



躍動する中国と米国：知的財産とビジネスのリスク管理

Changes Are Afoot in China and the US: Proactive IP and Business Risk Management

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How IP Is Transacted in China related Mergers and Acquisition?

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I. Introduction

Recent outbound deals such as Nanjing Automobile's acquisition of MG Rover, Lenovo's acquisition of IBM PC business, TCL's purchase of Alcatel mobile phone, CNOOC's failed attempt in taking over Unocal, and Haier's unsuccessful bid for Maytag, have created a perception that Chinese companies are ambitiously buying foreign assets globally. In fact, compared to the inbound deals where foreign companies acquiring or merging in China, the outbound deals are still far smaller in terms of total amount and volume, and the integration post closing between the Chinese buyer and the foreign seller still has a long way to go. Intellectual Property (IP) issues in these outbound deals are more likely to be examined and resolved under foreign laws where foreign sellers are familiar and comfortable with. Conversely, the inbound deals have presented various forms and proved to be a good option of penetrating and expanding in China market, but IP issues are likely to be reviewed under the PRC legal regime which most foreign buyers are not familiar with or confident in, and often time can be a critical deal issue.

II. Types of China related M&A Deals

Foreign companies buying China related assets and equity for the past three years has surged to record high amounted to about 17.6 billion US dollars, among which, 7.2 billion US dollars are from the United States, 2.6 billion US dollars are from Singapore and 2.5 billion US dollars are from UK.¹ The increased M&A activities in China are primarily due to the relaxed Chinese regulatory regime, readjusted China strategy by foreign buyers, and/or the bet on the appreciation of Chinese Yuan. Yahoo, for example, has been in China for six years, but it was not until year four, Yahoo Hong Kong acquired a Hong Kong based software company called 3721 which had operations in mainland China, and until year six, Yahoo invested significantly in Chinese Internet company Alibaba, almost three years after its rival Ebay acquired Chinese auction site Eachnet.

Since last few years of 20th century, foreign companies have been allowed to acquire FIEs (Foreign Invested Enterprises), then gradually from year 2002, foreign

¹ Statistics are from a recent CSFB report entitled China M&A: A Lot to Buy (or Sell)?



companies can acquire listed companies (not listed shares), State Owned Enterprises (SOEs), domestic companies and listed shares of listed companies. For the past three years or so, we have seen deals involving FIEs, domestic companies and listed or unlisted SOEs, such as UPS' expensive US 100 million conversion to WFOE from its marriage with Sinotrans, Fedex's proposed acquisition from its JV partner Tianjin DTW, Amazon's US 75 million acquisition of Joyo.com, Anheuser-Busch's acquisition of state owned Harbin Brewery, HSBC's investment in Bank of Communication, CITIC Capital and Warburg Pincus' restructure of Harbin Pharmaceutical, and Carlyle Group's recent US 375 million acquisition of Xugong Science & Technology. These transactions all involved buying the entire business by assets, or partial or entire business by shares. Deals such as acquiring partial assets by product or service lines have also emerged, such as AsiaInfo's acquisition of Lenovo's IT business. But since most Chinese sellers are relatively smaller compared to their foreign counterparts, fewer inbound asset deals involved buying only product lines. On the other hand, more outbound deals have merely purchased certain businesses of a large foreign seller, such as Lenovo buying IBM PC business, TCL buying Thomson color TV business, and Beijing BOE Technology acquiring Hynix Semiconductor's TFT-LCD (thin-film transistor LCD) business. The trend may be reversed in future.

III. IP to Be Transacted

In these inbound China equity or asset deals, foreign buyers focus mainly on market share, distribution channel, brand and IP. After being educated gradually, Chinese targets have started to realize that these factors could bargain for a better deal. Increasingly IP, as the major deal issue, can prolong, advance or break the transactions. IP counsel for both sides appear more frequently in due diligence and throughout the deal negotiations. Often time, buyer's IP counsel can be the person to close the entire transaction.

During these China related transactions, IP may be assigned from seller to buyer, it may be licensed or cross licensed, between or among various parties related to the deal, and it may be granted back from assignees or licensees. The technology involved is most likely to cross the border which will trigger technology export and import control China has imposed. In order to achieve the deal goal, structure the deal may involve numerous internal licenses from one entity to another within the target, which should be done as early as possible, as sometimes pre-approval and post recordation might be required, which may delay the deal process.

Various forms of IP can be transacted in these inbound deals. They may be classified into two categories: registrable IP and unregistrable IP. Registrable IP may include patents, trademarks, copyrights, domain names, semiconductor layout designs, plant varieties and trade names and logos. Unregistrable IP may include



confidential business information and technology know how. In each transaction, there might be unregistered IP to be transacted which can be in the form of copyrights such as software and trademarks such as certain actually used marks which fail to register. The unregistered IP belongs to the registrable IP category which is oftenly ignored.

IV. Manage the Process

A. Get your opponent on board as soon as possible

As a matter of M&A practice, seller's counsel normally gets involved in the deal earlier, in particular in an auction sale. But in many deals related to China, Chinese sellers may not engage in a reputable international firm as early as the buyers, seldom there will be an IP counsel *per se* on seller's side at early stage of the transaction or throughout the transaction, especially if the seller has no offshore presence. Therefore, buyer's counsel may have to deal with the Chinese target directly most of whose employees and management may not speak English. When it comes to IP, buyer's counsel may have to deal with the target's engineers or management most of the time, in order to conduct and complete due diligence. If the Chinese target has a reputable local law firm and/or a reputable international law firm representing it, the difficulty for buyer's counsel to communicate with the target would be substantially reduced. Thus, when buyer's counsel comes to the scene without seeing their counterpart, it is a good idea to suggest that the seller hire its own counsel as early as possible.

B. Involve right IP counsel at the early stage

It is important to involve IP counsel at the early stage of the transaction, as most issues that are left before a deal can be closed are more likely to be IP these days. At that pre-signing stage, it would be too late to renegotiate the price or restructure the deal, had IP issues not been taken into consideration or not been considered properly when negotiating the term sheet. If the Chinese seller has its own IP counsel, it will be relatively easier to conduct IP due diligence and resolve deal related IP issues, as seller's IP counsel is likely to have done its homework in understanding the target's IP assets. But this is not the case in most transactions. The best could hope for is to have a decent deal counsel who has some knowledge of IP representing the seller. As a buyer, however, it is essential to have a Chinese speaking IP counsel on board as early as possible whose language and cultural background alone can offset substantially the inconvenience of lack of IP counsel from the other side.

Buyer's IP counsel should work with the deal counsel on the same side and deal counsel on the opposing side closely. Ideally, the IP counsel should get involved in structuring the deal, but few deals actually involved IP counsel at that



early stage. IP counsel needs to understand how the entire deal is structured, and then conduct IP due diligence and draft IP transaction documents accordingly. We have seen deals at later stage of negotiation where target's IP turned out to be a lot more troublesome with huge potential risk exposure than buyer initially had thought, but the price and structure agreed upon unfortunately did not consider those risk factors. IP can become deal breakers in those scenarios. When language, cultural and legal barrier is high in deals related to China, IP counsel's ability to communicate with the target management, with target counsel, with buyer's deal counsel, and more importantly with buyer's management, should be valued highly.

C. Conduct Focused IP Due Diligence

The hardest part of conducting China related IP due diligence is to get adequate documents and information from the Chinese target, and then translate the documents and information received into a meaningful assessment for deal team and buyer's management. It takes both understanding of the culture and legal nuances. No Chinese company can survive the western style due diligence, in particular with IP. Few buyer's counsel understand it. Few Chinese targets have a very good document retention system, in particular with IP documents. Few buyer's counsel understand it. A great deal of information can be obtained through friendly interview with the target employees and independent verification, in particular for IP information. Few buyer's international counsel have the ability to achieve it. The target or target's counsel tend to control information and documents as tightly as possible, therefore, buyer's IP counsel must focus on the IP issues that may break or save the deal. Do not throw a laundry list that has little or no bearing to that focus as it may irritate your counterpart or spoil the relationship with the target. Since due diligence will be scheduled step by step and phase by phase, start from the broader category but still with the focus of core deal related technology first. It is important to conduct onsite review and interviews. Casual talks during the onsite review may be a gold mine.

D. Negotiating and drafting-need sensitivity, physical and mental strength

When negotiating with the Chinese target, look at the bigger picture, i.e., whether there are any good reasons the target would do the deal. Sometimes the drive such as political necessity or management's interest really is unstoppable. Take advantage of these behind the scene factors. Of course, if there are multiple buyers in the picture, then you want exclusivity for certain period of time by making quicker decisions. Although most term sheets are non-binding, it is still advisable to make your term sheet as detailed as possible. IP must be covered in the term sheet with specificities.



Again whoever drafts has the advantage. But as buyer's counsel, make sure to provide a reasonable first draft. If your draft is too extreme to your client's advantage, your Chinese counterpart may completely disregard your draft and throw back a newly written draft in Chinese for your review. Choose a civilized place for kickoff or major negotiations if you can-Beijing, Shanghai or Hong Kong is better than a provincial city in target's home turf. As most management of the target cannot read English, it is sensible to provide bilingual draft, but make sure your Chinese translation is precise and follows the latest English draft. Do NOT turn in a belated Chinese draft not reflecting the latest English draft, which happens from time to time. Being cool and humane, treat your local counsel or your opposing counsel with respect and professionalism. Also, it takes physical strength during the negotiation and escalated within the last several days of negotiation before signing. Exercise during the deal and try to like Chinese food, being always optimistic and always awake with the coffee or tea. You probably can gain more than you thought at the last stage because your personality, physical and mental strength topped your opponent.

E. Shifted IP Focus at Different Stages

Pre-signing, counsel should focus on the terms of IP agreements, and the IP schedules. Make sure to schedule registrable IP as detailed as possible. Do not simply rely on the schedules to identify unregistrable IP, such as trade secret, as these items are better described in the main IP agreement in a detailed fashion without an exhaustive list. Schedules are normally closed at the time of signing which may exclude certain unidentified unregistrable IP if they are simply scheduled. Post signing before Closing, counsel need to focus on IP schedules and deliveries at Closing. At signing, IP schedules may seem to be complete, but there might be "refinement" post-signing in reality, so long as both parties do not oppose. With the Closing in prospect, counsel need to identify the IP items (documents, information and physical embodiments) to be delivered at Closing, and also make arrangement for recordation of assigned IP and responding to official actions for IP pending registration to be assigned. Post Closing buyer's counsel will need to focus on transfer, recordation and continuity of IP prosecution to be assigned or licensed. Without planning and adequate management, Closing may be delayed and IP assigned may get lapsed.

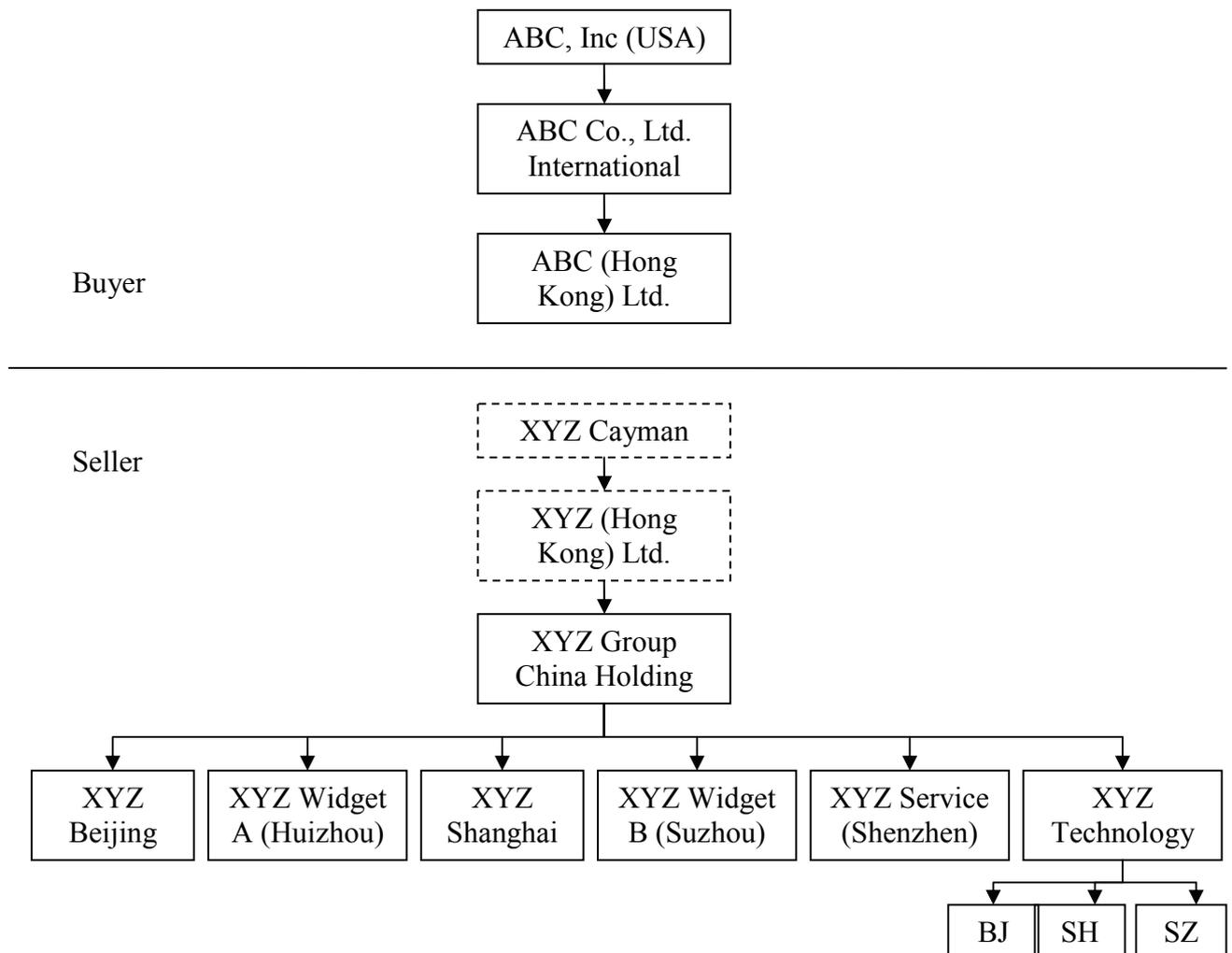
V. How IP Is Transacted- a Hypothetical Case Study

IP issues are generally more lengthy if Buyers purchase assets versus shares. IP issues normally are less complicated if Seller's entire business is bought. IP issues are definitely more thorny if only a line of business or several product lines are sold. In each different transaction, the foreign Buyer not only must deal with



specific IP issues related to China, but also subtle and sensitive cultural and social issues.

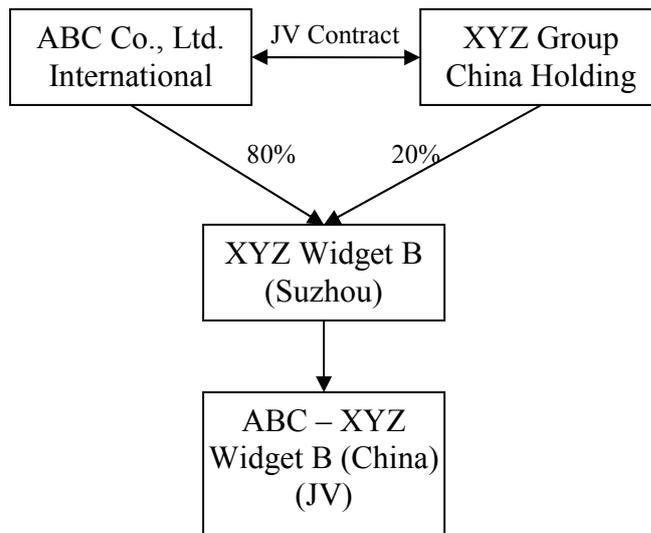
For the purpose of discussion, let us consider the scenarios of ABC company, the Buyer, acquiring XYZ company, the Seller, a Chinese company whose parent could be set up offshore or onshore. XYZ could be a pure domestic company, or an SOE, or an FIE with subsidiaries and operations in major cities in China. It makes and sells two different lines of products: Widget A and Widget B. XYZ has nationwide R&D facilities in Beijing, Shanghai and Shenzhen. The charts below illustrate the structures of the Buyer and Seller pre-Closing:





There are many ways ABC could buy XYZ partially or entirely. The easiest way is to structure an indirect equity purchase offshore where one of the ABC entities acquires XYZ Cayman or XYZ Hong Kong, but unfortunately not all Chinese targets have an offshore holding structure like XYZ (Hong Kong) Ltd. or a special purpose vehicle (SPV) like XYZ Cayman. Therefore, indirect offshore equity purchase may not be an option and increasingly foreign buyers are facing more complicated direct onshore asset deals in China.

Let us consider the most complicated scenario in terms of IP transaction—buying a line of business only. Assuming ABC USA would like to buy XYZ Widget B business but due to regulatory restriction ABC is required to form a joint venture (JV) with XYZ instead of converting the target into a Wholly Foreign Owned Enterprise (WFOE). Here XYZ is an SOE without offshore structure such as XYZ Hong Kong and XYZ Cayman and the industry is foreign investment restricted prohibiting WFOE. The structure post Closing is illustrated below:



After investing by cash and technology to the existing target entity XYZ Widget B (Suzhou), ABC Co., Ltd. International will hold 80% and XYZ Group China Holding will hold 20% of the target. The domestic company XYZ Widget B (Suzhou) after being injected with capital and technology will then be converted into a JV with a new name ABC-XYZ Widget B (China).

In a deal like this, following IP transactions could be considered, negotiated and consummated:

- Assignment/License of IP covering Widget B Business to ABC;



- Assignment/License of IP from non-selling XYZ entities that possess technology related or materially related to Widget B Business to the Suzhou entity/JV;
- Transfer of XYZ's existing license agreements or royalty bearing agreements related to Widget B Business, if any, to JV;
- Assignment/License of IP from ABC to XYZ and/or JV;
- License JV developed technology to ABC or XYZ;
- Call (Buyer's option to buy) or Put (Buyer's option to sell) options related to JV share/JV technology in case of liquidation, termination or major default.

VI. Terms related to IP

A. Agreements that may have IP Elements

IP assignment or license normally is set forth in a separate agreement, but the main transaction agreement such as the Asset Purchase Agreement (APA) or Share Purchase Agreement (SPA) should serve as a road map covering the main terms of the IP agreements or refer to the specific IP agreements.

- Asset Purchase Agreement or Share Purchase Agreement

In present case, there may not be an APA or SPA as the parties may not sell or buy outright but to inject capital or assets into the Suzhou entity and then convert it into a joint venture (JV) with a new name. The parties may also choose to set up a new JV where ABC invests in cash and the technology and XYZ invests in technology and other assets related to Widget B. Therefore, a Joint Venture Agreement can be the main transaction document outlining how IP is to be allocated and transacted.

- Specific IP Agreements

There will be a number of IP assignment, IP license, and IP cross-license agreements among various parties involved in the transaction. ABC, as the foreign Buyer, is encouraged to negotiate the following with XYZ:

First, the right to use XYZ's technology outside China including JV developed technology which may involve a technology license from XYZ Group China Holding, XYZ Widget B (Suzhou) and/or the yet to be formed ABC-XYZ Widget B (China)² to

² The effective date of such a license agreement will be dated after the JV is approved and subject to the government approval, which may increase the uncertainty. Thus, in practice, the license is likely to be signed with the Suzhou entity as the appendix to the JV contract which will be approved by the Chinese government at the arm's length of the transaction.



the ABC entity that makes direct investment into the JV. Depending on the bargaining power, an assignment of XYZ's technology outside China or in US can also be achieved if the overseas market is not of high importance to the Chinese Seller. But in most cases, the best a foreign Buyer could get in a deal of this nature is a limited license.

Second, license ABC technology for limited scope and period of time to JV. Often time, the PRC government expects that foreign Buyer inject technology into the JV including to co-brand with the JV, as a condition for approval. In Chinese, technology transfer (技术转让) could entail multiple meanings such as ownership assignment, license arrangement, or cross license. Foreign Buyer is advised to negotiate a license deal versus an assignment deal to the extent possible. Under the PRC law, any improvements made thereafter by JV based on the licensed technology will belong to JV, not the original licensor. If the original licensor would like to own the improvements, it must pay additional consideration. So at the JV negotiation stage, Buyer's IP and deal counsel should evaluate whether improvements made by JV based on ABC licensed technology would be critical to ABC, and then decide how to structure the technology license. Technology license can also be in the form of a cross-license where ABC licenses technology for XYZ-JV's use within China, while XYZ licenses technology for ABC's use outside China.

Third, negotiate a call or put option to buy from or sell shares/technology to the Chinese partner. As in a deal structured like this, WFOE is not permitted at the current stage due to the legal restriction, the call option may also serve to convert the JV into a WFOE when the legal environment relaxes. If the target has turned into a WFOE of ABC, the division of IP ownership will become an internal issue which will be relatively easier to deal with.

- Master Confidentiality Agreement

The APA or SPA should have terms of confidentiality. Each IP agreement should also have a separate clause of confidentiality stipulating the rights and obligations of the providing parties and receiving parties in connection with confidential information. In bigger size transactions, a master confidentiality agreement may be in place. When drafting confidentiality clauses of each individual IP agreement, IP counsel should not forget to cross reference master confidentiality agreement, if any.

- Transition Service Agreement or Human Resource Agreement

Depending on the nature of the transaction, transitional service may be needed before Closing or certain period after Closing. During the transition, if foreign Buyer needs the Chinese Seller to provide transitional technical service, then license and use of assigned or sold IP rights during the transition period by Seller may be necessary.



HR agreements may have provisions related to work made for hire, the ownership of work made for hire, confidentiality preservation obligations and non-compete obligations by employees. Therefore, these agreements should be cross-referenced in drafting IP agreements.

B. Define IP

It is not an easy task to define what IP rights should be assigned to XYZ Widget B (Suzhou) from other XYZ entities. ABC clearly would like to gather all

Widget B related technology into the Suzhou entity as the basis for the future JV. However, XYZ may want to retain the technology that is not exclusively related to Widget B, such as the technology that is also related to Widget A. Therefore, where to draw the line will be the heatedly debated issue by both sides. The management and the deal counsel should realize the importance of the division and deal with the issue hopefully in the term sheet. But in practice, even at documentation stage, the parties are still debating on what to be assigned. Since most Chinese companies do not have a good IP development record or clear intra company license practice, it is even harder to server IP from other non-selling businesses.

- Define IP in relation to the Business

Buyer's counsel normally would hold so long as the technology is in any way related to the Business being acquired, it should be transferred to the new company. While Seller's counsel normally argue to assign only those technologies that are exclusively related to the Business or important to the Business being sold. This line is to divide what to be assigned to the Buyer, and what to be licensed to the Buyer. In the hypothetical, ABC should insist that XYZ must assign all IP that is related to the Widget B business to the Suzhou entity as a start. But the parties may end up with assigning only the technologies that are developed for the Widget B business.

- Assignment vs. License

XYZ may argue certain technologies related to Widget B were not developed in Widget B division, nor were used by Widget B Business. Therefore, these technologies cannot be assigned to the Suzhou entity, but can only be licensed to the Suzhou entity and the license should not be exclusive, as the other businesses of the XYZ have the need to use such technologies. If ABC accepts the argument it is better to craft a non-compete clause to ease the possibility that XYZ's other businesses would compete with JV or ABC in future. Further, XYZ may also argue it has a need to use the assigned technology requesting JV/ABC to grant a non-exclusive license back. ABC should assess whether to accept a license back arrangement and under what terms. In addition, if there are any existing license agreements between XYZ and the third parties related to Widget B, ABC should



seek to review these agreements and decide whether to have these agreements transferred to the Suzhou entity or JV. It is better to have JV re-execute a license agreement with the third party to avoid uncertainty.

- Whether to schedule unregistered and unregistrable IP

It is a common practice to schedule registered IP, such as patents and trademarks. But when it comes to unregistered and unregistrable IP, such as unregistered marks and trade secrets, it is better to describe these items in a detailed fashion than simply schedule them. Because due diligence may not reveal a complete list of these items and may prevent Buyer from adding additional items discovered post-signing should schedules be the only exhaustive means. Further,

certain unregistered Chinese marks used by the target may not be recognized as a result of the inconsistent use.³

C. Representation, Warranty and Indemnification

Chinese companies are not used to lengthy representation, warranty and indemnification clause, sometimes they could take all of them when under represented or sometimes reject most of them when over represented. As a foreign Buyer, this clause is a way to limit the risks that IP due diligence discovers or is unable to discover. Therefore, a broader representation and warranty clause from Seller is ideal for Buyer, but keep in mind Seller definitely would always want a narrower one. So it would be realistic to tie representation and warranty clause with IP due diligence. These days it is harder to obtain an unqualified representation and warranty that IP to be assigned does not infringe any third party's rights. It may be more realistic to represent that at the time of Closing, IP to be assigned does not infringe.

Sophisticated foreign Sellers would craft a complex IP indemnification scheme which appears to be attractive but in fact there are a lot of conditions being imposed before a Buyer can directly consume the indemnity dollars. Typical conditions include capped amount (maximum amount to be indemnified), deduction (certain amount of out of pocket payment by Buyer), time limit (indemnify only 3-5 years after Closing), types of claims (only related to infringement by assigned patents, for instance), settlement offer (any settlement offer must be approved by Seller), litigation progress report (Buyer must report the progress of a pending qualified case), etc. Most Chinese sellers won't be as

³ Inconsistent use is where the mark owner uses a mark that is slightly different from the registered mark which may subject the registered mark to cancellation under the PRC trademark law. In practice, we have seen quite frequent inconsistent use during IP due diligence. In the hypothetical, for instance, assuming XYZ is registered as a mark, XYZ entities may have been using "xyz" in small letter or "XYZ Suzhou" attached with the product Widget B. Both "xyz" and "XYZ Suzhou" are unregistered marks.



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sophisticated if they are not represented by good international counsel. Therefore, foreign Buyer may try to negotiate an indemnification clause with fewer restrictions. Since most IP to be transacted is registered in China, due to the low damages award, the total indemnification amount should be substantially lower otherwise it would be harder for the Chinese Sellers to accept and for the PRC government to approve.

D. IP Disclosure Schedules

The IP Disclosure Schedules are the curve-out of IP warranties and representations, but often time overlooked in drafting. Buyer's counsel should keep an eye on this as early as due diligence phase, although it is Seller's counsel who should ultimately provide the disclosures. Without a careful administration and cooperation by the counsel for both parties, delay in providing the IP disclosure schedules may occur which may ultimately delay the deal process.

VII. Summary

ABC-XYZ acquisition could be dependent on so many factors, including the intervention and favor or disfavor from the Chinese government. But one thing is clear, that foreign Buyers who understand Chinese social and cultural sensitivities, and who comprehend IP issues specific to China better, are likely to succeed in these transactions.