CHINA CENTRIC
ASSOCIATES

Straight Talk About Intellectual Property in China

Mike Corkran
CEO, China Centric Associates

Almost nothing elicits greater concern about starting a business in China today than protecting a company's valuable intellectual property (IP). The recent trade negotiations between the U.S. and China have focused on IP risks and misappropriation as a major issue. This fear is legitimate but is also impacted by Westerners misperceptions about the China IP environment and how to manage IP in China for safe and commercially successful results. Some of the world's most technically advanced companies have decoded the challenge and are developing and producing with confidence highly sophisticated products in China today that incorporate their "crown jewel" technologies.

Is it or is it not China IP piracy?

It may be a surprise to learn that much of what Western companies claim to be IP piracy by Chinese is not. Too often Western companies consciously choose not to patent technology in China that is routinely protected in the U.S. and Europe. Usually these Western companies incorrectly believe that Chinese patents are unenforceable, so why bother. Even in the U.S., if you choose not to patent an invention, a competitor is not breaking the law if he copies your idea. In fact, if the idea is a good one, it is good business for a competitor to copy your idea IF you did not have the foresight to protect and defend the technology. This is the unfortunate position many Western companies find themselves in when they choose not to file for IP protection in China.

Perhaps even more surprising is that even if these "supposed knock-offs" find their way into the U.S., where a company does have patent protection, the China company is usually not the party breaking the law. When infringing products enter the U.S. market, it is usually because a U.S. company buys the counterfeits in China – where they are legal – and then imports them into the U.S. for use or resale. In this scenario, it is the U.S. importer, not the Chinese company that is actually violating the law.

Much has been reported recently about *"forced technology transfers"* in which foreign companies are forced to transfer technology ownership to a China entity in order to do business in China. Over 25+ years working in China and helping to start 100+ companies across the technology spectrum involving companies of all sizes, I know of exactly ZERO examples of *"forced technology transfer."*

Do China partner candidates, suppliers or customers try to negotiate for tech transfers that could be damaging to the Western company? Yes they do just like anywhere else, but that's just negotiation. The Western company can say no – that's also negotiating! Maybe a deal will fail, but the decision to transfer or not transfer is the foreign company's alone. Depending on the circumstance, the best deal may be no deal or finding a better one with a different partner. If a company concedes to demands, executing a bad deal, that's bad negotiating – not *"forced technology transfer."*

For example, I know of one client who told me they were victims of *"forced technology transfer"* when a JV partner declared they would not partner without a technology transfer. As the story was told, rather than do a bad deal or walk away, our client took a patented formula they never used in any other market and transferred that to the China JV. The China partner was satisfied, the JV proceeded and even with this lower grade tech transfer the JV was very successful. Regardless, this was not *"forced technology transfer"* – it was negotiation between two parties and shrewd approach by the U.S. company to solve the challenge without true risk.

I am not trying to absolve Chinese companies from any involvement or culpability in IP piracy – far from it. Piracy happens in China, just like in every country, including the U.S. The Chinese IP environment remains immature and presents risks to Western companies who do not understand how to manage IP effectively in this environment. However, the almost ubiquitous accusations leveled against Chinese companies only scratch the surface of what is a very complex issue.

Historical differences in IP concepts

To understand today's intellectual property rights situation in China, it is necessary to understand the contrasting history of IP in China and the West. The first known Western-like IP laws date back to a Greek island about 2,000 years ago. If a chef invented a recipe, no one else was allowed to duplicate the recipe for one year. From that simple beginning and with 2,000 years of commercial and legal concept evolution in the West, modern IP concepts are instilled throughout most developed economies. For example, the U.S. Patent Office was founded in 1790 based on English legal principles and it has taken over two centuries for the imperfect U.S. system to develop from an already established conceptual base.

In contrast, about 2,500 years ago, Confucius and his followers were laying the foundation for Chinese philosophy with contrasting concepts that included the notion that information is like the air and water -- no one can own it. It was not until the late 1980's when Western businesses arrived in China in meaningful numbers, claiming that knowledge could be owned by individuals or companies. Westerners are asking a country with an opposing philosophical foundation to adopt a new paradigm – one that took the West over 2,000 years to develop. We are asking – even demanding – that this be accomplished in a very short time span in China.

There is a practical dimension of what can be expected. It is easy to write laws and China's written IP laws are similar to those of the West. But the reality is that it takes many years to develop a body of legal precedence in a society on which to run a regulatory and legal system; to train a national judiciary to be able to administer the laws; to train a national bar to advise and assist in protecting the rights of companies and individuals; and to train an entire commercial class of business people to intuitively understand, accept and live by new knowledge ownership concepts. It is unrealistic to expect that China can navigate an IP development path in thirty years that took us centuries. Today, China still lags the "administrative" experience and does not yet have fully mature mechanisms to operate a sophisticated IP system as we do in the West.

One last thought-provoking question – how solid and fair are IP protection laws and enforcement in the U.S.? From multiple personal experiences, here is the U.S. intellectual property reality. If you think your patent is being infringed upon, you hire a lawyer. Legal costs will likely run hundreds of thousands of dollars– if not higher. Your chances are low of getting quick injunctive relief against the offending party, because few of these situations are *"black and white."* It commonly takes years to resolve these conflicts. While a few results in lucrative outcomes for the harmed party, more commonly a compromise settlement takes place.

China IS Adopting Solid IP Regulations

It is strongly in China's interest to adopt Western-like regulations as quickly as possible and they are doing so at a rapid pace. China is and will continue to implement solid IP practices for two reasons. First, Chinese entrepreneurs are developing their own IP that they want to protect. Second, China needs a continuing flow of higher technology foreign investment opportunities to fuel their economy to advance the nationwide standard of living for its people. China understands that Western companies will not bring their best technologies unless they have a reasonable expectation that their IP will be respected.

That doesn't mean the West shouldn't push for more rapid and substantive IP reforms and better administration practices in China. We absolutely should. At the same time, we need to understand that there is a practical limitation to how fast China can actually accomplish this task. When I first began working in China in the early 1990's, there was essentially no IP protection in China. By 2000, there had been great progress and Western companies were winning IP cases in China courts and arbitration. Today the progress is immense compared to the starting point and with a consistently positive trend line.

Practical Management of Intellectual Property in China

Today, the IP environment in China is still not ideal. So, how does a company operate and protect its IP in China? The answer is with prudent technology management, which is always a better strategy that reliance on courts anywhere. Management techniques can be employed to minimize exposure. These practices most commonly are built around the concept of *"compartmentalization."* Compartmentalization is partitioning components of technology (hardware, software, process or application know-how) into "packages" and controlling access to those packages. This the strategy historically used by Coca-Cola® as an example. There are a number of ingredient and process "packages" that comprise the Coca-Cola® formula. Only a few people inside the Company know the actual

composition and total formula of Coca-Cola®. Even though there is no formal legal IP, the formula is a closely guarded secret. IP is not just patents, but it includes valuable process and trade secrets that enable a company to succeed.

In our experience, there is almost always some form of compartmentalization that can protect the trade secrets and IP of a product or process, but it takes careful analysis and planning. Once a company has determined the form of compartmentalization, the next step is restricting access in such a way that the company is operationally and commercially effective while sufficiently restricting access to the whole know-how and technology pool.

In some cases, effective compartmentalization could mean seeking multiple suppliers, each of whom only supplies a portion of a product. In other cases, it may mean supplying a critically sensitive component from outside China. It could mean installing sensitive "ingredient" functionality at the last moment before shipment, such as with software loads. It could mean segmenting your R&D department to partition access to core technologies even within your own company. There are as many paths to compartmentalizing technology. The range of possible actions is situationally driven and limited only by the creativity of the technology-owning company.

It is always a better strategy to "manage and control" technology internally than rely on regulators, arbitrators or courts in either your home country or a foreign one. When entering a foreign country, take the time up front to analyze technology risks and integrate a specific technology management strategy and program into your company's overall business plan for the country being entered. This has to be implemented from Day #1 of operations in a new country or the damage will already be done.

Additionally, every company should insist that employees and suppliers with access to sensitive IP sign non-disclosure agreements and even non-competition contracts. These agreements are enforceable in China. Finally, with absolute certainty, companies need employees to understand the concept of IP or even what information a company deems confidential. Companies need to engage in active training and education programs to ensure that their workforce clearly understands the issues concerning IP.

Media reports concerning IP in China are almost always oversimplified. China does not have the mature environment we have in the West; however, their legal system is developing quickly. Although not simple, Western companies can protect their rights in China courts today. These facts should not discourage businesses from entering the China market because with prudent management, a company can protect their IP and enter the China market with confidence.