area the PRC is much better at payment than some former European countries.

The simplest method of advancing this payment problem is to insist on a letter of credit issued by a U.S. bank with payment being made against the tender of noncontroversial documentation like a bill of lading or a certificate from the American supplier. Most PRC negotiators are just not willing to agree to this kind of payment and want instead on a letter of credit issued by the Bank of China. With such a letter of credit there is always the possibility for delays in checking the documentation and otherwise

levying funds. There is a way contractually to handle these potential delays by limiting the amount of time the central bank has to check the documents and to provide interest at a predetermined rate for payment which occurs beyond that specified time.

It is typical for payment in equipment sale contracts or license agreements with the PRC to provide for partial payments with an up-front payment for shipment and then payments upon shipment of the equipment and final payment on commissioning of the process or facility. In these cases it is always prudent to require that the commissioning payment be made on the earlier of the commissioning date or X number of months following the effective date of the contract. This covers you in the event the equipment cannot be installed because of unavailability of utilities, failure of your partner to build the facility or any other matter for which your partner is at fault.

On the matter of equity payments, most PRC negotiators prefer lump-sum payments of the type described, although some will consent to royalties. The length of royalty payments is generally much shorter than in western license agreements. For example, in the Shanghai technology legislation the time limit for a contract is five years, except in cases of equity deals. This has been extended to 10 years under the new technology transfer rules. However, it is my experience that on non-equity deals, it is very difficult to obtain more than seven years.

#### Countertrade

An increasingly common method of payment is countertrade. This results in the PRC partner making payment for the technology in the form of some product. If it involves the sale of a similar product it is called buyback. For example, you sell the technology for making lamps. They sell lamps back to you. It might even be a closely analogous product that fits your marketing system. When Pepsi-Cola licensed its Cola within the USSR for the first 7%, the

Soviet paid by giving Pepsi-Cola bottles for sale within the U.S.

On the other hand, if the product is something with which your company is not at all familiar, you may have to seek the help of one of the trading houses that specialize in countertrade transactions. This obviously involves some commission in that trading house and should be taken into account in setting your price.

It is a common technique for PRC negotiators to begin discussions based on a cash price and to switch afterwards very late in the negotiations to compensation based on countertrade. If you are not careful in understanding that countertrade has a definite dollar value, you can lose a lot of profit after you have put a lot of work into the negotiations.

In countertrade situations, you should always list the specifications and quality requirements for the product, how the product will be priced and delivered, and what happens if the product is not delivered in a timely fashion and in the quality and quantity desired.

#### Force Majeure and Arbitration

Every PRC contract should have a force majeure clause and an arbitration clause. All PRC negotiations will concern in such clauses. However, there is a great deal of difference as to what individual negotiators will put in such clauses. I have been successful in getting clauses listed as a matter of force majeure in very few contracts in the PRC. It is most cases that will not be possible, but you should look for creative alternatives like certification of the existence of force majeure by your local chamber of commerce. The essential elements to cover in a force majeure clause are strikes, acts of God, natural disasters, imposition of government controls over import and/or export, riots, war, power interruptions, and all other causes beyond the reasonable control of the seller.

Under the Foreign Contract Law, arbitration can be submitted to "Chinacot or other arbitration bodies." In practice, the Chinese have agreed to arbitration in Sweden under the Rules of the Arbitration

Institute of the Chamber of Commerce. That is an acceptable arbitration forum, although I prefer the International Chamber of Commerce in Paris, the London Court of Arbitration, or the American Arbitration Association, if I can get it. The essential elements in an arbitration clause are single arbitrator, appointing authority, place of arbitration, language of arbitrations, governing law and the qualifications of the arbitrator.

#### Confidentiality

ICC negotiations will allow some discretion with respect to confidentiality of the information transferred and you should attempt in the beginning stages of negotiations to insure that this provision is as strongly drafted as possible to avoid unnecessary problems later in the negotiations. It is always easier to start with a very hard position and to modify it than to start with a soft position and find that you have to modify that as well.

#### TERRITORIAL RESTRICTIONS ON EXPORT OF PRODUCT

Certain territorial restrictions on the export of product have been permitted in some ICC contracts in the past. If one cannot accomplish this directly, you should look at achieving the same thing by providing primary and secondary sites of emphasis in terms of marketing areas.

#### Export License Provision

The question of the necessity for an export license for the technology or product involved should be covered prior to the time you begin negotiations and if such an export

license is required, that should be written into the agreement as a precondition to the agreement's effectiveness.

#### Authority of Signing Party

Only certain organizations have the authority to make international contracts. Before you get too far in negotiations, it is essential that you check the authority of the organization with whom you are dealing and whether they have had a preliminary feasibility study approved.

#### NEGOTIATING THE DEAL

##### Strategy

As far as negotiating strategy is concerned, it is particularly appropriate to be sensitive to the cultural differences between the Chinese and us. For example, in China one negotiates for long periods of time in order to build trust between the parties. The negotiations are generally kept on quite an amiable basis and it is a serious breach of etiquette for one to become angry, impatient or to put the other party in a position where he/she loses face. In the agreements drafted in China, there is considerably greater ambiguity, which allows for the development of a living document that the parties will continue to interpret throughout the agreement.

China is not as homogeneous as it might first appear. If you negotiate in some of the Special Economic Zones or with individual end users, you may usually expect much more flexibility than if you negotiate through some ministry in Beijing. Moreover, China is ever changeable and what was true last year, may change completely next

year. You should be sensitive to changing political and organizational winds.

##### Major Hints for Negotiators in the PRC

1. Expect the Chinese negotiators to be very knowledgeable about your industry and to be extremely well prepared for negotiations.
2. Expect negotiations to last a long time. Continue to be patient even when faced with delays that are difficult to understand.
3. Be firm but polite in your positions. Chinese negotiators understand firm positions. However, discounting or losing your mind when things get tedious can poison a negotiation.
4. Expect to be faced with a standard "three" contract. Try to bury difficult points in appendices rather than in the body of the agreement.
5. Always seek different ways of reaching theory issues. There is always more than one approach to a problem and the Chinese appreciate parties who are constantly trying to resolve problems, rather than adopting inflexible positions too early in negotiations. Consider using a three-column approach to negotiations, after negotiations have lasted for some time.
6. Try to identify key decision makers early in the negotiations. However, understand that decision making in China is a complex process.
7. Always hold back a little discount for each level of approval. There is nothing worse than having no water left in your price when you have one important level of approval left.
8. Remember the Chinese are relationship bonds, but they are also very smart business people.