

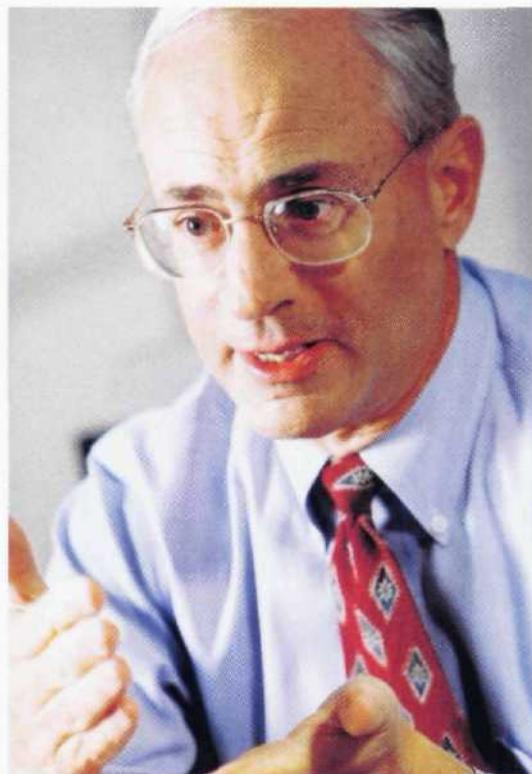
FIGHTING FOR YOUR RIGHTS

How bad is IP theft in China?
And what can you do about it?

It's not coincidence. The past 18 months saw two major IP lawsuits involving Chinese electronics firms. In the first, Cisco Systems sued Chinese telecom manufacturer Huawei Technologies for allegedly stealing router source code. In the second, Taiwan Semiconductor Manufacturing Company (TSMC) accused Shanghai-based foundry Semiconductor Manufacturing International Corporation (SMIC) of stealing trade secrets. The cases served as vivid reminders that in China IP rights are often problematic. IP theft is rampant in China, according to Patrick Powers, director of the Beijing office of the Washington, D.C.-based trade group the US-China Business Council. "If you do business in China, you should assume that your designs and products can and will be copied," he warns.

"Everyone who deploys in China experiences at least some IP theft," says Ned Barnholt, CEO of Agilent Technologies, which maintains a manufacturing facility in Shanghai and several R&D facilities in Shanghai and Beijing. The thievery is made all the more toxic by the lack of any effective way to obtain satisfaction. "The risks of IP theft are high because criminal penalties are too weak to deter IP rights violations," says Powers.

So what's a company to do? Nobody wants to lose their vital IP, but that seems to be the price of doing business in the world's fastest-growing economy. Or maybe not. According to legal and industry experts, it is possible for an electronics firm to deploy in China (without losing its IP shirt) by understanding the cultural basis for IP theft and then taking positive steps to discourage theft. "If you're willing to plan ahead, you can keep IP theft to a bare minimum," Barnholt promises.



To avoid theft, Agilent makes sure that no partners have access to 100 percent of its most critical IP, says CEO Ned Barnholt: "We tend to partition our development efforts so that we do some of it in China and some of it in other parts of the world."

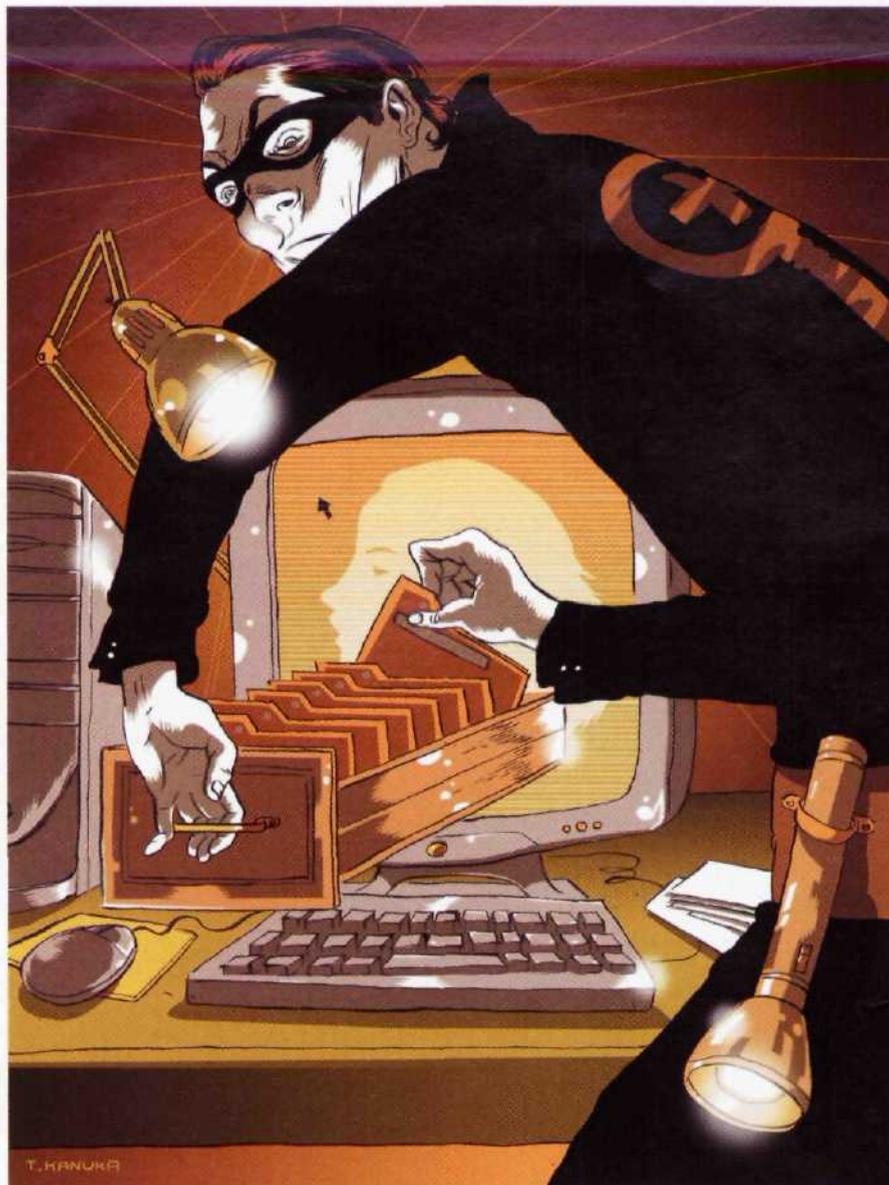
By Geoffrey James

The Nature of the Beast

Electronics executives must understand from the get-go that IP is viewed differently in China than in the U.S. In the U.S., IP is sacrosanct, something a company owns in the same way it owns its manufacturing equipment. That viewpoint reflects centuries of tradition; the first English patent was filed in 1449. By contrast, Chinese culture tends to view IP as something that contributes to the public good and whose impact increases in proportion to the degree to which it's dispersed. China didn't have patent laws until 1990, and those were added to the legal code because of international pressure rather than due to an internal sense of legal necessity, according to Usha Haley, a business school professor at the University of New Haven and author of *The Chinese Tao of Business: The Logic of Successful Business Strategy* (John Wiley & Co., 2004). "The entire idea of intellectual property is alien to Chinese culture," she insists.

This bias against IP ownership creates a business climate in which IP theft is simply not considered a serious breach of business ethics. In fact, foreign ownership of IP is sometimes viewed in China as a form of neocolonial oppression. Haley cites the example of a popular business book recently published in China that characterizes Microsoft's profit margins—which it gets by controlling its vital IP—as a form of stealing from the Chinese people. The Chinese government's insistence that foreign investment take place through joint venture partnerships is another manifestation of this anti-IP attitude. "The government does not want foreign companies dominating in China," says James Mulvenon, deputy director of the center for Asia-Pacific policy at the RAND think tank. "Instead, the government wants key technologies transferred to local Chinese firms."

Not surprisingly, joint venture partnerships are a primary nexus of IP theft, according to Mulvenon. Many Chinese firms see such partnerships as bootstraps



rather than long-term commitments to mutual growth. To make matters worse, there is a very close relationship between key Chinese commercial players and the ministries that are supposed to regulate them. "The result is a lot of market-tilting behavior and strong pressure for technology transfer," says Mulvenon. China's recent admission into the WTO was supposed to force the country to follow international IP norms but has done little to change actual business behavior. "The government views the WTO rules as a starting point for negotiations rather than a set of binding regulations," explains Mulvenon. "The implementation of every part of the treaty is going to require a long, drawn-out fight."

The Chinese government considers the electronics industry a critical source

of the IP for fueling China's continued growth. Mulvenon cites China's recent attempt to establish unique "Chinese" Wi-Fi standards as a cynical attempt to raid the IP coffers of non-Chinese electronics firms. Even though the proposed Chinese standard was technologically inferior to the current international standard, the Chinese government was hoping that it would force Western firms to expose proprietary product internals to Chinese partners, according to Mulvenon.

Victims of IP theft have little opportunity for recourse, because it's very difficult (although not impossible) to obtain a favorable judgment in IP cases tried in Chinese courts. One difficulty is that the courts lack a disclosure process to force defendants to cough up incrim-

inating documents. This throws the entire burden of proof of IP theft onto the plaintiff, which must build a case by using external sources and independent research. Another difficulty is that China's legal system lacks the concept of legal precedence. Rather than making judgments based on prior cases, judges interpret Chinese law as they individually see fit, forcing plaintiffs to build a complete and unique case for every IP lawsuit. This is extremely challenging, because "the standard of evidence is extremely high," says Iain McDaniels, deputy director of China operations for the US-China Business Council.

Even then, the penalties for IP theft are so light that even a successful lawsuit is unlikely to deter future IP thefts. Because the cost/benefit equation of pursuing a lawsuit in Chinese courts is questionable, many companies do little or nothing when they encounter theft. Some fear that if they aggressively pursue their IP rights, the central government will create regulatory roadblocks that will harm IP owners' ability to do business in China. Other firms soft-pedal IP complaints because they hope to make a big sale to the Chinese government. Ironically, such kowtowing rarely pays off. Mulvenon cites the example of Microsoft, which exposed its source code to Chinese firms, only to see the government settle on Linux as its computing standard.

This is not to say that the IP picture in China is entirely bleak. "Chinese electronics firms are

becoming increasingly concerned about protecting their own IP from their own domestic competitors," explains Amy Xu, a Shanghai-educated attorney at the

lawsuits in countries where laws are more stringent. The Cisco/Huawei squabble is a case in point. Rather than attempting to pursue the case in the Chinese courts, Cisco brought suit in Texas, where Huawei has its U.S. headquarters. It's a strategy that seems to have worked. "Huawei is voluntarily making changes to certain router and switch products," says Penny Bruce, Cisco's senior manager for corporate public relations. Similarly, even though TSMC is headquartered in Taiwan, the company brought its suit against SMIC in Northern California, where SMIC maintains U.S. offices.

A Pound of Prevention

Short of slapping a U.S. lawsuit on IP thieves after the fact, how can electronics firms protect themselves? Experts recommend a two-pronged approach. First, even though Chinese IP laws are weak, electronics

firms should always avail themselves of those protections that do exist. Second, firms must take proactive steps to keep their IP out of the hands of potential thieves (see chart, "How to Protect Your IP in China").

The first line of defense against IP theft is the joint venture contract, which should always be written so that it preserves IP rights under both Chinese and international law. Although this may seem obvious, many companies neglect to hire legal expertise to appropriately interpret Chinese contract law, according to Xu. "Chinese law has significant differences from the law practiced in the United States and Europe," she explains. "It's nearly impossible for a U.S.-trained lawyer to accommodate its complexities."

HOW TO PROTECT YOUR IP IN CHINA

Before your IP is stolen

Action	Advantage	Disadvantage
Make certain that your JV contracts protect your IP.	Helps you identify the risks of doing business in the country.	Contracts may not reflect the actual intent of your JV partner.
File Chinese patents for all relevant IP.	Provides official record and the grounds for legal action.	Restricted to inventions rather than designs and processes.
Implement extensive physical and digital security.	Keeps key elements of IP out of the hands of potential thieves.	Security measures involve extra overhead and hassle.
Segment IP so that JV partners lack the total picture.	Prevents your products from being copied in their entirety.	JV partners may find it hard to function without full access.

After your IP has been stolen

Action	Advantage	Disadvantage
Persuade local government agencies to enforce regulations.	No court costs.	May require some under-the-table "influence."
File a civil lawsuit in China.	Courts have sometimes ruled in favor of foreign IP owners.	No disclosure process, so no "smoking gun."
File a criminal lawsuit in China.	Courts have sometimes ruled in favor of IP owners.	Standard of evidence is so high that conviction is unlikely.
Get customs officials to seize fake goods.	Can wreak major financial damage on IP thieves.	May require some under-the-table "influence."
Bring a lawsuit outside of China.	Patent and IP laws are stronger outside of China.	Case may be difficult to pursue if the evidence is in China.
Protest to the central government.	Creates publicity and warns would-be thieves.	Central government is unlikely to take any meaningful action.

IP-focused law firm Dorsey & Whitney. Huawei, for example, not only denies stealing Cisco's IP but also insists on championing its own IP rights, both in China and abroad. "Over the years, we have invested hundreds of millions of dollars to develop and patent our innovations, and we have strict intellectual property protections in place throughout the company," insists Richard Lee, Huawei's manager of corporate communications.

Chinese firms are also becoming more sensitive to IP issues because as they expand into international markets, they become vulnerable to IP



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For example, even more than the U.S. legal system, the Chinese legal system depends heavily on formal documentation, all of which must be prepared according to strict guidelines. All arrangements must be in writing, because verbal contracts, even when they seem definitive to non-Chinese ears, are considered negotiations rather than commitments. All official documents must not only be signed and dated but also stamped with the company “chop,” a seal that carries more weight in Chinese law than a signature. The contract should specifically prohibit (or at least limit) subcontracts between the joint venture partner and other Chinese firms, lest subcontractors become a conduit for IP theft. Finally, the contract should stipulate what will happen to all equipment, inventory and documents if the joint venture is terminated.

Electronics firms deploying in China should also take the precaution of filing patents in China. “We’ve filed U.S. and European patents in China and filed original patents in China for products and processes we invented in China,” says Agilent’s Barnholt. IBM and Motorola have also been very active, filing hundreds of Chinese patents each year, according to Xu, who is surprised at how many firms neglect this simple precaution. “Filing a Chinese patent costs only three to four thousand dollars, including the legal expense,” she says. “That’s about half the cost of a U.S. filing.”

Chinese patent law differs from U.S. patent law, though. In China, for example, patents generally only cover actual physical inventions rather than processes or business models. Chinese

patent law also adheres very closely to the first-to-file rule, so that patent rights go to the firm that files first, even when it is abundantly clear that another firm is actually responsible for the invention. “Companies must work with qualified counsel to understand what is and isn’t considered protected IP,” recommends Ben Goodger, head of commercial consultancy for Asia at Rouse & Co. International, an IP consultancy headquartered in London.

Physical security is critically important. Electronics firms should keep all legal documents and chops in a safe place (that is, far from joint venture partners), lest they accidentally “disappear.” Technical documents should be published on copy-proof paper and provided to joint partners only on a

need-to-know basis. Web and network access to corporate computing resources should be strictly limited, and all connections should include hardware or software firewalls. Furthermore, electronics firms should consider embedding a logo or a secret marking on all products that contain important IP, so that the products can be tracked if they later pop up in unexpected places.

Electronics firms should also segment activity with joint venture partners so that the partners don’t have access to 100 percent of the most critical IP. At Agilent, for example, “We tend to partition our development effort so that we do some of it in China and some of it in other parts of the world,” says Barnholt.



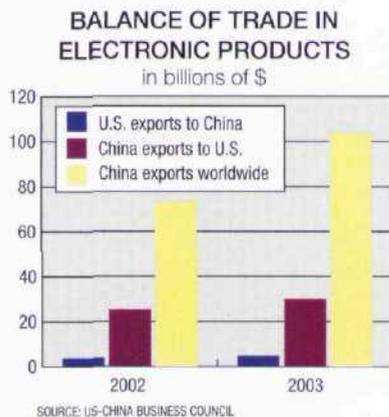
Another valuable technique is to compartmentalize production of components, which tends to minimize the likelihood that others can easily copy a design, according to Powers. For example, even though many computers sold in China have Intel CPUs, Intel manufactures the bulk of its

CPU chips for the China market elsewhere, according to Dave Mack, president of analyst firm Technology Business Research. However, although compartmentalization is a key element of any IP preservation plan, electronics firms must be careful not to overdo it. “The goal is to create processes and procedures that leave you in control but still empower local people to succeed under your guidance,” says Gary Weaver, senior vice president of operations for Toshiba’s U.S. PC division.

If all of this sounds like a major hassle, it’s better than the two alternatives: not deploying in China at all or deploying in China and then watching your IP slip through your fingers. Over time, the situation may get better, and there are some signs of positive change as Chinese firms become more aware that playing a major role in international markets also means playing by the rules. However, centuries of Chinese tradition and bias against IP are likely to die hard. “China is at least a decade away from anything close to the level of IP protection we have in the U.S.,” says RAND’s Mulvenon. “Until it catches up, international firms must take active steps to protect their IP.”

What worries you most about your IP in China? Send your thoughts to feedback@eb-mag.com.

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