Risks of Grant-back Provisions in Licensing Agreements: A Warning to Patent-heavy Companies

By Susan Ning, Ting Gong & Yuanshan Li[1]

I. SUMMARY

In recent years, the interplay between intellectual property rights ("IPRs") and antitrust issues has been on the radar of antitrust authorities in China.[2] Since 2014, the National Development and Reform Commission ("NDRC") and the State Administration for Industry and Commerce ("SAIC") have launched a number of investigations relating to the abuse of IPRs, which includes the high-profile investigation into IDC and Qualcomm.[3] From litigation perspectives, in 2013 Guangdong People's High Court issued a thorough and intriguing verdict on *Huawei v. IDC,* which is an Anti-monopoly dispute regarding the abuse of IPRs.[4]

Against this backdrop, the article will focus on one of the highly controversial issues of IPRs, the grant-back provision, which is widely used by companies doing businesses in China. We will analyze this provision under the Chinese laws, in particular the Anti-monopoly Law of the People's Republic of China ("AML").[5] Lately, this provision has been regarded, by its very nature, as being likely injurious to the proper functioning of normal competition, the article also intends to shed some lights on patent-heavy companies when they do businesses in China.

---

1 Susan Ning is a Senior Partner and Head of Antitrust & Competition at King & Wood Mallesons Beijing office (see: http://www.kwm.com/en/cn/people/susan-ning). Tong Gong and Yuanshan Li are associates of Antitrust & Competition at Beijing office.

2 There are currently three antitrust authorities in China. The Ministry of Commerce ("MOFCOM") is responsible for merger filings; the National Development and Reform Commission is in charge of price-related antitrust issues; the State Administration for Industry and Commerce is entrusted with the non-price related antitrust issues. In practice, there are jurisdictional overlaps between NDRC and SAIC when dealing with antitrust behavioral issues.

3 The NDRC issued the decision suspending its investigation to IDC in May 2014; in addition, the NDRC issued the administrative penalty decision to Qualcomm on February 9, 2015 (the administrative penalty decision of the NDRC [2015] No.1), Chinese version of the decision is available at: http://jjs.ndrc.gov.cn/fjgld/201503/t20150302_666170.html (last visited on January 28, 2016).

4 Appeal case *Huawei v. IDC* on abuse of market dominant position, the verdict of final judgment in Chinese is available at: http://www.cpahkltd.com/UploadFiles/20140418175022999.pdf (last visited on January 28, 2016).

5 Anti-monopoly Law of the People's Republic of China was adopted at the 29th meeting of the Standing Committee of the 10th National People's Congress of the People's Republic of China on August 30, 2007.This Law entered into force as of August 1, 2008.

II. SCRUTINY OF GRANT-BACK PROVISION BEFORE THE ENACTMENT OF THE AML

A grant-back is an arrangement under which a licensee agrees to authorize the licensor of IPRs to use the licensee's improvements to the licensed technology or new application obtained in using the licensed technology.[6] Generally, a grant-back is deemed to have pro-competitive effects of reducing the licensing risks for licensors, promoting investments and application of new technology, and facilitating innovation and competition accordingly. On the other hand, however, exclusive grant-backs may allow licensors to be able to control the improvements or innovative achievements and therefore reduce licensors' motivation to innovate. The latter has become an increasing phenomenon in China. The negative effects of grant-backs on innovation and competition are therefore the focus of China's legislation. Before the enactment of the AML, grant-back provisions in licensing agreements were mainly scrutinized under China's Contract Law, the Foreign Trade Law, and the Regulations on Technology Import and Export Administration.

A. Abusive Use Of The Provision To Exchange Improved Technologies Shall Be Void Under China's Contract Law

According to Article 329 of the Contract Law of the People's Republic of China ("Contract Law"), "a technology contract that illegally monopolizes technology, impedes technological progress shall be null and void."

China's Supreme People's Court further identified circumstances that are applicable to Article 329 of the Contract Law, such as restricting one party from making new research and development on the basis of the contracted technology, or restricting a licensee from properly using the improved technology, or imposing unfair and disproportionate conditions on either of the parties exchanging the improved technologies. As an example, a provision that includes the following content will be automatically void: requiring a licensee to gratuitously provide the licensor with the improved technology; or transfer improvements to the licensor non-reciprocally; or the licensor jointly or solely owns the IPRs of the improved technology without consideration.[7]

B. Exclusive Grant-Backs Are Of Competition Concerns

According to China's Foreign Trade Law, where the IPR owner is involved in incorporating an exclusive grant-back condition in a licensing contract, which impairs the fair competition order of foreign trade, the authority entrusted by the State Council with the task to manage foreign trade may take necessary measures to eliminate such impairments.[8]

---

6 *See* Article 2(2) of Section II, the Draft Antitrust Guideline on the Abuse of Intellectual Property Rights in China (NDRC's part) ("Draft Guidelines of the NDRC"). The NDRC, after about six months of preparation, published its part of the draft about the Antitrust Guideline on the Abuse of Intellectual Property Rights on December 31, 2015, seeking public comments globally. The definition of grant-backs is also available in 5.6 U.S. Department of Justice and the Federal Trade Commission, Antitrust Guidelines for the Licensing of Intellectual Property, April 6, 1995, available at: http://www.justice.gov/atr/public/guidelines/0558.htm (last visited on January 28, 2016).

7 *See* Article 10 (1), the Interpretation of the Supreme People's Court on Some Issues Concerning the Application of Law in the Trial of Technology Contract Dispute Cases. The Contract law was issued on March 16, 1999 and took effect on October 1, 1990.

8 *See* Article 30, Foreign Trade Law which was issued on April 6, 2004 and took into effect on July 1, 2004.

C. Provisions To Restrict Technology Improvements Shall Not Be Included In A Technology Import Contract

According to Article 29 of the Regulations on Technology Import and Export Administration of China, a technology import contract shall not contain restrictive provisions restraining the receiving party from improving the technology provided by the supplying party, or restraining the receiving party from using the improved technology.[9]

In view of the above, the forms of grant-backs that are legally risky are grant-back provisions without any payments, non-reciprocal grant-backs, and exclusive grant-backs. The article will further discuss different forms of grant-backs in the following section III.

III. GRANT-BACK PROVISION UNDER THE AML

First of all, as a general principle enshrined in the AML, the proper use of IPRs is not subject to the scrutiny of the AML. Only the abuses of IPRs are to be held liable under the AML.[10]

Moreover, when assessing a grant-back provision, a licensor's market power is crucial to establish a potential antitrust violation by a grant-back provision under the AML. The stronger the position of the licensor, the more likely it is that exclusive grant-back obligations will have restrictive effects on competition in innovation.[11]

Furthermore, under the AML's analytical framework there are two approaches to assessing a grant-back provision: the rules regarding dominance (Article 17 AML) and the rules regarding vertical restraints (Article 14 AML). It is worth noting that, in practice, we are aware that most grant-backs in China are scrutinized under the dominance rules. It is only in the latest draft of SAIC and NDRC's draft guidelines that it explicitly brings a grant-back provision under the scrutiny of Article 14 AML, which the article will discuss in Section III.B.

A. Grant-Backs Under Dominance Rules

1. Article 17 (1) Of The AML

In light of Article 17(1) of the AML, an operator who holds a dominant market position is prohibited from engaging in selling commodities at excessively high prices.

---

9 The Regulations on Technology Import and Export Administration was issued on December 10, 2001 and took into effect on January 1, 2002.

10 Article 55, the AML.

11 In the Draft Guidelines of the NDRC, it proposed additional factors for assessing whether a IPRs holder has a dominant position on relevant markets, particularly: (1) the likelihood and cost for the transaction counterpart switching to other substitute IPRs; (2) the extent of the downstream market relying on commodities with relevant IPRs involved; (3) the countervailing power of the transaction counterpart to the operators. In addition, in the latest development of the AML, Standard Essential Patents ("SEPs") will not be considered as constituting a single relevant market in which the holder of SEPs has a dominant position *per se*. Instead, the Draft Guidelines of the NDRC furnishes five elements in establishing the market power of an SEP holder.

In the *Qualcomm* case the NDRC stressed that a grant-back requirement is not *per se* illegal but Qualcomm's grant-back requirement was problematic. The underlying reason was that Qualcomm required licensees to license back their non-Standard Essential Patents (non-SEPs), and to grant-back patents of the licensees free of charge. Qualcomm argued that the grant-back requirement was designed to protect its business and to protect its customers from patent infringements. However, the NDRC rejected such argument and ascertained that Qualcomm should respect licensees' innovative achievements and should consider the value of the patents granted back by the licensees, especially in cases where some Chinese licensees also have patent portfolios of high value. Qualcomm's requirement of royalty-free grant-back restrained the impetus for technology innovation, hindered the innovation and development of wireless communication technologies, and eliminated or restricted the competition in the market of wireless communication technologies.[12]

Finally, the NDRC condemned the royalty-free grant-back provision imposed by Qualcomm to the Chinese licensees on the basis that it was in violation of Article 17 (1) of the AML.

In another scenario, the parties may agree upon the pricing conditions on which the licensor will license or sell the improvements of its licensee to third parties. The so agreed proceeds realized from each such licensing or sale shall then be shared between the parties.[13] It is understood that if the original patentees are unable to share the value of their future improvements, they would insist on a higher royalty in order to cover the cost on research and development of the licensed technology, or even decline to license to third parties. Sharing royalties of improvements could facilitate the exploitation and dissemination of new technology. Nevertheless, the Chinese antitrust authorities still raised concerns about such arrangements especially when they are in conjunction with exclusive grant-back agreements, given the licensee still lacks the right of enjoying its absolute interests of innovation in this case.

2. Article 17 (5) Of The AML

According to Article 17 (5) of the AML, an operator who holds a dominant market position is prohibited from engaging in imposing unreasonable trading conditions without justification.

Pursuant to Article 10(1) of the Rules on the Prohibition of the Abuse of Intellectual Property Rights to Exclude or Restrict Competition issued by SAIC on April 7, 2015 ("IP Rules of SAIC"), as an unreasonable trading condition, an undertaking with a dominant position is prevented from requiring the transaction counterpart to exclusively (without any justification) license back the improved technology without justification, which may violate Article 17(5) of the AML.

Provisions of exclusive grant-back are considered to reinforce the position of licensor on the technology and product market, and mitigate the innovation motives of licensees in the relevant market, as their rights of utilizing the improvements are restricted. In line with this reasoning, Article 10(1) of the IP Rules of SAIC provides that an exclusive grant-back has concerns of restricting or eliminating market competition when the licensor occupies a dominant position in the relevant market.[14]

---

12 Point 1-(2) of section 2, NDRC Decision of Administrative Penalty (2015) No.1.

13 The exclusive grant-back refers to the grant-backs that only allow the licensor to implement the improvements or innovative achievements created by the licensee.

14 In the European Union and the United States, an obligation to grant the licensor an exclusive license for the improvement of the licensed technology or to assign such improvements to the licensor is likely to reduce the licensee's incentive to innovate since it

In the antitrust jurisdictions in the European Union and the United States, the effects of exclusive grant-back on competition are considered different depending on whether the improvement under a grant-back obligation is severable from the licensed technology. An improvement is severable if it can be exploited without infringing upon the licensed technology. An obligation to grant the licensor an exclusive license to severable improvements of the licensed technology or to assign such improvements to the licensor is likely to reduce the licensee's incentive to innovate since it hinders the licensee in exploiting his improvements, including by way of licensing to third parties. This is the case both where the severable improvement concerns the same application as the licensed technology and where the licensee develops new applications of the licensed technology.[15] As to the *INCO* case in the United States, the licensees were required to license back only patents that could not be exploited without risking infringement of INCO's basic patent. The court cleared the concerns that INCO's control of the industry is thus substantially increased through the obligation of grant-backs. It asserted that anyone wishing to exploit one of these improvements without the risk of infringement would have to come to INCO for a license regardless of who held the rights to the improvements. In effect, much of the control over the improvements during the life period of the basic patent that INCO gains by the license-backs it already has by virtue of its basic patent.[16]

However, the aforementioned justification for an exclusive grant-back is yet to be tested in China since the attitude of the antitrust enforcement authorities in this regard is still vague. Compared with an exclusive grant-back, a non-exclusive grant-back, which leaves that licensee free to license improvements technology to others, is less likely to have anticompetitive effects.[17]

3. Reciprocal Grant-Backs May Still Trigger Antitrust Risks

In cases where licensees are required to make their improvements to the contractual technology available to the licensor, the licensor is also sometimes obliged to circulate any improvement made by him or any other licensees. As such, either party to the agreement is free to use and benefit from the improvements.

In China, the positive effects of reciprocal non-exclusive grant-backs in promoting competition have been affirmed by SAIC.[18] However, the risk of antitrust concerns regarding reciprocal exclusive grant-backs is not excluded. It is understood when the reciprocal arrangement is in conjunction with exclusive grant-backs, it may facilitate the improvements funneling into the licensor whose power of control on the relevant market ramps up.

---

hinders the licensee from exploiting the improvements, including by way of licensing to third parties. *See* COMMUNICATION FROM THE COMMISSION Guidelines on the application of Article 101 of the Treaty on the Functioning of the European Union to technology transfer agreements (2014) O.J. C89/03 (the "EU Guidelines"), and Section 5.6 U.S. Department of Justice and the Federal Trade Commission, *supra* note 6).

15 *See* point 109, the COMMISSION REGULATION (EU) No 316/2014 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to categories of technology transfer agreements, (21 March 2014) O.J. L 93/17 ("TTBER"). Also Van Bael & Bells, Exclusive Patent Grant-Back License Does Not Violate Competition Law, (published on June 20, 2014), available at: http://www.mondaq.com/x/322080/Patent/Exclusive+Patent+GrantBack+License+Does+not+Violate+Competition+Law (visited on January 28, 2016).

16 The *International Nickel Company, Inc, (INCO) v. Ford Motor Company and Caswell Motor Company, Inc.*, 166 F. Supp. 551; 1958 U.S. Dist. LEXIS 3578; 119 U.S.P.Q. (BNA) 72; 1958 Trade Cas. (CCH) P69,169; see also Van Bael & Bells, Exclusive Patent Grant-Back License Does Not Violate Competition Law, (June 20, 2014), available at: http://www.mondaq.com/x/322080/Patent/Exclusive+Patent+GrantBack+License+Does+not+Violate+Competition+Law (visited on January 28, 2016).

17 Section 5.6, *supra* note 6.

18 Article 18, the Draft Guidelines of SAIC.

4. Other Grant-Backs Scenario With Antitrust Concerns

Although the Draft Guidelines of SAIC and NDRC were not mentioned explicitly, there are other scenarios involving grant-backs that may still trigger the scrutiny of the antitrust authorities when referring to the experience of the European Union and/or the United States.

For example, if the innovation subject to grant-backs occurs very late in the life of the underlying patent or the obligation of grant-backs is not subject to the termination of a license agreement, the result will be to transfer to the licensor a promising patented technology that would otherwise belong to the licensee. This will be considered an anti-competitive effect on market competition so as to create or prolong monopoly unreasonably.[19]

5. Penalties Of Grant-Backs Under Dominance Rules Of The AML

According to Article 48 of the AML, where an operator is condemned for abusing their dominant market position, the competent authorities shall order a halt to the offending behavior, confiscate the illegal earnings, and impose a fine of between 1 and 10 percent of the previous year's sales. In the *Qualcomm* case, the NDRC finally issued an administrative sanction decision finding Qualcomm guilty of breaking the AML. In consideration of other abusive behaviors of Qualcomm, the NDRC laid down a fine in total of RMB 6.088 billion ($975M). Besides, NDRC required Qualcomm to implement multiple measures to fulfill its commitment, one of which is to withdraw the requirement for a Chinese licensee to grant-back their patents to Qualcomm for free in a license agreement.

B. Grant-Backs Under The Rules Regarding Vertical Restraints

The antitrust committee under the state council is in preparation of issuing a consolidated antitrust IP-related guideline. The three leading antitrust law enforcement agencies are currently drafting their IPRs-related guidelines respectively. In addition to the Draft Guidelines of the NDRC, SAIC also disclosed its sixth version of draft Guidelines on January 8, 2016 soliciting public opinions ("Draft Guidelines of SAIC"). In the meantime, the Ministry of Commerce ("MOFCOM") has almost completed its own version and also sought comments among experts. Exclusive grant-backs have been referred to in the published version of the two draft guidelines. In line with the IP rules of SAIC, both the Draft Guidelines of the NDRC and SAIC deem exclusive grant-backs as an unreasonable condition imposed by an undertaking with a dominant position.

The Draft Guidelines of the NDRC, for the first time, introduce an analytical approach for assessing an exclusive grant-back under the vertical rules.[20]

According to the Draft Guidelines of the NDRC, even if the licensor has no dominant market position, exclusive grant-back provisions entered into between operators with no competitive relationship may still raise concerns about eliminating or restricting competition in line with Article 14 of the AML regarding vertical restraints.

---

19 *See International Nickel Co. v. Ford Motor Co.*, *supra* note 16.

20 Article 2(2) of Section II of Draft Guidelines of the NDRC provides four factors in evaluating whether exclusive grant-backs will restrict or eliminate competition, i.e. whether the licensor provides substantial consideration for the grant-back; whether the grant-back is reciprocal; whether the grant-back leads to IPRs funneling to one single entity, resulting in the acquiring or strengthening of the control of the relevant market by the entity; and whether the grant-back damages the incentive of the licensee to innovate.

The Draft Guidelines of the NDRC requires the analysis of vertical agreements including exclusive grant-backs to be made "in combination with items (1) and (2) of Article 14 of the Anti-Monopoly Law." Article 14(1) and 14(2) refer to the resale price maintenance ("RPM") violations. Accordingly, it seems to indicate that vertical restraints in IP agreements including exclusive grant-backs shall be considered as AML violations only if they are related to or involve RPM.

Furthermore, the whole Draft Guidelines of the NDRC do not refer to Article 14(3), i.e. the catch-all provision relating to vertical monopoly agreements other than RPM. In view of this, it seems that only price-related grant-back provisions will likely be subject to the AML rules regarding vertical restraints. Neither the Draft Guidelines of SAIC refers exclusive grant back to any indent of Article 14. Therefore, the following is expected to see in the final version of the guidelines or cases on what approach would be taken by the NDRC in handling grant-backs provision: would they consider exclusive grant-backs as a separate violation or would they only punish it when it is a part of an RPM scheme? Especially it may be technically difficult for the enforcement agencies to "combine" Article 14(1) and 14(2) of the AML during their assessment of such other vertical restraints as exclusive grant-backs.

1. Exemption Of Monopolistic IP Agreements

The Draft Guidance also provides for a rebuttable "safe harbor" for monopolistic IP agreements.

Article 2(3) of Section II of the Draft Guidelines of the NDRC provides that "If one of the following conditions is met, the IPR agreement can be presumed as exempted in accordance with the provisions of Article 15 of AML:

The total market share of the undertakings with competitive relationships in the relevant market is below 15 percent; the market share of each undertaking without a competitive relationship in the relevant market involved by the agreement is no more than 25 percent.

However, the NDRC leaves discretion for its enforcement of the safe harbor. Even if the relevant IPR agreement is in accordance with the threshold of the safe harbor, if the NDRC finds evidence to prove that it restricts competition significantly or consumers are not able to enjoy the benefits, the exemption is not applicable. As Chinese authorities used to refer to the experience in the European Union and the United States, it expects to see if exclusive grant-backs provision could apply under the threshold of the safe harbor in China.[21]

2. Reciprocal Non-Exclusive Grant-Backs Is Generally Cleared Of Antitrust Concerns

SAIC has emphasized in Article 18 of its Draft Guidelines that reciprocal non-exclusive grant-backs generally have no effects of eliminating or restricting competition.

3. Penalties Under The Rules Regarding Monopolistic Agreements

In line with Article 46 of the AML, where a monopolistic agreement is reached and implemented in violation of the AML, the anti-monopoly authorities shall order the operators to cease doing so, and shall

21 In the European Union, provisions of exclusive grant-back are not subject to the block exemption and should be assessed case-by-case. *See* point 109, *supra* note 15.

confiscate the illegal gains and impose a fine of 1 percent up to 10 percent of the sales revenue in the previous year. Where the monopoly agreement has not been performed, a fine of less than RMB 500,000 shall be imposed.

Where any business operator voluntarily reports the conditions on reaching a monopoly agreement and provides important evidence to the anti-monopoly authority, it may receive a mitigated punishment or exemption from punishment as the case may be.

IV. CONCLUSION

In view of the above, grant-back provisions are always under the spotlight of China's laws and regulations, and will also be an enforcement priority of the AML in the future given China is considered as a big IP recipient state. Based on the draft guidelines and published cases under the AML, patent holders should be cautious of including grant-back provisions into license agreements, especially when the provisions impose a free or exclusive grant-back obligation on the licensee. As to other kinds of grant-back requirements, they are not without risk under the Chinese legal regime.

Multinational companies with market power and strong patents (e.g. SEP holders) should therefore be very cautious when reaching agreements involving grant-back provisions. In addition, given the current practical and legal uncertainties, technology-intensive companies specialized in the fields of information and telecommunication, pharmaceuticals, medical devices, automobiles and agriculture machinery are advised to step up their compliance with China's antitrust rules and review their business models and contracts in a timely manner to avoid the potential risk of violating the relevant Chinese laws.