

Leveling The IP Playing Field In China

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Over the past 15 years, companies developing, manufacturing and selling products and services in China have “gotten drunk” on the financial upside of moving these operations to China from North America and Europe. The reliance on China as the “World’s Vendor,” and all the financial benefits it brings, however, exposes companies foreign to China to a significant, largely unrealized, latent risk similar to that found in North America and Europe: intellectual property litigation in China over domestic Chinese patents. In short, the IP litigation playing field is close to being leveled between Europe, North America, and China.

There is a startling increase in intellectual property IP enforcement suits against foreign companies brought by those holding Chinese IP. Focusing on patent related issues, this increase in enforcement is related to the increasing rate of filing of patent applications in China by domestic Chinese individuals and companies.

For instance, patent filings by domestic Chinese companies in 2009 were up approximately 50 percent over 2008, overtaking filings made by foreign entities. There also appears to be an increasing number of patent enforcement actions brought against foreign companies.

While many of these patent litigations wind up being frivolous, as the number of domestic patents held by Chinese IP owners increases, it is inevitable that meaningful enforcement will ensue. The well publicized result of the China patent enforcement against Schneider Electric, for a reported \$23 million, is one example. Other types of IP rights, including trademark, trade secret and copyright, are also subject to this trend. Foreign companies availing themselves of the economic benefit of operating in China should evaluate the increasing IP infringement risks against their investment in China.

Companies in industries ranging from consumer products to high-tech software have moved essentially all of their operations to China in a successful effort to

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Published on Industrial Maintenance & Plant Operation (<http://www.impomag.com>)

leverage China's low cost structure, and take advantage of the improving sophistication of the Chinese vendor network. The move has been a wild success, as companies the world over have reduced costs, improved profits, and expanded their markets. The transition to relying on China as the "World's Vendor" has allowed these companies to succeed and grow despite increasingly hostile business environment in the major-market countries in North America, Europe and Japan.

This wholesale shift of operations to China has been completed largely without concern for the risks of infringing domestic Chinese IP held by Chinese companies and individuals. This risk is separate and apart from the well understood (yet difficult to resolve) counterfeit and grey-goods culture of China, where a Chinese company copies or misappropriates a third party product made in China. In both the counterfeit and grey-goods scenarios, the damage to the third party, while possibly significant, is measured in lost market share, disrupted distributor relationships and price reduction pressures.

Comparatively, the increasing enforcement of domestic Chinese IP against foreign companies is likely to have a more dire effect on the foreign company, including interruption of manufacturing (and hence inventory levels), the significant uncertainty of the legal result, diversion of management resources to non-strategic efforts, injunctive relief, and even criminal penalties.

The driver behind this increase in domestic enforcement of IP is a combination of the changing socio-economic environment in China, conversion from a supplier market to a more balanced supplier/consumer market, an improved legal framework, and government subsidized IP procurement plans. As China's middle class grows, and its manufacturing dominance begins to convert into a consumer-based economy, Chinese companies have begun looking for new sources of revenue to continue the impressive growth of the Chinese economy. Also, Chinese industry is becoming more robust in supplying markets outside of China, and other countries like Vietnam and Malaysia are competing effectively for manufacturing work.

These and other factors encourage domestic Chinese companies, once solely satisfied with supplying products for sale around the world, to consider other more sophisticated ways to improve and diversify their sources of revenue. The motivation behind the increasing domestic enforcement is also related to the traditional defensive use of IP to protect a market, which was historically only utilized in the US and Europe.

The legal framework for enforcing IP has also improved considerably in China recently. Many new aspects of the IP law provide enforcement opportunities similar to those in North America and Europe. To be sure, enforcement of IP rights in China is still a challenge due to the lack of a unified and consistent enforcement regime to support the improved legal framework.

What it comes down to, though, is IP enforcement will be treated as another optional source of revenue having potentially low costs with large positive revenue impact on the bottom line. As the benefits of domestic Chinese IP enforcement become better known, the risks to foreign companies related to this increasing

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trend will become more significant.

Protecting against this increasing risk, however, is as simple as “doing the same thing, just more of it.” The difficulty in protecting against this new level of risk is changing the attitude and status quo of operating in China. No longer can foreign companies ignore or downplay Chinese IP.

Historically, to mitigate the risk of infringement by commercial operations in North America and Europe, companies traditionally investigate relevant IP rights in those markets. This due diligence allows the companies to assess the level of risk, mitigate it by several means, and enter the market with some level of assurance that they will not be subject to an IP challenge that otherwise could have earlier been dealt with.

By implementing due diligence efforts on domestic China IP similar to those efforts made in North America and Europe, foreign companies can assess the risk of infringement, mitigate that risk, and enter the Chinese market with the certainty they are used to elsewhere. Establishing best practices for operating in China, in areas other than IP due diligence, can also be effective in resolving these issues.

The investigation of the landscape of domestic China IP in a company’s operating area is very similar to that effort made in North America or Europe. Typical efforts include performing searches to identify existing IP in relevant technology areas, evaluating the search results, and addressing any blocking IP identified. Resolving the IP issues identified in the due diligence effort can be done by the traditional methods of designing around, invalidating, licensing, or purchasing the IP.

Additionally, basic best practices can be effective, and include securing contractual protection with third parties related to IP issues. Again, the clauses used in standard contracts in North America or Europe can be modified pursuant to specific Chinese law to provide protection through indemnification or other such clauses. Also, be certain to address the rights associated with domestic Chinese employee-developed IP that can create an obligation for royalty payments to the employee.

Strategically plan the Chinese IP rights to be obtained by the foreign company to combat accusations of infringement, and focus on creating strong relationships with business partners in China to help resolve IP issues before they escalate to litigation. As these issues have become more mainstream in China, there has emerged an improved availability of resources to help implement and execute due diligence and business best practices. Major law firms and consulting firms now have expertise in these areas in order to support the new level of business sophistication required to operate in China.

The main effect of taking these additional steps to protect a company from IP risks associated with operating in China is investing the same company resources to implement best practices, as well as increased professional fees for investigating and minimizing the legal risks related to IP enforcement. The level of resources used here will be consistent with that spent on the same efforts for North America and Europe.

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The enforcement of domestic Chinese IP rights is becoming more commonplace, and foreign companies are bearing the associated risks and expenses. Foreign companies can manage these new risks by realizing that the IP enforcement landscape in China has almost reached the same level as the IP enforcement landscape in other major commercial markets.

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