

U.S.-China Phase One Trade Deal: A Recap

by Dave Townsend and T. Augustine Lo

After months of anticipation, President Donald Trump signed an interim “Phase One” trade agreement (“the Agreement”) with Chinese Vice Premier Liu He at the White House on January 15, 2020. Under the Agreement reached after some 18 months of intense negotiations between trade officials of the two countries, China has committed to improve the ability of U.S. businesses to operate in China. China has agreed to revise its domestic intellectual property (“IP”) procedures and laws, refrain from forced technology transfers, improve regulatory approvals for U.S. agricultural and food products, meet certain targets in purchasing U.S.-origin goods and services, and allow certain U.S. financial service providers to operate in China.

For its part, the United States has agreed to suspend indefinitely its List 4B Section 301 tariffs originally scheduled to go into effect on December 15, 2019, and to reduce its List 4A Section 301 tariffs imposed in September 2019 from 15% to 7.5% (scheduled to take effect February 14). However, for now, the U.S. will maintain all the List 1, 2 and 3 tariffs at 25% that still cover approximately two-thirds of annual U.S. imports from China worth roughly US\$300 billion. The Administration has indicated it intends to keep all those remaining Section 301 tariffs in place as an incentive for China to abide by its Phase One commitments and to negotiate and enter into a further Phase Two agreement that would deal with many significant and as-yet unresolved trade and investment issues between the two nations.

The Agreement contains individual chapters on IP, technology transfer, food and agriculture, financial services, macroeconomic policies and exchange rates, Chinese purchase targets for U.S. goods and services, and dispute resolution. We summarize below each of these chapters and conclude with some initial assessments of the Agreement and its likely practical effects. Readers may also want to consult our earlier article concerning the background and context for the Agreement [here](#).

Intellectual Property.

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Designed to address one of the root causes of the trade dispute, the IP chapter requires China to make specific amendments to its IP laws to protect foreign owners of IP rights. While styled as reciprocal commitment to legal protections, only China has affirmative obligations to adopt such new IP rules. The Agreement does not clarify the mechanisms by which China will adopt these rules – whether by formal legislation, administrative provisions, or other policy guidance, which could potentially leave room for future disputes about whether China has complied with this requirement. However, the Agreement does provide that China must issue an “Action Plan” within 30 working days on how it intends to fulfill these requirements.

- **Trade Secrets.** China agreed to amend its trade secret law to cover electronic intrusions, breaches of nondisclosure agreements, and other unauthorized disclosures. China will also revise its civil legal procedures to adopt a “burden-shifting” framework in trade secret misappropriation cases so that the defendant would need to prove its innocence once the complainant has introduced sufficient evidence to withstand dismissal of the case. China agreed that its courts will be more open to granting preliminary injunctions for threatened use of a trade secret. In terms of criminal enforcement, China also agreed it will be more willing to prosecute cases even in the absence of actual loss by the rights holder and will apply criminal laws to cyber thefts. China also agreed to limit unnecessary requests by government agencies for information and to penalize unauthorized disclosures of trade secrets by government employees.
- **Pharmaceutical IP.** China will create a nationwide system to notify the holder of a relevant Chinese patent of any third party seeking to market a pharmaceutical product that may infringe upon such a patent and will allow the patent holder to seek judicial relief before any marketing approval is given for that third party’s product.
- **Patents.** China will adjust the duration of patent terms to compensate for unreasonable delays in approval and issuance of a Chinese patent where the application process exceeds four years. China will also adjust drug patent terms to compensate for delays in marketing approval for such drugs in China, but China may limit that adjustment in the patent term to five years and cap a drug’s patent term at 14 years from its market approval date.
- **E-Commerce Piracy and Counterfeits.** China will require expeditious takedown of online marketing of pirated goods, immunize erroneous takedowns in good faith and punish major e-commerce platforms for failing to remove IP infringing items.
- **Geographic Indications.** China will refrain from extending protection to generic geographic terms and will allow the United States to express objections when China negotiates a trade agreement with any third country that would put U.S. goods at a disadvantage.
- **Manufacture and Export of Pirated or Counterfeit Goods.** China will curtail counterfeit drugs; share information on the registration and inspection of pharmaceutical plants; increase enforcement against other counterfeits, including the destruction of counterfeits and the materials and implements used in their production; and require Chinese government agencies to use only licensed software, subject to third-party audits.
- **Trademarks.** China will not enforce bad-faith trademark registrations.

Technology Transfer.

This chapter requires that China refrain from compelled technology transfers as a condition for licensing or participation in joint ventures, particularly where there is no

regulatory need. China also agreed not to direct outbound foreign investments to further its national industrial goals, so that such outbound investments from China would only be made on a market basis.

Although the U.S. Trade Representative (“USTR”) had cited such forced technology transfers in its Section 301 report that formed the basis for all of the Section 301 tariffs and the White House has frequently accused China of this kind of abuse, this entire chapter is only two pages long. Moreover, this chapter may be difficult to enforce given that an aggrieved U.S. company would need to raise its complaint with the USTR for a specific proposed or finalized transaction that also may be highly dependent on other Chinese government approvals.

Food and Agriculture.

China agreed to certain regulatory measures intended to clear the way for more U.S. exports to China. In addition, China agreed to increase its purchase of U.S. agricultural commodities beyond certain baseline levels set in 2017.

China agreed on a commodity-specific basis to regulatory approvals and recognition of U.S. Department of Agriculture (“USDA”) and Food and Drug Administration (“FDA”) standards that are intended to increase opportunities for U.S. exporters to China. These include Chinese acceptance of U.S. standards and certifications for dairy products, poultry, beef, live cattle, processed meat, aquatic products, rice, potatoes, nectarines, blueberries, avocados, barley, alfalfa, feed additives, distillers’ grains, and pet and animal food.

China also agreed to administer tariff rate quotas (“TRQs”) consistent with World Trade Organization (“WTO”) rules and to allocate such TRQs for wheat, rice and corn before the beginning of the calendar year. (TRQs are a common tariff-based barrier that many countries, including the United States itself (which sets TRQs on imported raw and refined sugar), use to limit the total volume of certain imports, especially in agricultural goods, by increasing the tariff rate when certain fixed annual quotas for such imports from all foreign sources are exceeded.)

In addition, China committed to purchase more U.S. food and agricultural products relative to a 2017 baseline. In particular, the Agreement requires that China purchase a minimum of agriculture goods of US\$12.5 billion more in 2020 and US\$19.5 billion more in 2021 than China did in 2017. However, the Agreement also states that such Chinese purchases will be made according to market conditions, which presumably means that China must want to import such goods to meet actual domestic Chinese demand and, further, that U.S. prices for such products must then be at or below the prevailing market rate. Given how much emphasis China has placed upon these as “market condition” terms in the Agreement, it seems there could be less certainty to these purchase commitments than may seem apparent. In addition, the European Union has already indicated that the Agreement’s minimum purchase requirements may violate WTO rules on non-discrimination among WTO members.

Manufacturing, Energy, and Services.

Beyond the food and agricultural purchases, China also agreed to increase its purchase of U.S.-origin manufactured items, energy products, and services. In particular, China agreed to increase its purchases as follows.

- China will increase purchases of U.S. manufactured goods by US\$18.5 billion and US\$33.9 billion, respectively, in 2020 and 2021, relative to 2017 purchases. This part of the Agreement includes industrial machinery, electrical equipment, pharmaceutical products, aircraft, automobiles, medical instruments, iron and steel, and other manufactured goods.
- China will increase purchases of U.S. energy commodities by US\$33.9 billion and US\$44.8 billion respectively in 2020 and 2021, relative to 2017 purchases. This includes natural gas, crude oil, refined products, and coal.
- China will increase purchases of U.S. services by US\$12.8 billion and US\$25.1 billion respectively in 2020 and 2021, relative to 2017 purchases. This includes services from the United States for IP, travel and tourism, financial services and insurance, IT-related services, and others.

As with agriculture and food products, these Chinese commitments are minimum purchase requirements and, again, subject to “market conditions” in China, including actual domestic Chinese demand and competitive pricing of U.S. products relative to comparable goods from other supplier nations.

Financial Services.

The Agreement requires that China take a number of steps to ensure timely and fair treatment of regulatory approvals necessary for U.S. financial service providers to enter the market in China. Among these commitments are the following.

- **Banking.** China will take into consideration the overseas assets of banks seeking government approval to provide securities investment fund custodial services in China. With regard to underwriting non-financial debt, China will now take into account the other international qualifications of U.S. financial institutions as part of China’s regulatory approval process.
- **Credit Rating.** China agreed to review and approve licenses for U.S. suppliers of credit rating services in China within three months. Both the U.S. and China agreed to allow credit rating services to acquire a majority ownership stake in a supplier’s joint venture.
- **Electronic Payment Services.** China agreed to accept applications from U.S. electronic payment service suppliers to operate in China and to decide on each such application within certain time limits measured from the application date.
- **Distressed Debt Services.** China agreed to allow U.S. financial service firms to apply for licenses that would allow them to acquire non-performing loans from Chinese financial institutions, and if granted, to ensure “national” treatment of such U.S. firms.
- **Insurance Services.** China agreed to remove the 51% cap on foreign equity ownership for life, pension, and health insurance operators in China and thus, for the first time, to allow foreign insurance companies to own and operate wholly owned subsidiaries in China in these insurance lines.
- **Securities.** China committed to consider, review, and approve qualified financial institutions for securities, fund management, and futures licenses. China also agreed

to remove the foreign equity cap for the securities, fund management and futures sectors.

Macroeconomic Policy and Exchange Rates.

Designed to address a long-standing U.S. complaint about alleged currency manipulation, this chapter merely affirms China's commitment to the terms of the International Monetary Fund and requires China not to engage in competitive currency devaluations to gain an advantage in export trade. However, in light of the Trump Administration's concurrent removal of its earlier U.S. Treasury designation of China as a currency manipulator, it is unclear what actual effect this provision will have on China's national currency, the yuan.

Dispute Resolution.

China and the U.S. can contest whether the other party has fulfilled its obligations under the Agreement, which includes a section on dispute resolution. Initially, each nation must undertake consultations at the sub-ministerial level with the other nation concerning an alleged breach and must share certain information to help clarify points of disagreement. If such consultations do not resolve the dispute, then the USTR and a designated Chinese Vice Minister would attempt to resolve the dispute bilaterally. Failing that, the complaining party may begin to retaliate in a proportionate amount for the breach. However, if such retaliation is deemed by the other side to have been taken in bad faith, the Agreement then allows that side to withdraw from the Agreement upon written notice thereof. Thus, dispute resolution under the Agreement will only be bilateral, done through political channels between the two nations, and without resort to arbitration or assessment by a neutral third party entity.

Given recent history between the two countries on economic issues, such a bilateral dispute resolution system could potentially escalate an issue and bring about the dissolution of the entire Agreement. For example, if the United States disagrees that China is providing sufficient market access for U.S. firms to a specified sector of the Chinese economy and takes some form of retaliatory action that China then considers to be "disproportionate" (such as re-imposition of punitive tariffs), China could withdraw from the Agreement. Only time and experience will tell how the two nations will manage such disputes to retain what each side sees as the advantages to stay within the Agreement. As importantly, staying within the Agreement likely is the only means toward a "Phase Two" deal that will deal with all the remaining stubborn issues, such as Chinese government subsidies for ostensibly "private" enterprises and the role and effect of Chinese state-owned enterprises and China's national industrial policies.

However, one final thing remains crystal-clear at this point: all of the punitive 25% tariffs on goods covered by Lists 1, 2 and 3, and the 7.5% tariffs from List 4A will now remain in effect for the foreseeable future, which means that U.S. importers and consumers will continue to bear the brunt of those tariffs indefinitely. That reality is likely to cause Chinese exporters to accelerate the diversification of their factory locations to third countries, including Mexico because of the favorable terms for goods made in Mexico

through the U.S.-Mexico-Canada Agreement that both houses of Congress have approved and sent to the President. It will also spur on U.S. importers seeking to realign their supply chains and to avoid direct importation from China if their imports remain subject to the 25% tariffs under Lists 1, 2 or 3, or the remaining 7.5% tariffs under List 4A. Finally, although items on List 4B are now sheltered from Section 301 tariffs, the United States likely would proceed to impose tariffs on List 4B items in the event of a perceived Chinese breach of the Agreement that is not addressed sufficiently, in U.S. eyes, through the prescribed dispute resolution mechanism.

Dorsey's attorneys at its offices in the United States, China, Canada, and United Kingdom can assist companies with assessing the potential impact of the trade matters discussed above. For additional information, please feel free to contact the attorneys listed, or see Dorsey's website, at www.dorsey.com.