

Protecting the Company Jewels in an Unprotected Country

by William J. Holstein

07/03/2007

a strategy+business exclusive

Protecting the Company Jewels in an Unprotected Country

As governments wrestle over safeguarding intellectual property rights in China with no solution in sight, more and more companies are taking the problem into their own hands.

by William J. Holstein

The uninitiated might conclude that Chuck Cheng, a veteran of Silicon Valley startups, was overly paranoid in organizing his company's product development efforts in China. Cheng's company, AppoTech, headquartered in the Shatin district of Hong Kong not far from the Chinese mainland border, designs systems on chips, or very sophisticated combinations of analog and digital functions on the same piece of silicon.

Rather than having his chips made in China, Cheng ships his designs to fabricators in Singapore and Taiwan — and only then does he send finished chips to application development centers in China's nearby Guangdong Province. These centers employ Chinese researchers who develop new ways to use Cheng's chips in audio and video products for export, mostly to the United States. But the researchers work on computers that cannot be connected to the Internet and their USB ports have been disabled to make sure no one can download any proprietary data or information.

Cheng's great fear, of course, is that his intellectual property will be stolen — the polite term is "reverse engineered." It's not unusual for Chinese copycaters to take pictures of foreign semiconductors, blow up the images so that they can see the precise circuitry, and then copy the design. Other Chinese employees of foreign software

companies have obtained source codes and auctioned them off on the Chinese equivalent of eBay. Cheng's safeguards make any of those steps much less likely. "I am forced to be very careful," says Cheng. "I set up my headquarters in Hong Kong because it has the infrastructure and culture to protect my intellectual property."

As Washington and Beijing engage in a shouting match over Chinese violations of Western intellectual property, the reality on the ground is that foreign companies are either finding practical solutions to prevent their IP from being stolen in the first place or are working through the Chinese system to put pressure on imitators to cease and desist. The wrangling between Washington and Beijing, including a U.S. threat to take the Chinese to the World Trade Organization, seems unlikely to have as deep an impact as what companies like AppoTech are already doing.

Their efforts fall into two broad categories: thwarting IP theft before it occurs and recovering losses after the fact.

Putting Safeguards in Place

More companies are realizing that they have not done the best possible job in setting up their Chinese operations to guard against theft. Extra care needs to be taken in understanding the background of Chinese partners

William J. Holstein

(bholstein2001@yahoo.com) has covered China for more than 25 years, since serving as a correspondent for United Press International in Hong Kong and Beijing from 1979 to 1982. A contributor to the *New York Times*, *Barron's*, and *Fortune*, he recently returned from a reporting trip to Japan, Hong Kong, and Malaysia.

or licensees, and the same is true for employees.

The basic mistake many companies have made, incredible as it may seem, is assuming that the Chinese operating environment is similar to the one they experience at home. So they fail to do obvious things. For starters, companies need to register their trademarks in China and Hong Kong. It's possible to seek redress for trademark infringement in China, but in many cases it's much more effective to get prospective Chinese partners to agree up front that if arbitration is needed, it will occur in Hong Kong or the United States. Companies should also explicitly decide what is privileged information and set up strict protocols for who has access to it. "Assume nothing," says Judith Crosbie, a longtime compliance monitor in China for the Gap, McDonald's, and other large U.S. corporations, and now an attorney for MMLC Group, a legal and consulting services firm in Beijing that specializes in, among other things, intellectual property protections. "The assumptions are the things that cost dearly and take years to sort out."

Under greater pressure from the Chinese government to bring leading-edge research to China as part of an unspoken arrangement that allows these companies to continue to enjoy lucrative manufacturing engagements, multinationals such as Microsoft, Intel, and Lucent do conduct advanced R&D there. But they focus on small slivers of their core intellectual property — perhaps just one element of a given application — so that no Chinese rival could ever assemble that body of knowledge into a coherent product, says Clifford Ng, a partner at K&L Gates in Hong Kong, the law firm of William L. Gates (father of Microsoft chairman and chief software officer Bill Gates). Microsoft claims that as much as 90 percent of the software used in China is

pirated, but that it still makes some money on legitimate sales. Intel's recent US\$2 billion-plus investment in a new plant in northeastern China involved chip technology that is three generations old.

Other very practical steps include enforcing codes of conduct for Chinese employees and creating a climate in which workers know there is a system in place for tracking the flow of information. "You need to train your Chinese staff on ethical expectations because that is not covered in their educational systems," says Crosbie. Product samples also must be controlled. Many companies fail to recover samples from customers after specific periods of time, giving potential pirates a leisurely opportunity to copy them.

Crosbie also suggests that U.S. and other foreign companies make it very clear that all outgoing e-mails will be scanned for key words relating to piracy, which is particularly important because of high employee turnover. "If you don't want employees to take manuals to their next employer, make sure that large volumes of data can't be transferred without triggering an alarm bell," she adds.

Company-wide nondisclosure policies should be supplemented with personal agreements, experts say, because of a cultural nuance that leads Chinese to view corporate dictums as less substantive than documents with their names attached that they've had to sign. "A blanket corporate policy is not very effective," says Stephen Selby, head of the Hong Kong government's intellectual property protection division. He says that both corporate and personal agreements should be reinforced annually.

In addition, foreign companies should create legal or compliance departments inside their Chinese sub-

sidiaries, ideally comprising Chinese and non-Chinese employees, whether Americans or Taiwanese or Hong Kong residents. And headquarters should also dispatch inspectors or other executives to examine field operations rather than relying on long-distance communications.

In addition to these efforts, companies are advised to take stern action if any employee, however prized, breaks the rules. “You have to kill the chicken to scare the monkey,” says Crosbie, employing an old Chinese expression.

Offenders May Be Prosecuted

Even as more and more companies explore novel ways to protect intellectual property rights, they are getting a smattering of help from an unexpected source: the Chinese government. Although their country is still a hotbed of piracy, a handful of very senior Chinese leaders have concluded they want better IP protection for their own companies; without this, they believe, China’s own development is impeded. “That’s the biggest incentive the Chinese have to straighten out their IP laws,” says Ng of K&L Gates. “They realize that they have to be able to protect their own rights, not just in China but also in international markets.”

At least 19 government agencies are now involved in intellectual property issues, says Hugh Stephens, senior vice president of international relations and public policy for Time Warner in Hong Kong. His company faces a particularly acute piracy issue because its movies and music can be distributed over the Internet once they exist in digital files. Stephens is a member of a Beijing-based coalition of foreign companies that is pressing Chinese leadership for change. It carries a rather awkward moniker — the Quality Brands Protection Committee of the China Association of Enterprises with Foreign

Investment — but it is the leading business organization fighting for IP protection on the mainland.

Labor tribunals, which offer arbitration in a wide range of disputes between employers and employees, are one way to attempt to punish employees or former employees suspected of wrongdoing. These tribunals may summon key foreign lawyers or executives within 48 hours, so a company has to be prepared to send in necessary personnel from Hong Kong or elsewhere in a hurry. “They are willing to work with people who are trying to work with them,” says Crosbie.

Foreign entities can also bring suit at the national Trademark Bureau or a local copyright office, or seek redress at the State Administration for Industry and Commerce, which issues all business licenses. Disney brought action in Beijing’s Copyright Bureau when it discovered that Shijingshan Amusement Park was featuring large characters that looked just like Mickey and Minnie Mouse, Snow White, Donald Duck, and other copyrighted characters. Partly because the case was highly visible, the Copyright Bureau was able to force the amusement park to take “emergency measures,” which meant removing the Disney-like characters.

The Chinese court system is also working — to an extent. Pfizer successfully sued a Chinese competitor making Viagra and received an undisclosed settlement. But that didn’t actually stop the competitor, and now Pfizer is stepping up the pressure. “Enforceability is always an issue in China,” Crosbie says.

In similar litigation, Cisco Systems claimed that Huawei Technologies had copied its router technology to compete against the U.S. company in global markets with nearly identical products sold at a fraction of the price. The case resulted in an undisclosed settlement,

but Huawei products distributed worldwide continue to closely resemble Cisco's. And in a high-profile case, General Motors sued Chery Motors for imitating the Chevy Spark minivan. An agreement ostensibly restricting Chery's actions was reached in November 2005. But Chery has nonetheless introduced another Chevy Spark knockoff, the QQ, with a slightly redesigned front end.

Very few details are available on most cases because the lawsuits are usually settled privately. But one well-chronicled incident involved Starbucks, which discovered a competitor in Shanghai that was using the Chinese name for Starbucks, Xingbake Café. It was also using a logo in the same colors and style as the American company's. The Seattle-based company sued its upstart rival in Shanghai No. 2 Intermediate People's Court in 2004 and the court found in favor of Starbucks in 2005. The Xingbake Café appealed, but last January the Shanghai Supreme Court upheld the decision.

Still the Chinese rival persisted, and the Supreme Court said it would have to "educate" the company by freezing its bank accounts and seizing items related to the case. Finally, in May, the Shanghai outfit agreed to change its name. Xinhua, the official news agency, reported that Starbucks and its imitator settled on a RMB500,000 penalty (US\$63,000), which would be paid in installments.

If all measures fail to stop a rival from copying and the company seeks to export its products, it may be possible for a Western company to bring action in Hong Kong, where the vast majority of goods from southern China are transshipped. The former British colony has retained a Western-style legal system even though it is now officially part of China.

Working the System

Overall, there is no single surefire method to protect IP in China. The key, the experts say, is to be persistent and keep raising the cost of what an imitator is doing. The Chinese system is faster than, say, India's, and can be made to work in a foreign company's favor if the company has Chinese-speaking personnel and is tenacious. "A great many people from the United States are completely mystified by the Chinese system, but it is comprehensible," says Hong Kong's Selby.

For example, the Chinese legal system has very specific standards of proof and documentation for allegations of piracy, and foreign companies must strictly comply to have a chance of winning. "If you understand what is required, you can get what you want out of the

Chinese system," he adds. Sometimes sheer political pressure, such as lobbying against a company through a variety of governmental organizations, can help; it drives up the Chinese company's costs because it has to expend time and resources to respond.

Chinese copycaters "go after soft targets," adds attorney Ng. "They are not hardened criminals. In 85 or 90 percent of the cases, you can solve the problem."

Highly publicized street raids on fake CDs and DVDs are largely political theater aimed at Washington, Ng argues. "If it's a US\$200 billion issue, then smashing \$20 million worth of CDs and handbags is just for the press — it doesn't mean anything," says Ng.

The headlines about raids and all the bluster between Washington and Beijing don't capture the real nature of how U.S. companies and others are striving to safeguard their IP in China. It is a messy, multifront kind of guerrilla war, but it is one that's possible to win. +

Resources

Business Software Alliance Web site: One of the most active trade groups arguing for better protection of software in China. <http://www.bsa.org/usa/>

Hong Kong Intellectual Property Department Web site: Details intellectual property protections and activities in Hong Kong. <http://www.ipd.gov.hk/eng/home.htm>

Quality Brands Protection Committee of the China Association of Enterprises with Foreign Investment Web site: The leading China-based foreign alliance working to improve IP protection. <http://www.qbpc.org.cn/>

State Intellectual Property Office of the People's Republic of China Web site: Information about China's intellectual property initiatives, rules, policies, and regulations. <http://www.cpo.cn.net/>

U.S. State Department Intellectual Property Web site: A wide-ranging compendium of information about legislative and diplomatic initiatives regarding IP. http://usinfo.state.gov/ei/economic_issues/intellectual_property.html

strategy+business magazine
is published by Booz & Company Inc.
To subscribe, visit www.strategy-business.com
or call 1-877-829-9108.