

Competition through Patenting

China's IP Strategy between High-tech Tax Incentives and the New Patent Law



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The Chinese State Council issued the "Outline of a national intellectual property strategy" on 5 June 2008. Although it is more of a political document without any direct legal effect, the paper reflects government's attitude in the field of intellectual property (IP) and foreign companies in China should therefore give it due attention. The document provides even more insight, however, when studied in connection with two other recent legal developments: namely the detailed definition of conditions for the recognition of high technology enterprises and the latest draft of a revised Patent Law.

China's Own Intellectual Property

The IP strategy paper describes the official target of increasing the quantity and quality of self-created intellectual property in China in order to meet the demands of economic and social development. To that end, China plans to change into an innovative country and to enhance the competitiveness of Chinese companies. Within the next five years, government already envisages raising the number of patents granted to domestic applicants every year to the level of developed countries. At the same time, the number of international applications by Chinese applicants shall be increased considerably and a group of world-famous brands established.

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Apart from these constructive political goals, the paper also addresses the risk of potential misuse of IP rights. A short paragraph states in a rather obscure way that the protection scope of rights must be reasonably defined and that fair terms of competition must be maintained. There is a concern that these remarks are aimed at foreign companies. Apparently, there is a growing sense among Chinese experts that multinational companies misuse their IP portfolios to restrict the development of Chinese competitors. Similar views were recently expressed by judges of the Supreme People's Court during a congress. The strategy paper deserves praise for explicitly stressing the necessity of countering infringements

more effectively, although similar declarations of intention have been heard for a very long time.

Hi-tech Enterprises and their IP Rights

Basic regulations about the recognition of high technology enterprises on the basis of the new Enterprise Income Tax Law were already promulgated on 14 April 2008 and a more detailed circular was issued on 11 July 2008. Certain basic conditions for recognitions were already defined under the earlier regulation. Eligible enterprises (the incentives apply to domestic and foreign-invested enterprises alike) must be established in China and they must have existed for at least one year. Furthermore, the enterprise has to conduct research and development work on a continuous basis and dispose of its own core IP rights. These core IP rights must have been acquired through the enterprise's own development, transfer, donation or acquisition within the last three years.

There are some indications that the authorities are willing to accept patents where the applicant enterprise is a co-owner, but that is not sufficiently clear. Rights under an exclusive license can also be regarded as core IP rights, as long as certain additional requirements are satisfied: The license must be granted for a term of not less than five years and licensed technology must be key technology that supports the main products or services of the enterprise. The circular (dated 11 July) also clarifies that only a worldwide license will meet the requirement for recognition of the licensee. Moreover, even the licensor must be excluded from the use of the invention. As far as subsidiaries of international companies in China are concerned, this condition has been criticised as unrealistic by most experts. It simply appears unreasonable from a business point of view to grant licenses with such a broad and exclusive territorial scope. Actual cases of such a license are also not known in practice.

Revision of the Patent Law

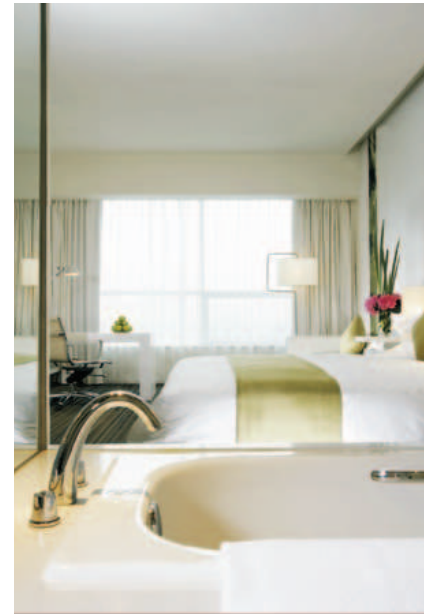
Drafts of a revised Patent Law have been circulated for public discussion before. A third draft was discussed in first reading by the Standing Committee of the National People's Congress (NPC) in September. This last draft contains some important amendments as compared with the previous draft. The change from the relative novelty standard to an absolute novelty standard for invention patents in the new draft is a positive development. Until now, novelty was awarded to Chinese applications even though an invention had already been used or sold in another country. Critics all agreed that this limited novelty standard actually led to a reduced quality for Chinese patents.

According to the new draft, however, any use abroad will, in the future, destroy the novelty of an invention for which a patent application is filed in China. This would remove one option available at present: Chinese companies that register Chinese national patents by making use of inventions which have already been used abroad. Even now, however, one NPC delegate expressed his doubts during the reading as to whether the introduction of the absolute novelty standard was suitable for China's current stage of development.

One of the most controversially discussed provisions in the previous draft was the requirement to file a Chinese patent application first for all inventions made in China, before any application could be made in other countries. This strict rule has been abolished in the latest draft, thereby reinstating an essential piece of autonomy to applicants in China, including foreign-invested enterprises. However, an official examination as to secrecy requirements still has to be conducted before any application for such inventions can be filed abroad. Discussion in the Standing Committee on this issue has apparently been quite controversial, so it remains to be seen how this provision will look in its final wording.

The legislator also intends to introduce new rules about compulsory licenses. Competent authorities will be entitled to impose a compulsory license for the exploitation of pharmaceutical patents, if this is done for public health requirements and to manufacture medicine for export to the least developed countries. The commissioner of the State Intellectual Property Office (SIPO) has explained that this provision has been added in order to implement an understanding

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reached at the ministerial talks during the WTO's Doha round of negotiations and the TRIPs' (trade related aspects of intellectual property rights) amendment protocol.

Apart from that, a compulsory license may also be imposed if a judicial or administrative procedure has confirmed that the patent holder eliminates or restricts competition in the exercise of his patent rights. This stipulation, already contained in the Patent Law Implementing Rules, is in itself not unusual. German Law also contains a stipulation about compulsory license if a patent holder refuses to grant a license, thereby misusing a monopoly position. However, the problem with the new clause in the PRC Patent Law is rather that it is broader and contains a reference to decisions made under the new Anti-Trust Law.

Art. 55 in that law is a general clause about the exercise of IP rights which constitutes misuse. The problem is that there is a lack of established rules and criteria to define such misuse, and this could create the risk of a biased application of this rule. Multinational companies who actively pursue and protect their IP rights in China could be natural candidates for such selective application. They will observe the implementation of the rules on compulsory license with keen interest.

Staying on Top of Your Rights

It is very encouraging that China is tackling the issue of IP rights and that it is developing its patenting legislation as a means of increasing its competitiveness. To evaluate the effects on their own business, companies should consider the following factors:

- Potential tax benefits which may be available for enterprises with a recognised high technology status should be weighed

against the potential risks and disadvantages which can be caused as a side effect of complying with the latest conditions for recognition. Companies will have to consider carefully whether it is worthwhile or even possible to change an established patent policy for the sake of maximising tax benefits in China. When shifting R&D work to a Chinese subsidiary, this should not be done before a comprehensive system for identification of patentable inventions, applications, treatment of employee inventions and contractual management of IP is in place, as well as a monitoring system for potential infringements.

- For international companies, the tax regulations create a trend to register more local IP rights in the name of their Chinese subsidiaries. It should be kept in mind that these rights will fall under the administration and jurisdiction of the Chinese patent authorities and courts and that certain restrictions on the transfer of these rights under Chinese law can apply, which may not be compatible with the global patent policy of companies.
- Domestic companies will invest more efforts to build up their own IP portfolios.
- In light of the absolute novelty standard, caution should be applied not to jeopardise the novelty of Chinese patent applications by any acts of prior use in other countries.
- Companies should review their IP-related contracts, especially licensing agreements, for compliance with competition and anti-trust law, in order to avoid the risk of compulsory licenses being imposed.

These recent developments create a complex environment in which international companies have to orientate themselves. Companies should assess the implications to their China-related patent, as well as their R&D strategy.

Laws, Regulations, Notices and Judicial Opinions

Guangdong Court Issues Labor Contract Law Guiding Opinions

The Guiding Opinions serve to provide courts and labour departments in Guangdong province with structure when applying the Labor Contract Law and Labor Dispute Mediation and Arbitration Law. The Guiding Opinions were promulgated on 6 July 2008.

Guiding Opinions on Several Questions Arising from Applicability of the Law on Labor Dispute Mediation and Arbitration and the Law of Employment Contracts

- **Overtime Pay** – 1. Overtime is calculated based on normal working hours and does not include other pay unless employer stipulates otherwise. 2. Employer may stipulate that salary includes overtime and therefore precludes the need to pay overtime. 3. Employer may also be exempt from paying overtime if evidence can be provided which indicates overtime is included in the agreed upon salary. 4. When overtime is included in salary then that salary may not be lower than the minimum wage. 5. If an employee claims for overtime it is the employer's responsibility to prove whether the claim is false or true.
- **Severance Pay** – 1. Employee claims for termination of a labour contract and payment of compensation due to an employer's failure to pay social insurance prior to 1 January 2008 will not be considered. Claims will be supported including only the period starting from 1 January 2008. 2. Employees may not claim for compensation or termination of the labour contract due to failure by the employer to pay social insurance in full or on time. 3. When terminating employees the Labor Contract Law shall apply to periods of employment starting from 1 January 2008 and previous employment will be subject to the Labor Law of the People's Republic of China (1994).
- **Conclusion of Labour Contracts** – Within 30 days of the start of employment if no agreement can be reached on a labour contract then the employer may terminate the employment without paying compensation.
- **Arbitration of Labour Disputes** – 1. Beginning 1 May 2008 the time limit for labour disputes will be set at one year as indicated in the Labor Dispute Mediation and Arbitration Law. 2. Disputes over social insurance will only be accepted if they are concerning the number of years pension insurance has been paid, if they arise due to an employee's loss of benefits due to nonpayment by the employer, or if they arise due to an employee's losses suffered due to work injury and in which the employer has failed to pay the injury insurance in full. All other disputes involving social insurance will not be deemed to be labour disputes.

Draft Regulations

The Standing Committee of the Shenzhen Municipal People's Congress issued regulations regarding labour relations on 2 June 2008.

The Regulations on the Establishment and Development of Harmonious Labor Relations in the Shenzhen Special Economic Region

- **Labour Unions Involvement in Negotiations** – Employees should be represented by the relevant Labour Union during negotiations associated with work stoppages or slow downs, but are not required to assist management in any way.
- **Overtime** – When an employee earns more than twice the average monthly salary for Shenzhen, overtime may be included in the agreed upon salary.
- **Employer Violation Database** – A list of employers who fail to timely pay wages or suffer a substantial amount of claims for on the job accidents or hazards will be made public. Repeat offenders will also be denied access to investment incentives and their legal representatives will be prevented from registering enterprises in Shenzhen.

Provisions Issued

The Shanghai municipal authorities have issued a series of provisions aimed at encouraging investment and management companies to establish their headquarters in Shanghai.

Encouraging the Establishment of Regional Headquarters by Foreign Multinational Corporations Provisions

- **Approval Time** – Shortened from 30 days to 10 days
- **Investment Minimum** – Lowered from USD 30 million to USD 10 million
- **Employment** – Procedures for hiring non-Shanghai residents and foreign citizens minimised
- **Business Scope** – Business activities to now include: finance management of the enterprise, outsourcing, logistics, import and export, and domestic distribution

Notice Issued

A notice from the Supreme People's Court which adjusted the jurisdiction of all high people's courts and intermediate people's courts came into force on 1 April 2008.

Adjusting Standards for Jurisdiction of the High People's Courts and Intermediate People's Courts

- **Summary** – The standards by which the high intermediate courts will accept cases have been changed so that they will no longer receive most cases of first instance, creating a more efficient system for the high and intermediate courts, but also resulting in a flood of new cases to the lower courts and second instance cases for intermediate courts.

Judicial Opinion

On 8 July 2008 the Supreme People's Court of China handed down a decision raised by the Liaoning High People's Court concerning the involvement of patents in industry standards.

Ruling on the Exploitation of Patents Used in Industrial Standards

- **Right to Exploitation** – Any patentee participating in the creation of or agreeing to allow the use of its technology to be used in a National, Industrial, or Local standard will be deemed as forgoing its exclusive rights to the patent and any use thereafter by third parties will not constitute patent infringement. However, the Patentee may request a fee from third parties, although no guidelines concerning how this will be enforced or how the fee is determined were provided.

PROFILE

Schulz Noack Bärwinkel (SNB) was the first German law firm to establish an office in Shanghai. Since 1994, SNB Shanghai has been advising mainly German, Austrian and Swiss companies in China. SNB's main legal advisory work is in Corporate, Banking, Trade and Distribution, Intellectual Property, Industrial Real Estate, Construction, as well as Procurement Law. Permanent advice rendered to German and other European industrial clients is the focus of SNB's work. Amongst SNB's long-term clients are well-known companies from the chemical, electronic, and medical equipment, the fasteners and paper industries. Dr. Jörg Michael Scheil has been a partner of our firm and Chief Representative of SNB's Shanghai office since 1999 and was appointed to the board of directors by several clients for their subsidiaries in China.

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