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In Memoriam — Paul S. Turner

Our colleague, Paul S. Turner, served the International Law Section of the State Bar of California as its Treasurer (2005 to 2006), as well as on the Section's Executive Committee first as an Advisor (2002) and then as a Member (2005 to 2006).

Paul died on October 7, 2006, after a six year struggle with lymphoma. He is survived by Linda Turner, his wife of 43 years; their daughter Rebecca and her husband Scott Anthony; Paul's sister, Barbara Turner Sachs; and numerous friends, relatives and associates.

Paul's friend and collaborator, Gerald T. McLaughlin, Dean Emeritus and Professor of Law at Loyola Law School in Los Angeles, recalls:

Paul Turner and I coauthored many articles. Paul was not only a superb lawyer, but a literate man as well. Paul cared greatly about ideas. But now Paul has gone and we mourn his passing.

I have often wondered how to keep the memory and spirit of a colleague and a friend alive. In his novel *The Bridge of San Luis Rey*, Thornton Wilder provides us with an answer. 'There is a land of the living and a land of the dead,' says Wilder. 'The bridge is love, the only survival, the only meaning.' Come back over the bridge any time, Paul. Your friends and colleagues miss you.

Contributions may be made in Paul's memory to Tower Cancer Research Foundation, 9090 Wilshire Boulevard, Beverly Hills, California 90211, www.towercancerfoundation.org.

This edition of the California International Law Journal is dedicated to the memory of Paul S. Turner.

Editor's Comments

In our last issue we introduced several new changes. We renamed our publication The California International Law Journal, we thought the new name was a more accurate description of the topics we cover. Also, notice the new color scheme for the Journal. In addition to those cosmetic changes, we are working diligently on making other changes. This issue contains our first MCLE exam; we intend to provide other exams in future editions. This edition also includes several articles on topics that we believe are front-burner issues for many international business people

We are also pleased to include a non-legal article that focuses on the most important element of any international transaction: communication across borders. During my years of working on international transactions I developed a non scientific system of communication that I hoped effectively bridged the language gap between native and non-native English speakers. I am sure that every international lawyer has developed his or her personal program for cross-border communication. A number of linguists and businesses engaged in international transactions have developed methods to bridge this communication gap. Recently a book was published in France that focused on a simplified English vocabulary designed to enhance cross-border business communication. The book's author Jean-Paul

Nerriere, has written an article for this edition of the Journal explaining his vision of a simplified English method of communication, which he has named "Globish". Mr. Nerriere offers observations and suggestions which we hope are helpful.

Future editions of the Journal will focus on areas that we believe are most relevant based on current events for example, with the increased attention given to Vietnam and its growth, our next edition will include a series of articles on various aspects of doing business in that country.

We look forward to hearing from you with suggestions regarding topics that you think are important and ways in which we can improve this publication. If you have an article that you think will benefit our members or an idea for one please contact me.

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Chinese Tax Considerations for Foreign Investors Structuring Joint Ventures in China

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I. Introduction

This article explores the principal Chinese tax considerations for foreign investors structuring joint ventures in China. This subject matter is by nature extremely broad, with each foreign investor having its own unique tax objectives and concerns. However, there are certain tax-related questions that are almost always raised during the planning stages of the joint venture. Grouped together, these questions relate to:

- How does China tax the foreign investors on income derived from the joint venture in China?
- How does China tax the joint venture vehicle itself?
- How can Chinese taxes be minimized through available Chinese tax incentives?
- What are the top tax management issues facing foreign investors doing business in China?

The discussion that follows examines each of these questions in order.

II. Chinese Taxation of Foreign Enterprises

China's basic framework for taxing foreign enterprises and foreign invested enterprises is set forth in the 1991 *People's Republic of China, Foreign Invested Enterprise and Foreign Enterprise Income Tax Law* ("FEITL") and its regulations ("FEITR"). China's tax treatment of foreign enterprises differs depending on whether the foreign enterprise has a permanent establishment ("PE") in China. Chinese domestic tax law defines a PE to be an "establishment or site" which includes a "management or business establishment, an office, factory, sites for furnishing services and business agents."¹ This domestic law definition of a PE can be modified (usually narrowed) under an applicable income tax treaty.

A. Foreign Enterprises with a PE in China

China taxes the net taxable income of a foreign enterprise with a PE in China at a combined

enterprise income tax rate of 33% (30% national tax plus 3% local tax) with respect to income that is considered "derived from inside China." Income "derived from inside China" includes (i) income of the foreign enterprise from production and business operations in China, and (ii) passive income (such as interest, rent, royalties and certain gains) derived inside or outside China that is connected with the China establishment.²

B. Foreign Enterprises without a PE in China

A foreign enterprise without a PE in China is subject to Chinese tax on its China-source income on a withholding tax basis. An overview of the Chinese withholding tax treatment of dividends, interest, royalties and capital gains is provided below.

1. Dividends

China currently does not tax dividends paid from foreign invested enterprises to their foreign investors. China's income tax treaties generally prescribe a withholding tax rate on dividends ranging from 5% to 10%. Where an applicable income tax treaty provides for a tax rate exceeding that set forth under Chinese domestic tax law, the Chinese tax authorities apply the lower tax rate granted under Chinese domestic tax law. The current withholding tax exemption for dividends forms a part of the favorable tax regime designed to encourage foreign investment. As discussed later below, China is in the process of promulgating a new enterprise income tax law that may end this preferential tax treatment for dividends. Consequently, treaty planning to cap the maximum Chinese withholding tax rate on dividends can be expected to take on greater importance in structuring inbound investments into China. A number of Chinese tax treaties provide for a maximum withholding tax rate on dividends of only 5% including the new China-Hong Kong Double Tax Arrangement (taking effect in 2007) and the China-Barbados Income Tax Treaty.

2. Interest

Chinese domestic tax law taxes China-source interest paid to foreign enterprises at a withholding tax rate of 10%, although the following interest payments are exempt from Chinese tax:

- Interest on loans extended to the Chinese government and Chinese state banks by international financial organizations (e.g.,

International Monetary Fund, the World Bank, and the Asian Development Bank).

- Interest on loans extended at a preferential interest rate to Chinese state banks by foreign banks.

The 10% withholding tax rate on interest is reduced under certain Chinese income tax treaties. For example, the withholding tax rate on China-source interest is reduced to 7% under the China-Singapore Income Tax Treaty but the interest must be paid to a Singapore resident bank or financial institution. A 7% withholding tax rate on interest is also available under the new China-Hong Kong Double Tax Arrangement (taking effect in 2007). Unlike the China-Singapore Income Tax Treaty, the China-Hong Kong Double Tax Arrangement does not condition eligibility for the reduced withholding tax rate on the recipient being a bank or financial institution.

3. Royalties

The withholding tax rate on royalty payments under Chinese domestic tax law is 10%. China grants a tax exemption for royalties paid for the use of certain proprietary technology that is considered advanced or is provided on preferential terms. Technology eligible for this tax concession includes technology provided for scientific research, the exploitation of energy resources, the development of communications, agriculture, forestry or animal husbandry production, or the development of important technologies.

Certain Chinese income tax treaties can reduce the domestic Chinese withholding tax rate on royalty payments. For example, the new China-Hong Kong Double Tax Arrangement (taking effect in 2007) and the China-Romania Income Tax Treaty both reduce the maximum withholding tax rate on royalty payments to 7%.

Royalty payments also attract a 5% Chinese business tax. Business tax is a type of turnover tax, which is not normally considered a creditable tax because it is not in the nature of a tax on net income. It is possible to avoid the application of business tax in certain cases. China exempts business tax on payments in consideration for certain technology transfers, technology development, and technology consulting.

4. Capital Gains

China-source capital gains (such as gains realized from the transfer of equity in an enterprise

in China and gains realized from the disposition of real property in China) are subject to a 10% withholding tax under Chinese domestic tax law. Some Chinese income tax treaties provide a tax exemption for gains realized on equity transfers (e.g., China-Barbados Income Tax Treaty), although restrictions on eligibility for the exemption may apply depending on the treaty.

III. Chinese Taxation of Joint Venture Vehicles

In structuring a joint venture in China, foreign investors commonly choose a foreign invested limited liability company established under Chinese law to conduct their onshore business activities. Foreign invested limited liability companies are termed “foreign invested enterprises” or “FIEs,” which can take one of the following forms:

- Equity joint ventures (“EJV”);
- Cooperative joint ventures (“CJV”), which are formed as legal persons; and
- Wholly foreign owned enterprises (“WFOEs”).

A. Overview

EJVs and CJVs are joint venture vehicles that have a Chinese party as a joint venture partner. The principal feature distinguishing EJVs from CJVs is that in an EJV, the joint venture partners’ share of profits and control is proportional to their respective equity interests in the EJV. In contrast, the joint venture partners in a CJV can contractually agree as to how profits and control are to be shared. In addition, CJVs differ from EJVs in that CJVs can be formed as non-legal persons.³

If all of the joint venture partners are foreign parties, the onshore joint venture vehicle could be structured as a WFOE, provided the business on the joint venture can be operated in WFOE form.

EJVs, CJVs and WFOEs are taxed as FIEs, which enjoy certain preferential tax treatment as discussed later in this article. An enterprise enjoys FIE tax status if foreign investors directly own at least 25% of the interests in the enterprise.

The relevant tax considerations for the operation of EJVs, incorporated CJVs, and WFOEs are discussed in the following sections. CJVs that are not formed as legal persons are treated as pass-through type entities for tax purposes (i.e., not taxed at the entity level), whereby each joint venture partner reports its pro rata share of income and deductions of the CJV on their respective tax returns.

B. Taxation of FIEs

China taxes FIEs on their worldwide income. FIEs are subject to Chinese tax on their net taxable income at a combined national and local enterprise income tax rate of 33%. China offers numerous tax incentives for FIEs that in many cases lower this tax rate to as low as 0 – 24%, depending on where the FIE is established and the nature of its activities.

1. Scope of Taxable Income

An FIE is taxed on both business and non-business income. The FEITL defines the scope of an FIE's taxable income broadly as "income from production and business operations and other sources."⁴ "Income from production and business operations" is defined as "income from production and business operations in manufacturing, mining, communications and transport, construction and installation, agriculture, forestry, animal husbandry, fisheries, water conservancy, commerce, finance, service industries, exploration and exploitation industries and other trades."⁵ "Income from other sources" includes dividends, interest, rents, income from the transfer of assets, income from providing or transferring patent rights, proprietary technology, trademark rights and copyright and other non-business earnings."⁶ However, dividends are not generally subject to double taxation in China so an FIE is not taxed on after-tax dividends that it receives from another Chinese enterprise.

2. Scope of Allowable Deductions

FIEs generally can deduct all expenses that are related to their production or business operations. However, certain expenses are specifically disallowed as a deduction. These include notably:

- Management fees paid to related parties;
- Expenses incurred to purchase or construct fixed assets (which must be depreciated over time);
- Expenses incurred to purchase or develop intangible assets (which must be amortized over time);
- Income taxes (business tax, however, is deductible);
- Fines for unlawful operations and losses sustained through the confiscation of property;
- Late payment charges and fines with respect

to taxes payable;

- The portion of losses sustained in natural disasters or accidents which are covered by insurance or indemnity; and
- Donations other than ones made to public welfare and relief organizations designated by the Chinese government.

3. Foreign Tax Credits

FIEs can claim a foreign tax credit for foreign taxes paid in respect of foreign-source income. Foreign tax payments made but later refunded or tax payments borne by others cannot be credited. China imposes a limitation on the amount of foreign tax credit that can be claimed. The creditable amount cannot exceed the amount of enterprise income tax otherwise payable in respect of the foreign-source income. The enterprise income tax payable in respect of the foreign source income is calculated pursuant to Chinese tax laws and regulations. This limitation applies on a country-by-country basis. Excess foreign tax credits can be carried forward for five years.

4. Net Operating Losses

An FIE can carry forward net operating losses to offset income for a period of five tax years. Net operating losses cannot be carried back to prior tax years.

5. Tax Consolidation

China does not permit tax consolidation for group companies (although the income/loss of branches can be consolidated). However, group companies can consolidate tax reporting and payment for convenience purposes, with the approval of the local tax bureau.

IV. Leveraging Chinese Tax Incentives

China has used tax policy as a means to encourage and direct foreign investment in China. In general, Chinese tax incentives vis-à-vis FIEs fall into one of two categories: tax incentives granted to FIEs based on where they are located and tax incentives granted to FIEs based on the nature of their activities. Additionally, foreign investors that reinvest profits into their FIEs are entitled to a refund of income taxes paid on the reinvested profits. While tax incentives have played a major role in Chinese tax planning for foreign investors, the forthcoming Chinese tax reform, as discussed below, threatens to scale back preferential tax policies granted to foreign investors. Existing FIEs are expected to be grandfa-

thered, allowing them to continue to enjoy the tax policies under the current tax regime until they sunset.

A. Location-Based Tax Incentives

Since the early 1980s, China has embarked on an aggressive campaign to attract foreign investment and develop its regional economies. This has resulted in the creation of numerous special investment zones, where FIEs can enjoy an enterprise income tax rate reduction from the normal 33% rate to 15 – 24%. The principal special investment zones in China can be grouped into the following categories:

- Special Economic Zones, where the enterprise income tax rate is reduced to 15% for FIEs engaged in any type of activity.
- Free Trade Zones, where the enterprise income tax rate is reduced to 15% for FIEs engaged in export-oriented and production-oriented activities.
- Economic and Technological Development Zones, where the enterprise income tax rate is reduced to 15% for production-oriented enterprises.
- Coastal Open Economic Zones, where the enterprise income tax rate is reduced to 24% for production-oriented enterprises.
- Border Open Cities, where the enterprise income tax rate is reduced to 24% for production-oriented enterprises.
- High-Tech Industrial Development Zones, where the enterprise income tax rate is reduced to 15% for enterprises that qualify as advanced high technology enterprises.

B. Activity-Based Tax Incentives

China also offers tax incentives based on the nature of an FIE's activities. China encourages FIEs to engage in manufacturing, export, and the development of advanced technology in China. Accordingly, FIEs engaged in these activities enjoy favorable tax treatment. In many cases, such activity-based tax incentives can also be combined with location-based tax incentives. The following sections describe the principal activity-based tax incentives available to foreign investors and their FIEs.

1. Production-Oriented Enterprises

China grants production-oriented enterprises a

two-year tax holiday beginning with the enterprise's first year of taxable profits. After this two-year tax holiday period expires, production-oriented enterprises enjoy a 50% tax rate reduction for the subsequent three years. The 50% tax rate reduction applies to the prevailing enterprise income tax rate enjoyed by the enterprise. Thus, for example, a production-oriented enterprise established in a Special Economic Zone is entitled to a 7.5% enterprise income tax rate (50% of 15%) for the three years subsequent to the expiration of its two-year tax holiday period. To qualify for this tax incentive, the enterprise must remain in operation for a period of at least 10 years.

2. Export-Oriented Enterprises

Enterprises treated as export-oriented enjoy a 50% tax rate reduction after their tax reduction or exemption period expires. An enterprise is considered export-oriented if the value of its exports for the year amounts to 70% or more of the total value of its product output for that year. However, the tax rate reduction applicable to enterprises established in Special Economic Zones, Economic and Technological Development Zones or other areas that pay a reduced enterprise income tax of 15% is capped at 10%.

3. Technologically Advanced Enterprises

Enterprises qualifying as technologically-advanced enjoy a 50% tax rate reduction for an additional three years after their tax reduction or exemption period expires. Neither the FEITL nor the FEITR provide guidelines as to what constitutes a technologically-advanced enterprise. In general, a government science and technology authority's endorsement of an enterprise's status as technologically-advanced should allow an enterprise to qualify for this tax incentive.

C. Profit Reinvestment Incentives

Foreign investors that reinvest profits from an FIE are entitled to a refund of 40% of the enterprise income tax paid on those profits. The refund percentage increases to 100% if the reinvestment is made into FIEs that are considered export-oriented or technologically advanced.

To qualify for the tax refund, the reinvestment must take one of two forms: (i) using distributable profits to increase the existing enterprise's registered capital, or (ii) using distributed profits to contribute to the registered capital of a new

enterprise. Moreover, the profits must be reinvested for at least 5 years; otherwise, the tax refund must be returned to the tax authorities.

D. Forthcoming Tax Reform

The tax incentives that are available to foreign investors under current Chinese tax laws and regulations are not generally granted to Chinese invested enterprises. This discriminatory tax treatment between foreign and Chinese invested enterprises contravenes principles of the WTO, to which China is a member. As part of its WTO commitments, China pledged to introduce a new unified enterprise income tax law that will tax foreign and Chinese invested enterprises under a single regime consistent with WTO principles.

It is unclear at this time how FIEs, foreign enterprises and domestic enterprises will be taxed under the new unified tax regime. Some anticipated changes include a reduction in the basic combined enterprise income tax rate from the current rate of 33% to 24% - 26%. The preferential tax treatment currently enjoyed by FIEs and foreign enterprises will likely be scaled back and, to the extent they remain, extended to domestic enterprises. The new unified enterprise income tax law should continue to contain preferential tax policies but they will likely be offered only to a narrow group of taxpayers such as those engaged in preferred industries such as high-tech and environmental protection activities and those that invest in China's central and western regions.

The new unified enterprise income tax is still undergoing the legislative review and approval process. There is no concrete timetable for the promulgation of the new law, although it is believed that the new law should take effect sometime in 2008 or 2009 at the earliest.

V. Tax Management in China

This article highlights a number of the principal Chinese tax-driven considerations for foreign investors structuring a joint venture in China. This article concludes with selected "do's and don'ts" that foreign investors should also bear in mind when approaching Chinese tax planning and tax management.

A. Conduct Due Diligence

Foreign investors entering into a joint venture in China through the acquisition of an interest in an existing Chinese business should conduct a thorough investigation of the target to identify significant tax issues that could expose the acquirer to potential future liability. The following are com-

mon tax due diligence issues that should be examined:

- *Delinquent tax returns and tax payment.* The acquirer should determine whether the target has timely filed all of its tax returns and is not delinquent in its tax payments.
- *Transfer pricing issues.* The acquirer should verify that the target's transfer prices comply with the arm's length principle.
- *Aggressive tax positions.* The acquirer should examine the target's tax reporting position to determine if the target has adopted any aggressive tax positions that might be challenged by the tax authorities.
- *Unapproved tax incentives.* The acquirer should confirm that tax incentives granted by local tax authorities are endorsed by national tax laws and regulations.
- *Loss of tax incentives.* The acquirer should determine if the acquisition might adversely affect the target's ability to continue to qualify for existing tax incentives.

B. Watch for Tax Law Changes

Chinese tax laws are characterized by frequent and sometimes unpredictable changes. As mentioned earlier, China's next major tax reform will likely take effect as early as 2008 or 2009, which will involve the unification of the separate tax regimes applicable to foreign invested enterprises and Chinese invested enterprises. The new unified enterprise income tax law is expected bring about changes to preferential tax policies, among others, that can affect how foreign investors structure their inbound investments into China.

C. Balance Practical versus Technical

Chinese tax laws and circulars are often worded broadly, which leaves local tax bureaus discretion to interpret how such laws or circulars are implemented in practice. This creates a situation where inconsistent tax treatments can arise amongst different tax bureaus. It is not uncommon where the "local practice" not only deviates from the practice of other tax bureaus, but also possibly a technical reading of the law. Management of Chinese taxes, therefore, should involve looking not only at practical solutions but also at the technical requirements of the law. In balancing practical versus technical solutions, an evaluation of risk factors, including enforcement risk and audit risk, together with an experienced tax advisor is indispensable.

D. Consider Regulatory Limitations

Tax planning strategies in China should not be adopted in a vacuum without considering associated Chinese regulatory implications. Notably, Chinese foreign exchange controls and business scope limitations often present hurdles when cross-border intercompany profit repatriation strategies are considered. Non-compliance with foreign exchange control requirements (for instance, registration of underlying contracts for approval with relevant government agencies) can prevent the outbound transfer of funds and, therefore, the realization of tax benefits. In addition, foreign invested enterprises might be prevented from making certain payments if doing so exceeds the enterprise's business scope. For instance, foreign invested enterprises established as international trading companies in free trade zones are generally permitted to purchase foreign currency for remittance outside of China only for trading transactions. Thus, these types of enterprises may encounter difficulties processing outward remittances of royalty payments and service fees. These regulatory hurdles may add complexity but are not necessarily fatal to a tax planning strategy if properly addressed ahead of time.

E. Appreciate Transfer Pricing Risks

The Chinese tax authorities are adopting more sophisticated measures to combat what they view as "tax avoidance" through intercompany transfer pricing abuses. Not only are the Chinese tax authorities arming themselves with more reliable sources of comparables data, they are also sharing information with other government bureaus and investing more resources in developing dedicated transfer pricing examination teams. Tax examiners are also employing more international approaches to transfer pricing examinations, including greater reliance on functional analysis as a tool to select transfer pricing methodologies. While the Chinese tax authorities' transfer pricing enforcement arm today remains focused on larger and industry-specific targets, it is a matter of time before they begin casting their net wider. Accordingly, foreign investors should be vigilant in supporting the reasonableness of their transfer prices in China. Adopting transfer pricing audit defense measures, including preparation of contemporaneous documentation (which may become a requirement in China shortly), is a clear "do."

Endnotes

¹ FEITR, Article 3.

² FEITR, Article 6(1).

³ Unincorporated CJVs generally do not confer limited liability protection to the joint venture partners.

⁴ FEITR, Article 1.

⁵ FEITR, Article 2.

⁶ FEITR, Article 2.

Mr. Fay advises on all aspects of taxation of foreign direct investments into China, including offshore holding company structures, contract manufacturing operations, M&A transactions, real estate investments, tax-efficient profit repatriation strategies, and transfer pricing. Mr. Fay also has extensive experience in advising multinational companies on corporate law matters relating to investment and business operations in China, including the establishment and operation of representative offices, joint ventures and wholly foreign-owned enterprises.

Globish, or “English Lite,” The International Dialect of the Third Millennium

by Jean-Paul Nerrière
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Mr. Nerrière is the author of “Don’t Speak English Parlez Globish”, published by Edition Eyrolles in Paris and available in French, Spanish, Italian and Korean. After a career in the Information Technology Industry, Mr. Nerrière retired in 1997 and became the Vice President of what would be called in the US “the Ivy League association.” He is now a member of the Academy of the Sea, and also heavily involved in matters relating to language, especially English and French. He was knighted in the order of Legion d’Honneur in 1992.

In the late eighties, I was a Vice President for IBM USA in charge of International Marketing worldwide. When travelling to Japan with my American associates, I observed that my communication in Tokyo with our Japanese colleagues was more efficient and less subdued than communication between the Japanese and my colleagues from Dallas, or even Boston.

A good number of non-Anglophones (non-native English speakers) try to speak English, and, in most cases, even seem to think they do speak English. They speak a language which seems to be perfectly efficient. It sounds a little like English, and is obviously derived from English. However, it is as remote from English as Cognac is from wine. Both come from the grape, but the processes being different, the products are different, even with an end result which is quite similar (if, or when, you drink too much of either of them). Anglophones do not always realize this because the non-Anglophones who dare speak to them in English are the ones who think they already enjoy a decent command of the language. The others are too inhibited, and in most cases, do not even try. They are quite happy to communicate with other non-Anglophones, however. Many non-Anglophones would confirm that it is much easier to speak English with a Ukrainian or an Argentinean, than with an American or a Scotsman.

Correspondingly, Anglophones have difficulty understanding non-Anglophones in Kiev, Paris or Valparaiso. Worse than that, and extremely frustrating, these foreigners have great difficulty understanding what Brits, Americans or Australians say. Hence the question: are those people communicating in English?

By definition, English is the language spoken in Great

Britain. English is the official language of or officially accepted in forty-four other nations. This amounts to 12% of mankind. Other than that, in the rest of the globe, quite a vast region, communication takes place in another dialect. (Merriam-Webster dictionary: “*dialect: a regional variety of language distinguished by features of vocabulary, grammar and pronunciation...*”) Microsoft must offer eighteen versions of English spell-checkers in its software products, thus verifying that English is neither unique, nor unified. Lawyers know that American contracts have to be translated into another kind of English when they land in the UK, not only because of different laws, but primarily because the words do not always carry the same meaning among barristers and solicitors.

Many Anglophones label what is spoken by most non-Anglophones as “broken English,” and I do not have any exception with this term, which is descriptive enough without being insulting. Let’s take for granted that among those non-Anglophones, this broken English allows some efficient and friendly communication. It is then easy to codify this limited English, to structure it, to make it an official version of English, and the limitations will be entirely consistent in Baghdad, Montevideo and Brussels. This is the idea that led to Globish: the organized and deliberate form of spontaneous broken English (“English lite”). My colleagues and I suggest Globish as the worldwide dialect of the Third Millennium.

Globish consists of a vocabulary of 1,500 words that we have selected by using the following methodology. We listed the words used by Voice of America for radio programs broadcast worldwide in a simplified language (called Special English, also 1,500 words), plus the ones recommended by Charles K. Ogden (The Englishman who defined Basic English in 1929, where “Basic” stands for British American Scientific International Commercial, 850 words), plus numerous sources which are included on Internet lists of the most frequently used words in English (based on hundreds of thousands of documents). We put all of this in spreadsheets, compared the sources, and came up with a list of 1,500 words, which we do not pretend to be perfect, but which are enough to get any message across. The Globish directory can be viewed at www.jpnglobish.com. Globish also recommends short sentences: if your sentence is more than 26 words; it is too long; or you have to break it into a number of adjacent shorter ones.

The idea of simplified English has existed for decades for specific purposes. Large aircraft manufacturers develop their maintenance documentation in a limited English because they will be the working tools of mechanics in all countries, most of them not conversant with English; e.g., Boeing Simplified English,

shared with the Aerospace and Defense Industries Association in Europe, with a vocabulary of 985 words, and Caterpillar Corporation (Caterpillar Technical English, also with 1,000 words plus technical vocabulary). It is instinctive and limited to technical subjects. Globish allows the same type of thing to be done on a broad scale for any kind of practical purpose, and adds a number of recommendations that go far beyond the list of 1,500 words.

Anglophones can be sorted out in two groups. Group A, the traditionalists, will think, “My English is perfect, or at least what it should be, and it is legitimate. If I am not understood in Mexico City, it is because they do not master the language. **That is their problem;** it is up to them to make progress. None of my business.” An Egyptian salesperson, who does not speak a word in Spanish, will win the contract under discussion, simply because his communication is based on Globish, or something close to it, and understood easily enough in Mexico.

Some Anglophones (Group B) will say, “I will accept that English, as spoken at home, is not a universal language. I have to get my message across at any cost. This is my target. I shall adjust to Globish, however painful for me, and I will enhance my chances of getting the contract”. Group B will be the winners.

Then, how can we qualify what is spoken to Anglophones by the French, the Koreans, the Brazilians, the Chinese, and all those other people, who represent at least the other 88% of mankind?

A vivid illustration of this is the experience an IBM employee and friend of mine, Edward Konrad Gibson, had on his way back from a mission in Hong-Kong. He had purchased tailor-made shirts from a tailor who knocked at his hotel room door, took his measurements, and agreed to deliver the shirts at 6:00 pm the same day. The shirts came back with initials on the cuffs that were not EKG. I accused him of stealing them from a friend. Not the case. He wanted the initials red, instead of the usual navy blue. He insisted, and, to be on the safe side, he printed “red”, with a big red felt pen, across the order form. And, sure enough, he got twelve splendid white shirts with the initials “RED” sewn in blue. He was furious. I made the point that this was nobody’s fault but his; he missed his target while trying to communicate. The target, as the hole on the golf course, can never be held responsible when missed. He who wants to communicate has to do what is needed to be efficient, and hit the target. Being perfect in academic English is of no use. Being practical and understood is what counts.

THE IMPLICATIONS OF THE GLOBISH VISION.

I contend that English, at least in this “lite” version,

will continue to dominate the world as an international communication tool. There are experts predicting that the Peoples Republic of China sometime in the future could become the first economic power in terms of GNP. I do not know, but I know that, if this ever happened, it would not mean that the Mandarin language would become the international vehicle for communication, although it is already the most widely spoken language today. It would be far too late. By then, all the Chinese executives who would have been instrumental in such a victory would be fully conversant in the lighter version of English. They would have achieved success, not despite the domination of English and their limited command of it, but because they could master enough of it to make it happen.

Some Anglophones could argue that, when they write to another Anglophone, immaculate academic English is expected. Indeed; but they should also keep in mind that, today, whatever you write is not written for your addressee only. With the information technology of the Third Millennium, an electronic copy of it can land in Oulan-Bator the same day, unbeknownst to you, via the Internet. Whenever you write, you write for the whole world now, and, if you’re involved in an international transaction, you should adjust accordingly. This same admonition applies when you speak and are recorded.

Is adjusting to Globish difficult for Anglophones? Globish is a diet. You have to do your best and follow the concepts and the recommendations, but, like in a diet, a dry martini every so often does not ruin everything, and you still keep slimming down. There is also software (“Glob-lexis”, by a French Company, “Diagonal”, in final beta test stage at the moment) which helps a lot. You submit a normal English document, it flags the terms that are not homologated in Globish, and provides all possible synonyms, with the Globish ones highlighted, plus definitions in simple terms. It is then up to you to decide what you keep, and what you substitute. An example is the Gettysburg Address in www.jpn-globish.com.

Glob-lexis also allows you to enrich the usual and universal Globish with the widely accepted terms specific to an industry or a corporation. With this tool, any company, any office, any agency can make sure that what is printed will be readily understood across the world by five to ten times more people.

OPERATING INSTRUCTIONS FOR GLOBISH

You must assess the level of the other group members, and adjust accordingly. First, you will become aware of facial expressions demonstrating deep concentration (not too good a sign), or inability to understand what you are saying. (You could conclude, “He is lost.” Wrong; you are the one who lost him, and, as a

consequence, you are now the one who happens to be lost, and you are the one who is already in the process of losing the business.)

Questions to the group on the status of the discussion will tell you whether everything was conveyed correctly. If not, you are back to square one.

In front of a group, the problem will be to identify the weakest person, and decide to adjust to his level, or to ignore that participant on purpose. Whatever you decide has to be decided based on facts and observations. Too many Anglophones carry on in their usual style, and seem to think “happen what may...”, or “at least I will have a meeting with the ones whose command of English is close to mine”. Unfortunately, in most cases, the ones who could contribute most are not the ones with the best abilities in a language they seldom use.

Globish is spoken and written with a limited number of English words: 1,500. This could sound like a most severe limitation. It is not. You can express anything with this set. Forty years ago, “Voice of America” radio station started developing a similar vocabulary, now at 1,500 words. VOA calls it “special English”, and, with it, they broadcast programs aiming at the 88% of mankind who would have difficulties with more elaborate English. As indicated earlier, their list was one of the sources used to put together the Globish list.

1,500 words are more than enough. Rather than using a word that may be beyond the vocabulary of a non-native English speaker, the combination of simple words can clearly convey your message. For example, instead of using the word “niece,” you will use “the daughter of my sister”, four simple words instead of one. You will get the message across.

In Globish, you repeat the same sentences at least twice. You express the same idea again with different words. You restate your opinion with another vocabulary. You use synonyms to rephrase what you wanted to say — which is just what I did in the last few lines, and what you do in your legal briefs. If your hit rate is 90% with the first attempt, it will reach 99% after the second one, and you will miss one per thousand, at worst, after the third one. This is when you deal with the 88% of mankind who are not speaking your language as a mother tongue, not with the 12% who happened to be born Anglophones.

Globish is not only words, it is also body language. In the multinational circles, it is sometimes believed that many Italians speak rather good English, but can barely understand it. Supposedly, it is because they use their hands and a lot of body language when speaking, while the rest of the westerners do not. We under-

stand them with this help, but, they cannot understand us without it.

Also, Globish relies on all available aids. While audio-visual or multimedia tools are nice to have as an option when addressing Anglophones, they are a must in Globish. You are in front of a person, or a group; they might not understand all you say. If they can see the highlights written on the screen or on the monitor at the same time, you increase substantially the odds of reaching your target. After the discussion, hard copies will be precious for them. Minutes of meetings, drafted on the spot with a small dictating machine in front of the participants, or shortly following a meeting, will allow the ones who missed a point time to respond.

Globish avoids humour. Humour does not translate. When I joined the IBM Chairman’s office in 1977, our CEO was suffering from an acute scarcity of healthy and acceptable speech-opening jokes. I thought I was given a chance to demonstrate how brilliant I could be. A phone call to France had me supplied with four books entirely dedicated to jokes, thousands of them. After weeding out sex, religion, and race, I was left with a strong collection of really entertaining ones. I tried them on colleagues, and was disappointed to see them still waiting for the funny part when I was finished with my punch line. Humour, if acceptable businesswise, does not make it across the cultural borders. Most American speakers are used to starting their address with a joke, in order to have the crowd relax, and to build a rapport with the audience. Foreigners listen politely, and laugh gently, even if the joke is not funny or is stale. They give it a polite, if not enthusiastic applause, and everybody is happy. You can stick to that style; it does not hurt; it is ritualistic. But do not believe that your humor will be shared in other countries, even if it seems well-received.

Globish does not have negative questions. This is because the replies can always be ambiguous. Let’s assume Bill in Pocatello and Satake-san in Tokyo both love cats. If you ask “you don’t like cats?”, Bill will answer “Yes”, and Satake-san might reply “No”, as he would in Japanese: his Japanese “No” means, “I do not agree with what you implied in your question. You surmise I don’t like cats. I have to say the contrary; hence, my answer is no”. It works like this in many other countries. The Globish recommendation, especially to the non-Anglophones, is to never answer a question with a monosyllabic “Yes” or “No”, but always with a complete sentence: “Yes, I do”, or, even better, “Yes, I love them”.

Globish avoids all metaphors and images. What would you think if I told you I slept “like a gun dog”? In French, it is very descriptive. “Dormir en chien de

fusil,” which literally translates “sleep in a gun-cock position;” when the expression was coined, the gun hammer on a flintlock really had the shape of a body resting in the foetal position. Incomprehensible in any language other than mine. Keep in mind that baseball, however interesting, is rarely played anywhere outside of North America. “Get to first base”, “touch base”, “hit a home run”, “cover three bases”, and all the expressions which are legitimate in the USA, do not work abroad. Never ever use the sport oriented ones

Acronyms do not travel well. NATO becomes OTAN where I live. UN becomes ONU, AIDS is SIDA. An MP is a member of the Military Police in the USA, but a Member of Parliament in the UK. It is up to you to avoid these potential confusions. As soon as you use an acronym, you will be on the safe side if you immediately provide the meaning of its letters. Even better: write your acronyms on a board, and leave them there for the duration of your discussion. Or distribute a paper with all the ones you think you might need, and their explicit meaning.

CONCLUSION

In the battle, over the last century, for the advantageous position of the effective communication vehicle worldwide, there is no debate that English won. Many nostalgic people in other languages, especially in France, resent this and bitterly miss the days when their language was the dominant one, at least for the elite. This is futile, the battle is over, and will not ever be reopened again: for the first time in the long history of mankind, communication is now global, with tools unheard of before like the internet, and airline travel.

With the unbelievable extent of its current empire, English is also weakening itself, like any great empire did in history. The result is that its predominant form has to be organized into a lighter form, which we call Globish. It is not, however, a “me Tarzan, you Jane” version. It is still correct English, albeit “decaffeinated”.

Anglophones who realize this, and accept it, will greatly enhance their efficiency in the global arena. And this could in addition lead them to an interest in foreign languages: learning any of them is always a great plus to understand different ways of doing business, to enjoy other cultures in their genuine shape, and to share other people’s interests. Foreigners who speak Globish will grow in the process of mastering it: it is up to Anglophones to enjoy a similar growth, and not let this kind of privilege to be enjoyed only by the 88% of human beings who were not born, or did not grow, in English speaking countries.

Recent Immigration Legislation

By Kathleen Lord Black¹

Immigration Attorney

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A yearlong battle between the House of Representatives and the Senate over immigration reform has essentially resulted in a stalemate. Congress has now adjourned to campaign for the November elections after not only failing to pass immigration reform, but also failing to pass two controversial immigration bills. These bills did not pass the Senate largely due to the efforts of senators, both Republican and Democratic, who do not believe immigration enforcement measures should be tacked onto must-pass spending bills. (REAL ID, for instance, was an anti-immigration bill that was passed without debate because it was attached to a military spending bill.) Senators Specter, Warner, Craig, Cochran, and others believe that attaching sweeping and punitive immigration measures to Department of Defense authorization or other must-pass bills circumvents the legislative process on an issue of critical national importance, i.e., immigration law and policy in the United States.

The two bills that failed in the Senate were (1) H.R. 6094 (**The Community Protection Act**) which includes a provision that would allow for indefinite detention, and (2) H.R. 6095 (**Immigration Law Enforcement Act of 2006**). These acts have received much criticism from human rights groups and constitutional scholars. For instance, the bills include provisions that would expand the expedited removal program to affect people who may have resided in the United States for many years. The **Illegal Immigration Reform and Immigrant Responsibility Act of 1996** (IIRIRA) created “expedited removal”, a new form of deportation, which the former Immigration and Naturalization Service began enforcing on April 1, 1997. Expedited removal allows the legacy INS to designate certain individuals who can be removed from the United States based on an order from an Immigration officer rather than an Immigration judge. The individuals subject to expedited removal are typically people who use invalid entry documents or who attempt to enter the United States through fraud or misrepresentation, and not long-time residents. The failed provisions would also overturn two Supreme Court decisions by allowing for indefinite detention of immigrants awaiting removal. In addition, they would grant authority to state and local police to enforce all federal immigration laws. Critics of these provisions objected to giving the government unchecked powers to punish immigrants, and to

making local police chase after immigrants, thereby driving undocumented immigrants even further underground.

Also, under the proposed measures, the Department of Homeland Security would not be accountable for its mistakes or misapplication of the law, giving the agency unchecked power. Again, these extreme measures did not pass the Senate. However, these measures may still re-emerge, since both of these bills did pass the House of Representatives and can be brought before the Senate again, either this year or next year.

What did pass was H.R. 6061 (**The Secure Fence Act of 2006**). This bill was approved by both the House of Representatives and the Senate, and has already been signed into law by the President. The bill authorizes 700 miles of fencing along the 1,951-mile U.S.-Mexican border. The bill has been sharply criticized by the government of Mexico and those who fear for the lives of those who attempt to cross the border illegally, and will divide the Tohono O'odham Indian tribe yet again. In the long-term, environmentalists predict irreparable harm to the migration of plants and animals, a process that is necessary to preserve the delicate ecology of the area.

The President has also signed a bill which includes funding for 1,500 border patrol agents, 6,700 detention beds, \$1.2 billion for border fencing, vehicle barriers, computer and other infrastructure for apprehending, detaining, and deporting illegal aliens. Moreover, the **Border Tunnel Prevention Act** was approved by Congress, making tunnel-building illegal.

It is still possible for the White House and the Senate immigration reformers like John McCain and Mel Martinez to press for a guest worker program and an orderly and fair pathway to citizenship for illegal immigrants. It is also possible that the U.S. may consult and negotiate with the Mexican government as to where the 700 miles of fence will be built along the 2,000-mile border. Perhaps the lessons of history may also be considered. The Maginot line in France and the Great Wall of China failed to keep out those who simply walked around the obstacles put in their paths by those who feared the huddled masses and Huns at their gates. Will our fence suffer a similar result?

Endnotes

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Basics of International Licensing

By Paul D. Supnik¹ and Carol A. Brittain²
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The following article presents a brief survey of common terms and practices encountered in international transactions licensing the use of intellectual property. Specific transactions may have different or additional requirements from those outlined below, and the following should not be relied upon as definitive or complete advice in a particular transaction.

1. Types of Intellectual Property Subject to License.

Under a licensing agreement, the owner of intellectual property (IP) permits another party to use the owner's intellectual property on the terms and conditions stated in the licensing agreement, including payment of royalties in exchange for use of the IP. The transaction underlying a licensing agreement could be stated simply as: "If you let me use your intellectual property, I will pay you for the use."

All types of IP may be licensed, including trade secrets, patents, copyrights, and trademarks. Worldwide, ownership rights to IP are territorial and are determined by the laws of each country or jurisdiction. Cooperating countries have created treaties and protocols to streamline the registration process used in various countries to protect IP rights, summarized below:

a. Trade secrets are scientific or commercial information kept confidential and used in business to obtain an advantage over competitors. Trade secrets may include "know how", meaning proprietary procedural knowledge to accomplish certain tasks. Trade secrets are not registered with any agency, but instead are kept secret within the originating company as proprietary information and not disclosed outside the company except under a confidentiality agreement or other conditions of confidentiality. In the United States (U.S.), protection of trade secrets and confidential information is primarily under state laws, which may include where adopted the Uniform Trade Secrets Act (18 U.S.C. 1832 et seq.), and certain federal laws.

b. Patents give protection to a new invention, preventing competitors from copying the invention for a number of years. Products, processes and designs may all be patentable. Patent applications containing a description of the

invention claims are submitted to a designated industrial property office in a jurisdiction, for example, the United States Patent and Trademark Office (USPTO). These industrial property offices often, but not always, examine technology related to that for which the patent is sought to determine whether a new invention or improvement exists and is therefore patentable. The examination process can be lengthy. If a patent is granted, the scope of protection provided by the patent is defined by the claims made in the application.

Patent applications must be filed in each jurisdiction in which protection is sought. Treaties and regional filing schemes may be helpful. For example, the Patent Cooperation Treaty (PCT) allows the filing of a patent application with the USPTO, which then distributes the application to the World Intellectual Property Organization (WIPO) in Geneva, Switzerland, which then in turn distributes the application to the designated countries for examination by their government intellectual property offices. The PCT has been adopted by the vast majority of industrialized countries. (See www.wipo.int/pct/en.) The PCT gives up to 30 or 31 months from the filing date of the U.S. application to invest in additional patent applications, which can be costly. The European Patent Office (EPO) in Munich, Germany, provides a system for obtaining a patent covering the 31 contracting countries of the EPO, thus including countries which are not members of the European Union. (See www.european-patent-office.org/index.en.php.)

c. Copyrights are IP rights acquired by fixing a creative work in a tangible medium of expression, such as books, software, art, motion pictures, music and sound recordings and other works of authorship. A copyright gives the author the sole "right" to make "copies" of a work for a limited although lengthy period of time, for example, life of the author plus 70 years. Copyright exists today in most countries without any formalities such as registration or copyright notice. In fact, the Berne Convention prohibits formalities as a condition of copyright protection. Registration in some countries can be helpful as proof of ownership. The United States still requires registration as a prerequisite for filing suit at least for domestic works and certain beneficial remedies in court. In some countries, registration of some form, although not with a "copyright office," may even be required for use of the material, thus serving as a control on what may be publicly distributed.

d. Trademarks are symbols representing reputation and goodwill associated with the products

of a particular producer or manufacturer. Trademarks refer to goods, and service marks refer to services. Marks can be words, logos, designs or other iconic representations. Ownership rights to marks are generally acquired in civil law countries by registration. In common law countries, first use of a mark with or without registration can establish ownership and the right to prevent use of confusingly similar marks in connection with similar goods and services.

Trademarks outside the U.S. must be registered in each jurisdiction. Owners of IP have some common law protection for palming off and unfair competition, but the protection tends to be limited. Treaties with foreign governments and regional filing schemes may be helpful in obtaining protection for trademarks. The Community Trademark (CTM) establishes protection in each of the 25 countries of the European Union, which does not include Norway or Switzerland. A single trademark application is filed through the Office for Harmonization in the Internal Market (OHIM) in Alicante, Spain. Once registered, the CTM is enforced through courts designated by the member countries of the EU.

The Madrid Protocol provides a simplified method of obtaining an international registration for a trademark by filing a single application based on an application or registration in a home country such as the U.S. If an application is filed to register a trademark with the U.S. Patent and Trademark Office (USPTO), an international application can be filed designating up to some 60 countries which are members of the Madrid Protocol. The international application is transmitted by the home country receiving office (in the U.S., the USPTO) to WIPO in Geneva, Switzerland. If the designated countries fail to object to registration by their government intellectual property office within the times designated in the Madrid Protocol (either 12 months or 18 months, depending on how the country elected to adhere to the Protocol), the international registration becomes effective in those countries. For a variety of reasons, not all marks are ideal candidates for the Madrid Protocol international registration. A similar form of registration, the Madrid Arrangement, is available to another group of countries and is also administered by WIPO. The U.S. is not a party to the Madrid Arrangement.

The Paris Convention facilitates preservation of the home country filing date of an application by establishing the filing date in a member country as of the home country filing date if the application

is filed within six months of the home country filing date. The six month grace period thus provided for filing allows the applicant an opportunity to determine whether to invest in filing applications in countries outside the home country, while also preserving the home country filing date and preventing third parties from acquiring intervening rights in the mark.

2. The Purposes of Licensing Intellectual Property.

IP may be licensed for various purposes, including:

- a. To evaluate a possible contractual relationship or a merger or acquisition (“We want to discuss a merger with your company. We need to understand your IP and whether a combination of our businesses would be profitable”);
- b. To permit a Licensee to use Licensor’s trade secrets in a contractual relationship (“We have a unique, secret industrial process not under patent, but we are willing to let you use it in exchange for royalty payments”);
- c. To permit a Licensee to use Licensor’s patented invention (“We have [patented software] [a secret process] [a pharmaceutical formulation] we are willing to let you use in exchange for royalty payments”);
- d. To permit a Licensee to use Licensor’s copyrighted material in a product (“We want to make a movie based on your book and will pay you royalties”); or
- e. To permit a Licensee to use Licensor’s trademark in a product (“We want to make and sell lunch pails with the image of your cartoon character and will pay you royalties”).

The purpose of a licensing agreement is therefore to define the IP and how it may be used, to define the payment flow in exchange for its use, and to provide appropriate representations and warranties between the parties.

3. Parties to a Licensing Transaction.

- a. **Licensor and Licensee.** The owner of the IP is called the Licensor, and the permitted user is called the Licensee. A Licensor may approach or be approached by a potential Licensee to enter into a licensing agreement. The same IP may be licensed to more than one Licensee: under non-exclusive licenses, multiple Licensees may use the same IP in the same type of products; under exclusive licenses, multiple Licensees may use the same IP but in different products.

b. Sublicensees. Under some licensing arrangements, a Licensor will not engage multiple Licensees, but will instead enter into one master licensing agreement with a single Licensee called a sublicensee or master licensee. In this arrangement, Licensor lacking experience, contacts or the business infrastructure to create and manage a licensing program grants authority to Licensee to locate and negotiate with potential sublicensees to produce items.

c. Licensing agent. If Licensor and Licensee are not already in contact with each other, a licensing agent may approach a Licensor, claiming to represent a potential Licensee, or the licensing agent may approach a potential Licensee, claiming to represent a Licensor. A licensing agent is a finder or broker, often paid with a percentage of the royalties paid or earned under a license. To ensure that he/she receives compensation from the transaction, a licensing agent often will want to control or be deeply involved in negotiations between Licensor and Licensee. Very early in the negotiations, a licensing agent should present written confirmation from his/her principal that the agent is a duly authorized to represent Licensor or Licensee and the extent of that representation. Even with written confirmation of such representation, all agreements and documents between Licensor and Licensee are normally signed by the principals rather than by the agent, regardless of the agent's apparent authority.

4. Common Provisions of a Licensing Agreement.

The following provisions are common in licensing agreements, but all transactions have particular characteristics which may require specific additional or variant provisions.

a. Parties. Licensor's and Licensee's full legal names should be used and, if the party is a corporate entity, the jurisdiction under which formed.

b. Licensed property. . A full description of the licensed IP should be used to avoid ambiguity and dispute over what IP has been licensed. This description is sometimes included in an exhibit rather than in the body of the licensing agreement.

c. Exclusive or non-exclusive license. In an exclusive licensing agreement, Licensee is the only party to have rights to use the IP for the purposes stated in the licensing agreement; for example, a t-shirt maker would be an exclusive Licensee if no other Licensees were permitted to use Licensor's

logo on t-shirts, but other licensees could use the logo on clothing other than t-shirts. In a non-exclusive licensing agreement, Licensor may permit multiple Licensees to use the IP in the same manner; for example, multiple Licensees could use Licensor's logo on t-shirts. (Separately, a 'sole' license is an exclusive license granted to a Licensee except that Licensor may use the IP in the same manner permitted to Licensee.)

d. Territory. The geographic area in which Licensee may exercise its rights to use the IP should be stated unambiguously, for example, "Japan, China and South Korea" rather than "Asia" or "East Asia."

e. Channels of distribution. Any restrictions on distribution should be stated as clearly as possible, although terminology common in the U.S. may not apply abroad. For example, "through wholesale channels only" may have a different connotation in different countries.

f. Term and extension or renewal. The term of the agreement can be through a specified date, "through December 31, 2010," or for a period of time, "three (3) years from the date of this agreement." Stating a specified date may be clearer. The agreement may provide that Licensee has the right to extend or renew the term of the agreement one or more times for specific periods and minimum guaranteed royalties, provided that Licensee gives at least [x] months' notice of intent to renew and provided (optionally) that specific minimum sales levels have been met in the preceding term.

g. Royalties. "Royalties" are the payments made to a Licensor by a Licensee for use of Licensor's IP. Royalties may receive favorable income tax treatment; Licensors should consult their tax advisors or attorneys on this issue.

(1) **Calculation of royalties.** . Royalties are calculated as a percentage of sales of the licensed products. Sales are usually stated as "Net Sales," meaning, for example, the actual invoice or selling price, minus specified deductions and minus returns and customary cash and quantity discounts actually given to bona fide customers. Because this provision is often subject to dispute later, defining the term Net Sales carefully is important. The attorney should confer closely with the client to ensure the definition reflects both the parties' intentions and the ability of Licensee's accounting system to produce the required calculations accurately. The licensing agreement may also specify that royalties will not be due on 'a reasonable num-

ber of samples which may be used or distributed in the normal course of business, not to exceed [5%] of Licensee's total production.'

(2) **Advance Royalties.** A common but optional provision provides that Licensee pays an amount, called an 'advance' or 'advance royalties', to Licensor upon signing the licensing agreement. Usually the advance is made against earned royalties, meaning that as Licensee makes sales of the licensed products, Licensee has a credit against royalties otherwise payable to Licensor on those sales, up to an amount equal to the advance. After the advance is fully recouped, Licensee makes payments to Licensor. For clarity, the licensing agreement should specify that the advance is 'against earned royalties,' unless the parties intend that the advance is in addition to the earned royalties.

(3) **Payment of royalties.** The licensing agreement should state how often royalties are due, usually monthly or quarterly. Payments are accompanied by a 'royalty report' from Licensee, showing calculation of the royalty. Licensor may wish to specify the form the report takes. An officer of Licensee is often required to certify the calculation of royalties earned. Royalty payments and reports are generally due 30 to 45 days after the end of the period in which the royalties were earned. The licensing agreement should specify in what currency royalties must be paid and how to calculate the exchange rate if sales are made in a currency other than the currency in which royalties are paid; for example, 'the midrate on the last day of the royalty reporting period, as stated in the U.S. edition of The Wall Street Journal.' The currency conversion rate should be readily findable by each party. Licensor and Licensee should consult their tax advisors or attorneys on treatment of royalty payments and receipts, including interjurisdictional aspects of funds transfer and tax liability and reporting.

(4) **Audit.** Licensee is usually required to keep accurate books of account records according to generally accepted accounting standards (GAAP), but smaller Licensees may not maintain their records according to GAAP. Licensor and its representatives should have the right 'upon reasonable notice and during reasonable business hours to examine and audit said books of account and records with respect to the subject matter' of the licensing agreement. Note that the motion picture industry does not use GAAP in connection with its agreements, but rather uses its own definitions built into its

agreements.

The licensing agreement may include the exercise by Licensor of any right to check or to audit Licensee's books and records, or the receipt or acceptance by Licensor of any statement or payment or the cashing of any royalty checks, will not preclude Licensor from disputing the correctness of the statement or payment for a period of [2] years after receipt.

Licensor may request provisions stating that if royalty payments or reports are understated by [2 to 5%], then payment of the shortfall is due immediately, plus interest at [x]%, and that if a royalty report understates the amount due Licensor by more than [5 to 10%] of the amount actually due, Licensee will pay costs of Licensor's audit [up to a maximum of \$[x]].

h. Sublicensing rights. Sublicensing permits Licensee to enter into additional licensing agreements with third parties called Sublicensees, subcontracting part of Licensee's rights to make items using Licensor's IP. Licensor receives a percentage of royalties paid by Sublicensees to Licensee. For clarity, all licensing agreements should state whether or not sublicensing is permitted. Licensor may wish to retain the right to approve the terms of each proposed sublicensing agreement.

i. Licensor's approvals; Samples. Licensor should have the right, and should exercise its right, to approve or disapprove the manner in which the IP is used, for example, through the inspection of samples of the products containing or employing the IP. If a Licensor does not monitor the use of its trademarks, a claim may be made that Licensor's rights are forfeit and not enforceable. Quality control is basic to trademark licensing in the U.S. and also may be required abroad to avoid loss of trademark rights.

j. Licensee's obligations to market. Licensor may wish to require that Licensee sell a minimum dollar amount or minimum number of units by specified dates during the term to avoid termination of the agreement.

k. Labeling and testing requirements. Both to protect Licensor's ownership rights and to meet regulatory requirements, items should display appropriate legal legends and information. Laws and regulations vary by jurisdiction and by type of product. Items are subject to regulatory labeling requirements depending on the type of product and may include contents, age grading, country of origin, manufacturer ID, and other aspects

depending on the items. Licensing agreements should specify that Licensee is responsible for ensuring items adhere to safety and labeling standards of the appropriate jurisdictions. Licensor should provide in writing appropriate labeling and wording regarding patent, trademark and copyright rights and should indemnify Licensee if Licensor provides incorrect information. Licensee should ensure its manufacturer produces items according to written specifications. Mislabeled goods can be stopped at customs and may subject the importer to costly fines or penalties. Reworking labeling is expensive in time and money. Licensor may wish to specify certain reputable safety testing companies to avoid sham testing by Licensee's manufacturers.

l. Representations and warranties. In addition to other standard representations and warranties, Licensor should represent and warrant to its ownership of the IP, and each party should represent and warrant to its authority to enter into and perform the agreement.

m. Registration of agents and agreements. Licensor should consider whether registration of licensing agreements and registered users is required or desirable in a particular jurisdiction, for example, in some of the former British Commonwealth countries. Licensors and Licensees should be wary of 'helpful' Licensees or distributors abroad who register a Licensor's trademarks or other IP as a 'courtesy' to Licensor. The IP may then be held ransom by an unscrupulous Licensee or distributor who demands to be paid off to assign the rights back to Licensor. Ideally, a Licensor registers its own IP in a foreign jurisdiction before negotiating or contracting with a Licensee abroad, but this is not always practical for a Licensor without a robust legal budget. Licensing agreements should ensure that all ownership rights to the IP vest in Licensor and that Licensee will cooperate to achieve that goal.

n. Termination; Sell-Off. The grounds on which the agreement may be terminated should be reasonably detailed and will vary depending on the underlying transaction. If a breach occurs which is grounds for termination, providing notice of the breach prior to termination, as well as an opportunity to cure the breach or to take substantial steps toward a cure, is a common provision.

o. Controlling law. If Licensor and Licensee are located or operating in different jurisdictions, the issue of which jurisdiction's law should control the agreement can be contentious. The specified controlling jurisdiction should bear at least

some relationship to the location of the parties, performance, transaction or forum designated for dispute resolution. Some non-U.S. jurisdictions may apply or attempt to apply local law regardless of the provisions in the licensing agreement. In drafting the controlling law provision, consideration should be given to jurisdictions in which Licensor has its strongest IP ownership position and to which jurisdictions provide the surest and fairest adjudications. When an agreement specifies that the laws of a certain jurisdiction will apply, consider adding language to the effect that the choice of controlling law shall be "without regard to principles of conflicts of laws" to avoid disadvantageous forum shifting.

p. Dispute resolution. Before entering into a licensing agreement, the nature of disputes that might arise should be considered, and the agreement should provide for the location and method of resolving a dispute, rather than leave it to chance later. For example, the choice of preferred jurisdiction might be based on whether a dispute is likely to be a claim for infringement or a claim for breach of contract. As in the U.S., dispute resolution may be through mediation, arbitration or court proceedings. Arbitration is more highly developed and is used more often outside the U.S. In some countries, specialized IP courts exist, while in other countries, general purpose courts handle IP matters. As with other transnational issues, consultation with local counsel abroad often provides the best insight and advice.

The court system abroad is significantly different from the U.S. legal system. The discovery process is different or virtually nonexistent, and if discovery is available, it tends to be cumbersome and not generally used. Depositions are virtually unknown. Some countries may not permit testimony of parties to the dispute, because the parties are considered biased. On the other hand, costs of litigation in some countries may be lower than in the U.S.

Courts applying common law exist in former British Commonwealth countries such as Australia and New Zealand. Other countries have hybrid legal systems; for example, Canada and particularly Quebec incorporates elements of French civil law, and South Africa has aspects in common with the Dutch legal system. While the common law-based courts are more similar to U.S. courts, discovery may still be more limited than in the U.S., and the assumption should not be made that either procedure or outcome will be the same as in the U.S.

Civil law courts are prevalent around the world. Discovery is usually conducted by or with the permission of the judge, if at all. Testimony is controlled by the judge, who may question witnesses personally. Some courts do not have live testimony and hear the matter solely on papers submitted.

Arbitration tribunals are frequently used outside the U.S., sometimes with specialized tribunals depending on the type of dispute. The location of a tribunal may be based on where the parties are comfortable, where one party believes that it will obtain a favorable hearing, or where the award is likely to be enforceable.

As an example, the International Film and Television Alliance (IFTA) has operated an international arbitration tribunal for over 20 years. The IFTA tribunal adjudicates disputes primarily involving contracts for the distribution of motion pictures internationally. The tribunal has a panel of arbitrators present principally in Los Angeles, but also in New York City as well as France, Germany, Canada, and several other countries. IFTA will generally accept jurisdiction of other entertainment industry disputes. (See www.ifta-online.org.)

Other tribunals include the International Chamber of Commerce (ICC) in Paris (see www.iccwbo.org/index_court.asp), the London Court of International Arbitration (see www.lcia-arbitration.com), the Arbitration Institute of the Stockholm Chamber of Commerce (SCC) (see www.sccinstitute.com/uk/home), the British Columbia International Commercial Arbitration Centre (see www.bcicac.com), the Singapore International Arbitration Centre (see www.siac.org.sg), the Hong Kong International Arbitration Centre (see www.hkiac.org), and the China International Economic and Trade Arbitration Commission (CIETAC) (see www.cietac.org.cn), among others. A relatively new arbitration tribunal set up by the World Intellectual Property Organization (WIPO), called The Arbitration and Mediation Center, focuses on arbitration and mediation of intellectual property disputes, and panelists have backgrounds in various aspects of intellectual property law (see www.arbiter.wipo.int/center.)

Consideration should be given to location, languages spoken fluently and understood by panel arbitrators, as well as to which issues are likely to be most important, whether contract law, or a broad-brush understanding of issues, or the technical aspects of licensing law or intellectual property law or the technology being licensed.

Discovery is usually not permitted in an arbitration unless specifically provided in the arbitration clause. Although arbitration is said to have the benefits of being faster and cheaper than litigation, that may not be necessarily correct. Privacy is one advantage of arbitration.

Before choosing an arbitration provision for a licensing agreement, consider how and if the arbitration award can be enforced either in the location where the award is rendered or in another jurisdiction. The New York Convention on Enforcement of Foreign Arbitral Awards (the “New York Convention”) allows an award rendered in a member country to be enforced in another member country without relitigating the dispute. Only limited inquiry may be made into the arbitration award, such as whether there was due process and adequate notice of the arbitration hearing or bias by the arbitrator. Without availability of the New York Convention or a court which takes that Convention seriously, the arbitration process could be an empty gesture.

q. Confidentiality. The parties may agree to keep the terms of the licensing agreement confidential, except pursuant to judicial order.

r. Indemnification and insurance. The parties may agree to indemnify each other for breaches and liabilities arising from the licensing agreement, but because their roles and risks differ, the provisions should be tailored to each party. For example, Licensor may agree to indemnify Licensee and its designated affiliates against claims arising from Licensee's use of the IP in strict compliance with the licensing agreement. Licensee may agree to indemnify Licensor and its designated affiliates against claims arising from claims that Licensee has harmed or infringed third parties. Licensor may require that Licensee provide a certificate of insurance covering Licensor and its designated affiliates against claims by third parties.

s. Customs letters. To prevent importation of counterfeit items, customs authorities may require Licensee to provide written authorization from Licensor to permit import of the licensed products. Customs requirements vary by jurisdiction. A form of customs letter may be added as an exhibit to the licensing agreement, to be printed on Licensor's letterhead and signed by an officer of Licensor. This can avoid items being held up in customs pending verification of Licensor's permission.

t. Miscellaneous terms. The following

terms are common to many agreements other than licenses and may be written in a variety of ways depending on the parties and their circumstances. Common but not mandatory approaches include the following:

- (1) **Relationship:** The parties are not joint venturers and may not bind or obligate the other.
- (2) **Assignment:** The agreement may not be assigned without the prior written consent of the other party, which may not be unreasonably withheld.
- (3) **Integration:** The agreement supersedes all previous negotiations and agreements both written and oral.
- (4) **Severability:** If a provision is held unenforceable by a court or law or arbitrator, the provision is deemed deleted or (optional approach) rewritten to the minimum extent necessary to make it enforceable.
 - (a) **Further actions:** The parties agree to take any steps reasonably required to effectuate the provisions of the agreement.
 - (b) **Counterparts:** The agreement can be signed by the parties on different physical copies but will constitute a single agreement. Each party should receive original signature pages from the other.
 - (c) **No waiver:** The failure of a party to enforce a provision of the agreement does not waive that provision.
 - (d) **Notices:** To give effective notice under the agreement, the method, timing and location should be clearly stated, for example, "by recognized international overnight courier, charges prepaid", "effective on the third (3rd) day following dispatch", and "at the address stated below."
 - (e) **Force majeure:** Circumstances beyond a party's control such as weather or war will excuse performance by the affected party for a specified period of time, after which a breach may be noticed and the agreement terminated.

20 5. Examples of structuring licensing transactions internationally

Following are three examples of transactions involving licensed IP, with suggestions for possible additional provisions the parties may consider, along

with other provisions which may be appropriate depending on the specific circumstances:

a. Software licensing. A U.S. computer manufacturer licenses its proprietary software to a joint venture with a China company along with sale of computer hardware. In addition to basic provisions in a licensing agreement, the parties may also consider providing for the following:

- Delivery, installation and acceptance provisions
- The point at which title and risk of loss pass for any equipment which may be sold at the same time the software is licensed
- Identification of documentation delivered
- Rights and obligations regarding project management, debugging, maintenance, enhancements or upgrades, and whether copies are permitted

The parties may agree to escrow the source code with a neutral third party, under written agreement as to conditions under which source code would be released to Licensee.

Licensor should retain ownership of the software in an entity controlled by Licensor and not in the joint venture entity, to avoid distribution of the software to Licensee upon a dissolution of the joint venture.

Local counsel should be engaged to structure and document the transaction, while Licensor's regular business attorney ensures the business purpose of the transaction is achieved.

b. Entertainment licensing. A corporation under the laws of France and under control of the French government licenses its cartoon characters to a U.S. company to produce and distribute a television series and to make and sell products bearing the characters' names and likenesses, all in the U.S. In addition to basic provisions in a licensing agreement, the parties may also consider the following provisions:

- Confirm authority of Licensor and permission of the French government to enter into the transaction
- Add provisions relating to distribution rights in addition to license provisions, including for example what is to be delivered by each party, when, and at whose expense

c. **Movie rights licensing.** A U.S. movie studio licenses a German distributor of films to dub and exhibit a movie in the European Union. Among the provisions of the licensing agreement, the parties may consider including the following:

- Duration – for example, 7 years
 - Media – specify
 - Means of exploitation – for example, theatrical, home video, pay television, internet, video on demand, mobile downloads
 - Language
 - Territory
 - Key elements, including identity of lead actors and director
 - Holdbacks – how long after theatrical distribution may the work be distributed on DVD
 - Windows – a period when the work may be distributed in a particular media
 - Warranties
 - Deliverables – the specific physical elements which must be delivered to comply with the agreement, such as posters, internegative, format of the deliverables
 - Quality, evaluation and acceptance – will Licensee have the ability to question the quality in any manner, such as technical quality (which is important in Germany), the identity of key elements such as talent and director, and whether the film conforms to the shooting script
 - Ownership of delivery materials – usually Licensee must pay for the delivery materials
 - Licensor approvals of promotional campaign
 - Release and exhibition obligations – the distributor usually is not obligated to release the film, but there is usually a minimum guarantee established; release of the film theatrically is highly desirable as it significantly enhances the value of other forms of distribution
 - Recoupment of minimum guarantee (“MG”) – often the minimum guarantee must be paid by notice that the film is ready for delivery
- Define recoupable costs – distribution expenses, prints and ads and other expenses may be recouped prior to any overages to the rights holder
 - Order of recoupment – which costs are recouped first
 - Sharing in gross receipts
 - Cross-collateralization – sometimes profits in one media or for one film are reduced by losses in connection with another media or another film
 - Support material
 - Music licensing
 - IFTA Multiple Rights Agreement – members of the International Film and Television Alliance often use this standardized agreement, and an abbreviated single page deal memo as a starting point for negotiation
 - IFTA Arbitration Clause

6. What does the future hold worldwide for licensing transactions?

Given current indications, it appears that licensing transactions will grow in volume worldwide, producing more enforcement issues and requiring greater awareness of differing and constantly changing laws, practices and expectations. Following are news headlines of recent licensing disputes:

a. The “Can’t We All Just Get Along” Approach: NEC, Harris Settle Patent Lawsuit Over Wireless Gear (as reported in *IP Law Bulletin*, August 2005)

- The court action:
 - NEC Corp., based in Japan, accuses Harris Corp. of infringing seven telecommunications-related patents in US and Canada
 - Harris countersues NEC for infringement of unrelated Harris patents
- The settlement:
 - NEC grants Harris a nonexclusive license under NEC’s patents
 - Harris buys certain NEC patents
 - Harris grants NEC a royalty-bearing, nonexclusive license under Harris’ patents

- NEC and Harris agree to patent cross license 'as to all other product categories'

b. The Lord of the Bling: New Line Settles Licensing Rights Suit (as reported in *LA Business Journal*, August 29, 2005)

- Facts: Movie mogul Saul Zaentz owned licensing rights to Tolkien's "The Lord of the Rings". Zaentz sued New Line Cinema for \$20 million, claiming the studio deprived him of unpaid royalties from "The Fellowship of the Ring," which grossed more than \$870 million worldwide.
- Under the license, Zaentz allowed Miramax (under contract with New Line Cinema) to make movies from "The Lord of the Rings" books in exchange for a share of "adjusted gross receipts"
- At issue: does "Adjusted Gross Receipts" mean
 - Gross revenues from foreign distribution of the film [producing a larger number] OR
 - Net receipts (after deducting expenses and distribution costs) [producing a smaller number]?
- Settled for: an undisclosed sum
- Lesson: Define terms carefully

c. Extra Points for Creativity: Nokia, Ericsson and InterDigital Communications (as reported in *IP Law Bulletin*, August 2005)

- The court action: InterDigital, cellular technology vendor, sues Ericsson, mobile phone manufacturer, for patent infringement
- Meanwhile during the Ericsson litigation, InterDigital enters into a licensing agreement with Nokia, a competitor of Ericsson. Royalty rates under the InterDigital/Nokia licensing agreement are to be calculated based on future licensing deals between InterDigital and third parties like Ericsson
- Back in court again: InterDigital sues Nokia for royalties set through arbitration – the royalty rate had been set based on InterDigital's settlement with Ericsson, and Nokia did not like the numbers

d. A True Drama of Brazil, India, AIDS, Abbott Labs, Pharmaceuticals, Patents and Licensing (as reported in *IP Law Bulletin*, December 2003 to July 2005)

- Brazil Threatens to Break Roche's HIV/AIDS Drug Patent
- Brazil Threatens to Import Indian Copy of Roche Anti-HIV Drug
- Brazil Threatens to Break Patents on AIDS/HIV Drugs
- Brazil Renews Threat to Break Patents on HIV/AIDS Drugs
- Brazil Threatens U.S. AIDS Drug Makers with Compulsory Licensing
- Brazil House Panel Paves Way for Breaking HIV Drug Patents
- Brazil Threatens to Break Patent on Abbott's Kaletra
- Brazil to Break Patent on Abbott Drug in Ten Days
- Abbott Races to Beat Clock in Patent Brawl With Brazil
- Abbott Yields to Brazil Pressure, Avoids Compulsory License on Kaletra

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CILJ MCLE Test Questions — Test No. 1 (Vol.14, No. 3)

MCLE Exam prepared by: Paul Supnik, Carol Brittain, Saralyn M. Ang-Olson, and Paro Astourian.

1. Under a licensing agreement, the owner (“Licensor”) of intellectual property (“IP”) intends to transfer all ownership rights in the IP to the user (“Licensee”) in exchange for agreed payments.
2. IP contained in a patent may be licensed. A patent application covering the invention must be filed with a designated industrial property office and the patent issued to be enforceable in a particular jurisdiction.
3. Trademarks may be licensed, but require registration with a U.S. governmental authority to be enforceable.
4. Use of copyrights may be licensed, but in most countries, copyright protection requires registration with a governmental authority to be enforceable.
5. Trade secrets may be licensed and require registration with a governmental authority to be enforceable.
6. Regional filing schemes to safeguard trademarks in various parts of the world include among others the Community Trademark scheme in the European Union, the U.S. Patent and Trademark Office, the Madrid Protocol, the Paris Convention, and the United Nations Trademark Program.
7. The purposes of a licensing agreement are to define the licensed IP and how it may be used, to define the payment flow in exchange for its use, and to provide appropriate representations and warranties between the parties.
8. An exclusive license means that only the Licensee may use the licensed IP for the stated purposes, to the exclusion of all other parties, including the Licensor.
9. In a licensing agreement, provisions relating to “territory” and “channels of distribution” refer to the same concept.
10. Royalties are always calculated as a percentage of “net sales,” meaning the actual invoice or selling price, less specified deductions, returns and customary cash and quantity discounts actually given to bona fide customers.
11. Advance royalty payments made by the Licensee to the Licensor upon signing a licensing agreement are usually netted against royalties earned upon later sales of the licensed products.
12. Aspects of royalty payments in licensing agreements include the frequency and due dates of payment, certification of calculated royalties earned, which currency royalties are to be paid in, and the determination of the exchange rate.
13. A licensing agreement need not specify that the Licensor has the right to approve or disapprove the manner in which a licensed trademark or service mark is used (for example, by reviewing samples of the products periodically), as long as the Licensee uses prudent manufacturing processes.
14. A licensing agreement often provides that Licensee must sell a minimum number of units of the licensed product and that sales must be made throughout the licensed territory.
15. With regard to which jurisdiction's law controls interpretation and enforcement of the licensing agreement, the jurisdiction specified should bear some relationship to the location of the parties, performance of obligations under the licensing agreement, the contemplated transaction, or the forum designated for dispute resolution.
16. While legal systems globally differ in some respects, worldwide procedures regarding depositions and testimony of parties are similar to those in the U.S.
17. When an agreement specifies that the laws of a certain jurisdiction will apply, the licensing agreement should contain language to the effect that the choice of controlling law shall be “without regard to principles of conflicts of laws” to avoid disadvantageous forum shifting.
18. Arbitration is more highly developed and is used more often outside the U.S., with specialized IP courts existing in some jurisdictions.
19. In the context of software licensing, the Licensor should preferably retain ownership of the software in an entity controlled by Licensor and not contribute the IP to an entity owned jointly by the Licensor and Licensee.
20. In a movie rights licensing agreement, ‘recoupment of minimum guarantee’ refers to the profits in one medium or for one film are reduced by losses in connection with another media or another film.

MCLE Test Instructions — Test No. 1 (Vol. 14, No. 3)

This MCLE test is a free benefit for members of the International Law Section of the State Bar of California. Therefore, you must submit this original form from the *California International Law Journal*, as photocopies of the test and answers are not permitted.

Please read and study the MCLE article in this issue of the *California International Law Journal*. Then, please answer the questions by marking “true” or “false” next to the appropriate number on the answer sheet below. There is only one correct answer to each question.

After you finish the test, please mail the original completed test and marked answers to:

International Law Section
State Bar of California
180 Howard Street
San Francisco, CA 94105

You may wish to retain a copy of the test for your records. Within eight weeks, the International Law Section will return your test along with the answers and a certificate for this self-assessment MCLE activity.

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