IP issues in outsourcing

Companies which are considering outsourcing should bear in mind the myriad of issues that could arise in relation to intellectual property

By **Bonan Lin** and **Fei Peng,** Zhongzi Law Office

Outsourcing is a business practice in which enterprises entrust specific external entities to take on parts of their business activities. Outsourcing is generally prevalent in business areas such as production, sales, research and development and human resources.

Outsourcing may involve a myriad of IP issues, such as ownership of technological achievements, protection of trade secrets, reward or remuneration for individuals who develop employment-related technologies, rights and obligations of the common proprietors in a joint ownership and infringement of third-party IP rights.

Ownership

'Technological achievement' means a technical solution which relates to a product, process, material or improvement thereto made by utilising scientific and technological knowledge, information and experience. Technological achievements can include patents, patent applications, technical secrets, computer software, integrated circuit layout designs and new plant varieties, among others.

According to the Patent Law, for an invention jointly created by two or more parties, or created by a party in execution of a commission given to it by another party, the right to apply for a patent belongs to the party or parties that jointly created the invention, unless otherwise agreed. After the application is approved, the party that applied for the patent shall be the patentee.

Similar provisions can be found in the Contract Law, according to which:

- unless otherwise agreed by the parties, the right to apply for a patent on an invention resulting from a commissioned development belongs to the developer;
- unless otherwise agreed by the parties, the right to apply for a patent on an invention resulting from a cooperative development belongs jointly to the parties thereto; and
- the right to use and transfer the technical secret resulting from a commissioned or cooperative development, and the method for allocating benefits that accrue therefrom, shall be agreed by the parties. Where such matters are not agreed or the agreement is unclear and cannot be determined in accordance with Article 61 of the Contract Law (according to which the parties involved may agree on supplementary terms through consultation to determine such matters; if a supplementary agreement cannot be reached, such matters shall be determined in accordance with the relevant provisions of the contract or the transaction practices), all of the parties are entitled to use and transfer the technology, provided that the developer in a commissioned development does not transfer the technology to a third party before it delivers the technology to the commissioning party. This includes circumstances in which any involved party has the right to use the technical secret by itself or to allow other parties to use the technical secret through an ordinary execution licence without the other party's consent and to retain exclusively the benefits that accrue from such use. If

> “If one party to the outsourcing independently infringes third-party IP rights, this party shall be liable for the infringement; other parties not involved with the infringement shall be free from liability”

one party assigns the right to transfer the technical secret to a third party or allows a third party to use the technical secret by way of an exclusive or sole licence without the other party’s consent or subsequent ratification, such assignment or licence shall be deemed invalid.

The “individual who made the invention”, as referred to in the Patent Law and the Contract Law, includes a person who independently or jointly made the inventive contribution to the technological achievements – in other words, the inventor or creator of the technological achievement. On determining the inventive contribution, it is necessary to analyse the substantive technical constitution of the involved technological achievement. The person who suggested the substantive technical constitution and thus realised the technical solution is deemed as the person who made the inventive contribution.

As stated above, according to Article 340 of the Contract Law, unless otherwise agreed by the parties, the right to apply for a patent on the invention resulting from a cooperative development belongs jointly to the parties therein. Under the mode of such co-ownership, the rights and obligations of the parties involved include the following:

- Where a party wishes to assign its joint patent application right, the other parties shall have right of first refusal to acquire such right under the same conditions.
- Where a party in the cooperative development waives its joint patent application right, the other party may apply by itself (or the other parties may jointly apply, if there is more than one). Where a patent is granted on the invention, the party waiving its patent application right may exploit such patent free of charge.
- If a party in the cooperative development does not consent to the patent application, the other party or parties may not apply for a patent.

In accordance with Article 15 of the Patent Law, where the co-owners of a patent application or a patent have concluded an agreement on the exercising of the right, that agreement shall apply. In the absence of such an agreement, any co-owner may independently exploit the patent or license another party to exploit the patent by way of an ordinary licence; any fee obtained from licensing shall be distributed among the co-owners. Except for the circumstances stated above, a jointly owned patent application or patent shall be exercised with the consent of all co-owners.

Reward or remuneration

An employment-related technology is a technology that is developed in the course of completing a task assigned by a legal person or an organisation, or developed by primarily utilising the material and technical resources thereof.

According to Article 326 of the Contract Law, where the right to use and transfer employment-related technology belongs to a legal person or organisation, the legal person or organisation may enter into a technology contract in respect of such employment-related technology. The legal person or organisation shall reward or remunerate the individual who developed the employment-related technology with a percentage of the benefits accrued from the use and transfer of that technology. Where the legal person or organisation is to enter into a technology contract for the transfer of the employment-related technology, the individual who accomplished the technological achievement shall have right of first refusal to be the transferee under the same conditions.

Meanwhile, in accordance with Article 16 of the Patent Law, the rights holder shall reward the inventor or creator of a service invention and, on implementation of the patented invention, shall pay the inventor or creator a reasonable remuneration based on the extent of distribution and application and the economic profits yielded therefrom.

Chinese law also includes provisions on the amount of the reward or remuneration for the developer (inventor) of an employment-related technology. In accordance with the Law on Promoting Transformation of Scientific and Technological Achievements, where a party which has accomplished an employment-related scientific and technological achievement transfers that achievement to another party, it should set aside not less than 20% of the net income accrued from such transfer to reward the person(s) who made a significant contribution to the accomplishment and transformation of the achievement. Where an enterprise or institution has succeeded in the transformation of a scientific and technological achievement which was made through research and development independently or in collaboration with another party and put it into operation, it should set aside not less than 5% of newly added profit accrued from exploitation of the achievement during a successive period of three to five years to reward the person(s) who made a significant contribution to the accomplishment and transformation of the achievement. Joint stock enterprises may, in accordance with relevant state provisions, convert the remuneration or reward into shares or capital contributions to grant to the person(s) who made significant contributions to research and development, exploitation and transformation of the scientific and technological achievement. Rights holders are entitled to share profits in proportion to the shares or capital contributions.

Finally, according to the implementing regulations of the Patent Law, on the manner and amount of the reward and remuneration as prescribed in Article 16 of the Patent Law, the rights holder may enter into a contract with the inventor or creator, or provide for this in its rules and regulations formulated in accordance with the laws. Where the rights holder has not entered into a contract with the inventor or creator on the manner and amount of the reward as prescribed in Article 16, nor provided for this in its rules and regulations formulated in accordance with the law, it must, within three months of announcement of the grant of the patent right, award to the inventor or creator of a service invention a sum of money as a reward. The reward for an invention patent shall not be less than Rmb3,000; the reward for a utility model or design patent shall not be less than Rmb1,000. Where an invention is realised on the basis of an inventor or creator's proposal adopted by the organisation to which he or she belongs, the rights holder shall award to him or her a monetary reward on favourable terms.

Where the rights holder has not entered into a contract with the inventor or creator on the manner and amount of the remuneration as prescribed in Article 16, nor provided for this in its rules and regulations formulated in accordance with the law, it shall, after exploiting an invention patent for the duration of the patent right, draw each year from the profits from such exploitation of the invention or utility model a percentage of not less than 2%, or from the profits from exploitation of the design a percentage of not less than 0.2%, and award it to the inventor or creator as remuneration. Alternatively, the rights holder may, by making reference to these percentages, award a one-off lump sum to the inventor or creator as remuneration. Where a rights holder authorises any other party or individual to exploit its patent, it shall draw from the exploitation fee that it receives a percentage of not less than 10% and award it to the inventor or creator as remuneration.

Protecting trade secrets

'Trade secrets' refers to any technology information or business operation information which is unknown to the public, can bring about economic benefits to the owner, has practical utility and for which the owner has adopted confidentiality measures.

The following behaviours are deemed to infringe trade secrets:

- obtaining an owner's trade secrets by theft, enticement, intimidation or any other unfair means;
- disclosing, using or allowing another party to use trade secrets obtained from the owner by the above-mentioned means; and
- disclosing, using or allowing another party to use trade secrets that a party possesses

in violation of an agreement, or contrary to the owner's demands.

A third party which clearly knows or ought to know that the case falls under the above-listed unlawful acts, but which nonetheless obtains, uses or discloses another party's trade secrets, shall be deemed to have infringed the trade secrets.

One of the ways in which to determine a trade secret is if the owner has adopted confidentiality measures in order to protect such a secret. The owner is said to have taken sufficient confidentiality measures if it:

- limits access to the classified information and notifies the contents thereof only to relevant personnel, who must be aware of the information;
- keeps the classified information under lock and key;
- attaches a confidentiality sign to any vessel in which the classified information is stored or carried;
- password protects the classified information;
- concludes a confidentiality agreement with any other party that has access to the information;
- limits visitors to any classified premises (eg, factory, workshop) or requests visitors to sign a confidentiality agreement; or
- takes other reasonable measures to guarantee the confidentiality of the information.

During the outsourcing process, if the owner has to let the other party know or use its trade secrets, the first, fourth and fifth measure above are the best options. A confidentiality agreement not only binds the other party involved in the agreement, but can also be used as evidence in case the confidential information is leaked, thus proving that the owner had adopted confidentiality measures.

Third-party patent rights infringement

If one party to the outsourcing independently infringes third-party IP rights, this party shall be liable for the infringement; other parties not involved with the infringement shall be free from liability.

In cases where all of the parties are associated with the infringement, it is possible for each party to bear liability individually. For example, if one party produced the infringing product and awarded the sale of the product to the other party, and there was no intentional liaison or division and cooperation between them, the two parties will bear liability individually, as the Patent Law has stipulated relatively independent infringement acts, such as producing and selling. Meanwhile, according to the Patent Law, if the seller is unaware that the infringing product was manufactured and sold without the patentee's authorisation, it shall not be liable to compensate the patentee for damages, provided that it can prove that it obtained the product through a legitimate channel.

There is also another feasible circumstance in which the actions of both parties in outsourcing constitute joint infringement and the parties shall bear joint infringement liability. Although there are similarities between joint infringement under Chinese law and indirect infringement under foreign laws, many differences exist.

According to trial practice in China, the following behaviour will likely be deemed as joint infringement:

- One party induces, incites, abets or helps the other party to implement the infringement;
- One party provides, sells or imports materials or parts and components exclusively used for producing a patented product to the other party, or provides, sells or imports materials, equipment or devices exclusively used for implementing a patented method;
- Two parties in outsourcing cooperate with each other to exploit cooperatively another party's product patent or method patent; or
- There is division and cooperation between the two parties to use a part or component of an infringing product to produce and sell another product.

中咨律师事务所
ZHONGZI LAW OFFICE

Zhongzi Law Office
7F, New Era Building, 26 Ping'anli Xidajie
Beijing 100034, China
Tel +86 10 6609 1188
Fax +86 10 6609 1199
Web www.zhongzi.com.cn

Bonan Lin
Managing partner
bonanlin@zhongziip.com

Bonan Lin is the managing partner at Zhongzi Law Office. His practice focuses on IP strategic counselling and litigation. His extensive experience encompasses patent procurement, patent re-examination, appeal and invalidation proceedings and validity, patentability and infringement issues in polymer science, organic chemistry, pharmaceuticals, new materials and chemical engineering.

Mr Lin is the co-author of *Chinese Patent Course*. He is an arbitrator at the China International Economic and Trade Arbitration Commission and serves as vice president of the All China Patent Attorneys Association.

Fei Peng
Senior associate
pengf@zhongziip.com

Fei Peng is a senior associate at Zhongzi Law Office. His practice covers patent preparation and prosecution, invalidity and non-infringement opinions, particularly related to the chemical and chemical engineering sciences. He has represented a variety of multinational clients in Chinese administrative and civil litigations in protecting patents and trade secrets.

Between 1993 and 2002 Mr Peng was a judge in a local court in Henan Province. He has a BA in chemistry from Wuhan University and an LLM from Tsinghua University.