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Technology And IP Focused Joint Ventures, Collaborations & Alliances – Part I

*The following report is based on a seminar with the above title presented April 15, 2010, by Weil, Gotshal & Manges LLP. In this issue we provide a summary of Part I of the seminar. In the July issue, we will present a summary of Part II of the seminar in which issues relating to China and India are discussed. The panel for Part I includes **Michael A. Epstein**, a partner in the firm's New York City office and a recognized expert in intellectual property law; **Charan J. Sandhu**, a partner in the firm's New York City office who concentrates in the areas of complex technology transactions and intellectual property; and **William M. Gutowitz**, a partner in the firm's New York City office who heads the firm's Financial Services M&A practice.*

Epstein: During this discussion, there will be a lot of references to the term “joint venture” or “JV.” We will be using those terms in the broadest sense, namely as an association or collaboration of independent entities that combine resources for a defined commercial purpose and share risks and rewards. Joint ventures can take many forms. For example, it could be an independent entity having its own management and governance or it could be a contractual arrangement where a separate entity is not formed.

There has been an uninterrupted period of steady growth in joint venture activity beginning in 2004 and continuing through 2008. During the same period of time, there has been acceleration in the number of major companies that are using their Web sites to seek out joint venture partners or collaborations.

It is no surprise that with this type of advertising going on, the number of JVs

is increasing. This corresponds to a recent survey of senior business executives that found that 50 percent expect that their company will increase joint venture activity in the next two years, and 65 percent have a positive attitude towards their future joint venture activity.

A number of factors contributed to this rise in collaboration and joint venture activity. The economic climate played a role. An increase in JV activity generally correlates with economic recessions and periods of lower merger activity. JVs have lower capital and liquidity requirements compared to hundred-percent acquisitions.

Lack of credit also played a role in joint venture activity because this activity surged when acquisition financing dried up. Also, the march to globalization has contributed to joint venture activity. JVs and other forms of collaboration have proven to be good ways to access foreign markets.

The number one reason, by a significant margin, given by top senior executives for forming a joint venture, is to expand within their own industry. The typical JV partner is likely to be an actual or potential competitor. This fact has real implications for how one shares intellectual property and technology with a joint venture partner and for what happens if the JV folds and it possesses shared technology and IP that the JV may have developed.

A survey found that 52 percent of senior executives felt that JVs in which their companies participated met or exceeded expectations. That percentage was even greater in the high-tech industry (64 percent) and the media industry

(73 percent).

An alignment of interests among the parties creating the JV is essential. There must be a transparent understanding of the reasons that the JV is being formed and the benefits that each party expects to receive from the JV. If this transparency is not present, the JV is likely not to succeed. JVs require continuing maintenance and diligence. If they are going to be successful, joint ventures require ongoing tender loving care.

Intellectual property or IP refers to patents, copyrights, trademarks and trade secrets. One of the key activities that the parties must undertake before going into a JV is due diligence with respect to IP – both offensive due diligence and defensive due diligence. We are going to focus on intellectual property, so I am not going to get into non-IP due diligence, which is certainly as important.

As to IP, parties want to look at validity, enforceability, ownership, scope and protection. If intellectual property is going to be transferred, you want to understand where third-party consents are necessary. You want to look at any IP-related litigation. Are there any claims or other circumstances that could ripen into litigation? Are there any open source software issues? Are there any privacy and data protection issues – particularly if the joint venture is going to be involved in activities in Europe where data protection takes on greater significance? Remember, IP issues are not limited just to “tech-heavy” industries.

It is important to do due diligence on the local legal regime. In the case of an international joint venture, there are at least three aspects to the local legal

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Michael A. Epstein



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William M. Gutowitz

regime that need to be considered. One aspect is what the laws say. The second is whether they are enforced. It may not matter what the laws say if they are not enforced. The third is the actual practice, the legal “lore” in the particular country.

If a joint venture is going to do business in a particular country and intellectual property is going to be developed in that country, one needs to know whether there are restrictions on the ability to transfer that intellectual property out of the country. Does that country provide protections for intellectual property – both IP that is transferred to a venture in that country and intellectual property that the venture develops? Are there likely to be any changes of law? What are the risks of doing a venture with a state-owned entity?

The fate of the joint venture formed in 1996 between the French Danone Group and the Chinese Wahaha Group to manufacture bottled water is instructive. The sole contribution of the Chinese company to the JV was its trademark, and the Chinese parent company agreed not to use the trademark for any independent business activity.

In 2000, the Chinese company began to create a series of companies that made the same product and were not involved in the joint venture. They put the trademark, which they had exclusively licensed to the JV, on the products of these companies. As a result the JV faltered. After much litigation the Chinese company made a significant payment to Danone, and the JV folded. This certainly didn't end up the way the parties would

have wanted up front.

What are the lessons learned? You have to do sufficient diligence on your partner. The agreement between the parties should provide specifically for how breaches will be handled. Venue, jurisdiction, and choice of law in these types of situations are important. Agreements should be structured to avoid multiple concurrent litigations.

In addition to due diligence, prior to the formation of a joint venture it is important to develop an intellectual property strategy. This strategy should focus on what IP each partner is going to transfer to the entity as well as on the general range of IP that the entity is going to develop and what rights the partners should have during the term of the JV and at the end of the venture. You may not get everything you want, but these are the issues to think about.

One IP strategy to consider is what is called a “black box” strategy. This strategy keeps the IP crown jewels out of the venture so that there can't be any reverse engineering or misappropriation of the relevant trade secrets. Another approach is a “killer apps” strategy whereby a partner that initially contributes the intellectual property stays relevant by continuing to invest in the IP so as to supply improvements and additional intellectual property to the venture. Consideration might also be given to withholding truly sensitive information until a late stage after the JV has proved out.

Part of the IP strategy should be minimizing technology leakage. Be sure you are going to employ traditional trade

secret confidentiality best practices. In addition, other mechanisms can be built into the joint venture that will maximize protection:

Can the operation of the joint venture be compartmentalized so that no one person has full appreciation and knowledge of the entire scope of the technology?

Will the counterparty agree to establish an IP protection committee which will take responsibility for the protection and the integrity of both the transferred intellectual property and the developed intellectual property?

Can one build into the structure periodic audits by the party contributing the intellectual property to make sure that the intellectual property is being handled consistent with the agreement and with best practices?

Can one include a provision that says that intellectual property can't be transferred by the venture without the permission of the partners or parents of the venture?

Can provisions be included that would allow the partners individually to enforce the various intellectual property laws so that they would have appropriate standing in the relevant jurisdiction?

Is it possible on a regular basis to conduct joint training on confidentiality so that there can be no excuse for a person at the JV to claim they didn't know what the rules were?

All of the above may not completely solve the problem, but they do provide ways to protect technology and intellectual property. The key to protecting the interests of the JV and its partners in the

IP is the multifaceted diligence that we discussed and the development of an IP strategy along the lines just set forth.

Charan and Bill will now discuss IP in connection with negotiating, forming, operating and terminating a JV.

Sandhu: I am a Technology and IP Transactions partner, and I have spent a significant amount of my time doing joint ventures in the United States, Europe, the Middle East and Asia. My partner in this part of the seminar is Bill Gutowitz, an M&A partner who I have worked with on many of these joint ventures.

JVs are interesting deals and particularly challenging in that they require solving fairly complicated multi-variable problems. The magic in these deals is taking the various structuring vehicles that we will discuss and putting them together so as not only to maximize the profitability of the joint venture but also to make sure that you as a partner in the JV are not impairing your independent business interest in the IP and technology.

There can often be a competing dynamic between a JV partner's interest as a JV owner and interest in the IP and technology being contributed. On the one hand, it may be in your interest as a JV owner to contribute sufficient IP so that the JV is a commercially viable entity and has a destiny of its own. On the other hand, you may want to retain or control rights to your IP and technology being contributed to the extent possible for other business objectives.

The key issues that we will go through are essentially these: How do you start thinking about what IP you will put into the JV and how will the JV use that IP? Should it be transferred by assignment or by a license? Should there be royalties or will it count towards capital contribution? Will there be exclusivity? Should there be a "hunting license" that involves an ongoing obligation to commit technology to the JV? And, what limitations do you want to put in place to any contributions?

During the term of the JV, who will own the "foreground IP," which is the IP created by the JV alone or in combination with its JV partners? Should there be any different result on ownership if any of the foreground IP the JV creates is an improvement on any IP contributed by a partner?

Finally, this is where Bill will join me, we will talk about termination and who owns the IP on termination. This will vary based on what the termination scenario is – whether it is buy/sell, liquidation or a run-off of some sort before liquidation. Another complicated issue on termination is whether the other partner will have continuing access to what we call "background IP," which is IP licensed by any of the partners to the JV.

It is important to consider how a partner will put IP into a joint venture. These include assignment, exclusive license, non-exclusive license, or supply of components that embody but do not disclose the IP. You should really stop and consider the consequences of an outright assignment or exclusive license where you give up all or a portion of your rights to the IP. This includes scenarios where you assign the IP to the JV, but you take back a license that is either exclusive or nonexclusive.

Then there are ways that IP can be made available to the JV without creating problems for the IP contributor vis-à-vis other business objectives. You have essentially no IP issues in using IP for other objectives if you grant a nonexclusive license to the JV. The most complete protection of your IP can be achieved by using a "black box" approach whereby you supply components embodying the IP to the JV. If I have, say, a \$500 million invention to an integrated circuit that is useful in a mobile application, instead of putting the technology into the JV so that the JV then controls it and knows it and understands it, I'll sell the commercial end product of the IP (i.e. the integrated circuit) to the JV. That way you safeguard your IP. This approach can be particularly effective for any IP that you value as your crown jewels.

In terms of ease of implementation, outright assignment in full and the IP terms of the component supply (but not necessarily the commercial terms) are typically easier to negotiate. Licensing can be more complicated because you may have to negotiate things like exclusivity and fields of use.

In terms of completeness of protection, in certain jurisdictions where IP enforcement may be lax you have to be aware that your IP could grow legs and essentially move into other hands under circumstances where you can do little to protect it. When you consider the risk of

such leakage and which of these structures will protect my IP the best, you generally conclude that the best solution is component supply.

Often, one of the key reasons that parties will consider a license over an assignment is the ability for a partner to retain rights to the IP, particularly on termination of the JV. Our experience has been that with certain types of termination events, it may be harder for a variety of reasons to reacquire your IP. If you have assigned your IP to the JV, it can, generally speaking, be harder to get back upon termination and liquidation. On the other hand, licenses by partners to the JV often simply fall away at the end of the JV with the JV partners retaining rights to their IP, with some exceptions for transitional periods for certain termination scenarios. The ability to obtain rights after termination can be of critical importance to the structuring, particularly if it turns out that you have negotiated a deal where you can't get your technology back at the end. You have to think very hard about what you are putting into the JV in that case.

What ends up happening is that you have to look at this technology by technology, and there is really not a one size fits all methodology or paradigm. You are not going to find one structure that will work in every JV, and there may not be one structure that will work for every technology in the JV. You should consider how important the technology is in your core business, and if it is particularly vital, maybe you can go the route of component supply or grant a nonexclusive license. However, as soon as you start asking for your IP to go into the JV on a limited basis, you can expect your partner to ask for similar limitations.

Issues can arise during the operation of a JV as well. By way of example, let's assume that one partner in a JV exclusively licenses certain advanced, cutting-edge technology to the JV, and the second partner assigns its more mundane technology to the JV. What happens then if the JV, using the first partner's licensed-in technology, develops an improvement to that technology that could also be used in that partner's business. In the absence of a prior agreement, who should own that improvement could become a hotly contested matter.

Issues can also arise where technology is developed independently by the JV

without using a partner's base technology but where the developed technology may be applicable to the partners' separate businesses. This too can give rise to conflict in the absence of a prior agreement.

The ownership structures for the different types of IP developed by the JV can vary. You can have ownership by the JV. You can have joint ownership by the JV and a partner, but the arrangements for this structure will generally need to be fairly complex. Another option can be ownership by the JV and license to a partner to share the IP. Finally, there is ownership by the partner with a license to the JV. This latter is rarer. It can happen in situations where there's joint development.

Gutowitz: There's no question that issues surrounding termination are often the stickiest structuring issues in forming a JV. It's tough to talk about divorce before you're even married.

The issues are particularly acute in the context of a JV where one of the partners has contributed competitively important intellectual property. We are not just talking about JVs that rely heavily on copyrights and patents, but also JVs to which a party will contribute valuable trade secrets, processes and knowhow.

In the termination context, you have to realize that what you may be doing is creating a competitor in a post-termination world. After a termination, your partner or a third party may end up acquiring the JV or the IP you contributed. Even if that's not the case, your partner may end up becoming educated in how to be a competitor through its involvement in the JV.

One important structuring goal is to avoid premature termination in the first

instance. Before you get involved in a JV, understand your partner's interests and goals. Are they consistent with yours, are they going to change over time, is there a shared vision among the partners on such things as how to move forward, governance of the JV, funding and product development? Are the partners compatible with respect to business culture, approaches to compliance and employee attitudes?

These factors are particularly important when you are dealing with cross-border JVs in which each partner brings to the table people with different experiences and from different environments. You also need to deal with inherent conflicts of interest by creating mechanisms to deal with those conflicts. All of these things sound straightforward, but in the heat of the deal, when these issues come up there is often a tendency for people to say, we'll deal with those issues later, we'll work it out in the JV.

It's better to address potential conflicting goals or approaches in advance, and one mechanism I've found that really helps to get the business people thinking about these things is to create an initial business plan before the JV is launched. This provides the business folks on both sides with an opportunity to sit down and work through exactly how the JV is going to be structured, its organization, profit goals, and markets that will be pursued, and perhaps to discuss how they plan to roll out and develop the technology.

To develop a JV structure that does not create incentives towards premature termination, you need to look very carefully at the interplay of deadlocks both at the board and partner levels, the events that can give rise to JV termination and

the consequences of termination. Try to create incentives for the partners to work out problems rather than to "game the system" by creating deadlocks or taking other actions that result in termination. Often the initial reaction is to say, well, if there is a deadlock we terminate – but that's often the last thing you want to have happen. There should be very few disagreements that merit termination and that cannot be resolved by either escalating the dispute within each partner's organizations or simply not going forward with the particular proposal. The key is to create incentives to resolve the dispute, rather than to terminate and have to deal with the serious consequences of a JV termination.

Sandhu: It's really good to have a prenup because, as Bill has mentioned, any termination is messy. Essentially the JV will end up having a life of its own, and where you start off at the beginning of your marriage is not where you're going to end up with the divorce.

Complicated issues arise on termination if the JV has granted a partner or third party a license to use its IP. Also, decisions must be reached with respect to ownership of the JV's foreground and background IP.

The final point I would make, especially in a foreign jurisdiction, is that you may want to structure a JV one way and the law may not allow you to do so. China and India are good examples of some of the issues that may be faced when JVs operate in those countries. See Part II of this report in the July issue of *The Metropolitan Corporate Counsel's* coverage of those issues.

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Technology And IP-Focused Joint Ventures, Collaborations & Alliances – Part II: Focusing On China And India

The following report is based on a seminar with the above title presented April 15, 2010, by Weil, Gotshal & Manges LLP. In the June issue, we featured a summary of Part I of the seminar. In this issue, we present a summary of Part II of the seminar in which issues relating to China and India are discussed. The Panel for Part II (participating by telephone) consisted of **Anthony Wang**, a partner in the firm's Shanghai office, which he helped to launch in 2004, with a practice that concentrates on complex private equity and venture capital transactions, cross-border mergers & acquisitions and capital markets transactions, and **Dev Robinson**, a partner in Amarchand Mangaldas's Intellectual Property Department, based in New Delhi. His practice focuses on patent and design laws and in the law of confidential information, with emphasis on licensing, litigation, prosecution and advocacy.

Wang: I'm not sure how much of the audience here has experience in dealing with China, so I'll give a brief history of China's foreign investment landscape. Historically, particularly prior to China's entry into the WTO, joint ventures were the main vehicle used by businesses interested in entering the Chinese market.

After China entered the WTO, many foreign companies chose to establish their own subsidiaries in China. However, given the credit crunch resulting from the global recession and a host of other business reasons, we note that foreign businesses are increasingly looking at joint ventures – whether with state enterprises or private local counterparties – to conduct business in China.

Moreover, in certain restricted industries, often technology focused or in other sensitive industries, which are simply off



**Anthony
Wang**



**Dev
Robinson**

limits to foreign-controlled companies, JVs with local partners are the only way to go in China.

Earlier today my colleagues spoke about a number of critical IP issues affecting JVs. Now, I would like to cover a few of the special considerations relating to JVs in China based upon its legal framework.

Under applicable Chinese law, a foreign invested enterprise (or an FIE), which includes the commonly used Sino-foreign equity JV, will have a fixed total investment amount, including a government-approved registered capital that is sufficient to fund the JV's business. The registered capital essentially represents the JV partners' equity contribution and the cash portion of the registered capital contribution should be at least 30 percent of the total amount invested. The remaining 70 percent of the registered capital can be funded by in-kind (noncash) contribution such as land, intellectual property rights and other tangible assets.

While the registered capital may be contributed in one lump sum, typically a minimum required portion is contributed up front, with the balance contributed within two years. Nevertheless, all forms of capital contributions, whether in cash or in-kind, will have to be verified by the relevant government authorities.

As I will discuss in more detail below, if the partner to a Sino-foreign JV intends to contribute intellectual property rights as its equity contribution (or a portion thereof) to its registered capital, then such contribution will be subject to even more stringent governmental approvals and oversight. However, if the foreign partner does not intend to contribute such intellectual property rights to the JV's registered capital, there will generally be a bit more flexibility. Nevertheless, any other IP contribution arrangements that do not involve registered capital contribution, including licensing arrangements, are still subject to some forms of regulatory approval.

Earlier today, Michael Epstein mentioned the famous Danone-Wahaha dispute, which demonstrates how important it is for foreign parties to carefully navigate the existing legal and regulatory framework in China. For example, under applicable PRC laws, certain restrictions on a licensee's ability to use improvements or that impose other restrictions may be prohibited by the Chinese regulators. In China, improvements in the licensed IP are generally owned by the licensee. Moreover, licenses of such improvements back to the foreign licensor or to a third party are also subject to PRC regulatory requirements, as well as potential export control requirements.

Returning to the issue of a foreign JV partner's capital contribution, I note that the PRC Company Law expressly contemplates that intellectual property rights may be properly used as noncash consideration to represent a partner's contribution to a JV's registered capital. While the term "intellectual property rights" is not specifically defined under the PRC Company Law, we typically think of such rights to include patents, trademarks, copyrights and

For questions about Part II of the seminar, please email anthony.wang@weil.com or dev.robinson@amarchand.com. For questions about Part I of the seminar or to access a video, please email michael.epstein@weil.com, william.gutowitz@weil.com or charan.sandhu@weil.com.

know-how. However, for purposes of registered capital contributions, the Chinese government generally does not consider the license of such rights to be intellectual property rights.

As a general matter, a license to IP rights would not constitute valid intellectual property rights for purposes of registered capital contributions, absent special governmental approvals or exemptions. The general principle in China is that intellectual property rights that are contributed to the joint venture's registered capital must be fully and independently owned by the joint venture and a grant of a license is deemed to be inconsistent with such general principle. Specifically, in order for the assignment of any assets to be recognized as a valid registered capital contribution, it is necessary that they be assets that the JV can fully own, exploit and dispose of without undue restrictions. Consequently, given such full ownership requirements, it's even more critical for foreign partners who intend to share intellectual property rights with the JV to determine the costs and benefits of contributing such rights as registered capital.

In light of the foregoing requirements, steps that a foreign party may typically expect to take to protect and preserve critical intellectual property rights may be problematic when contributing such intellectual property rights as registered capital. For example, an express reservation of rights in connection with an assignment could be deemed to be unduly restrictive and therefore not a valid assignment. Also, one cannot assign IP rights to the JV solely to the extent necessary to operate the company's business but otherwise retain ownership rights to use the IP rights in areas outside the PRC company's business.

As my time is winding down here, I will quickly wrap up by saying that even when the issues I have discussed have been addressed, a foreign partner in a JV will need to go through a qualified appraisal process to assure regulators as to the value of the IP. In this regard, it's critical to have discussions on formal and informal levels among the parties, the government regulators and the qualified appraisers, so that any contribution of intellectual property is handled in a way that that reflects the commercial intent of the JV partners. Dev will now discuss the Indian considerations.

Robinson: India is an attractive destination for a potential JV setup. Our system of law is like that in the United States, however, it's practiced differently. We are a common

law jurisdiction. We do have a rule of law. We can go ahead and sue the government if that is what it comes down to. We have a large English-speaking population, which is of help when communicating internationally.

The intellectual property law system here is considered fully TRIPS compliant. That means that there are no surprises about how an intellectual property is going to be secured, how it's going to be leveraged and what minimum rights an intellectual property holder can expect.

Before I get onto the JVs I will briefly touch on some IP cases. Two recent cases that limit patent rights deserve mention. The recent case of *Chemtura Corp. v. Union of India* held that an infringing manufacturer was not liable for infringement simply because the infringer was manufacturing the products for use by the government. In India, government use is an exception to IP rights. Therefore, the use was held to be non-infringing even if the manufacturer didn't have a license.

Hoffmann-La Roche v. Cipla stands for the proposition that public interest in a life-saving drug outweighs the public interest in granting an injunction in interim proceedings to the appellants. This was the first case to deal with infringement of a patent on a molecule. The court reasoned that an interim injunction should not be granted to prevent the production by Cipla of a life-saving last-resort cancer medicine incorporating a molecule patented by Hoffmann-La Roche because that company alone could not supply an adequate amount of the medicine at an affordable price. Besides, the defendant was able to demonstrate a credible challenge to validity.

In *Bajaj Auto Ltd. v. TVS Motor Company*, it was held that an injunction is not automatically voided by making a counterclaim for revocation. In *Bayer Corporation v. Union of India*, the court held that Bayer could not link marketing approvals for products as a basis for manufacturing medicines that were under patent. The court held that whether patent linkages should be introduced requires a policy decision by the government.

The law of confidential information is becoming stronger in India. Protection of confidential information is being viewed here as a far more technical subject with the result that our courts have recognized the need to provide greater detail with respect to its definition and the steps that must be taken to protect it.

As far as joint ventures are concerned, the regulatory framework is not as dracon-

ian as it used to be in the past. In fact it's now rather friendly and moves along quickly. Very briefly, there are some guidelines that have to be followed when investing in certain business categories. The Reserve Bank of India has guidelines on the repatriation of investments, and there are some caps on the percentage interest of JV partners. Investments are being encouraged in Special Economic Zones and Software Technology Parks that provide tax breaks or easy access to industrial infrastructure in consideration of promoting exports.

Indian companies have in the past looked to JVs as a structure to produce partnerships with Western companies that could help them to cope with the technology deficit. While the total number of patent filings has gone up, a deficit still remains. An Indian partner in a JV frequently looks to its foreign partner for supply and upgrade of technology available to the JV.

What we have noticed in our last few JV transactions is that the Indian partner is less likely simply to agree to the terms proposed by the foreign partner. So, foreign investors can expect a certain amount of horse trading. However, Indian companies are still eager to enter into JVs if the technology carrot can be dangled.

Given the freer market environment that has developed in India in the last four or five years, JVs are still considered a good option for foreign companies that want to test the Indian business climate. Long-term strategies could include buying out the JV partner, e.g. Merrill Lynch (DSP), Morgan Stanley (JM), or selling stake and setting up as a distinct entity, e.g., Goldman Sachs (Kotak Mahindra).

In terms of the regulatory environment, there is an automatic and a government route. The automatic route applies to most sectors now, where there is no cap in terms of repatriation and equity contribution. The government route involves more regulation and applies to certain sectors like atomic energy, lottery, gambling, and multi-brand retail where there is a government interface for approval. In terms of capitalization norms, there are some norms in certain sectors — finance and real estate are two of them.

Sectors that have seen more activity in terms of JVs are fast-moving consumer goods, finance, automobiles, engineering and infrastructure (highways and ports). Notably, some of the larger JVs have been in the infrastructure space. Renault, Walmart, Nissan, Vodaphone and Alstom have all used the JV route to enter India.