Doing Business in China — Strategic Considerations and Effective Approaches to IP Protection

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"Doing Business in China — Strategic Considerations and Effective Approaches to IP Protection" was the topic of discussion during the October 22, 2007 presentation of The Web Conference Series for Corporate Counsel. *InsideCounsel* Editor-in-Chief Robert Vosper moderated the discussion. Mr. Vosper was joined by Foley Intellectual Property (IP) Partner Catherine Sun, chair of the firm's Asia Practice; Foley International Business Partner Zhu (Julie) Lee; and Cummins Inc. Patent & Intellectual Property Chief Counsel Bruce Schelkopf. The panel discussed solutions for understanding and navigating the potential obstacles to IP protection when doing business in China's burgeoning marketplace.

Addressing Trends

China's economy has grown at an annual rate of nearly nine percent for 25 consecutive years, and its growth is forecasted to continue at an annual rate of eight percent. In addition, the IP and business landscape in China is evolving rapidly, presenting explosive opportunities for business development.

In China and on a global level, IP is becoming an increasingly powerful business tool. But even as the clout of patents, trademarks, and copyrights continues to expand, counterfeiting and infringement have become more prevalent, making enforcement paramount to success in China's aggressive market.

Sharing Solutions

The opportunities in China are unprecedented for U.S. businesses, and exploration of these opportunities demands a thorough consideration of proactive strategies to manage IP risks for the protection of the technology and the business. Effective IP portfolio management and protection can determine whether a business ultimately will sink or swim.

There are three basic tenets for effective IP practices when doing business in China:

- Acquire IP assets in China when there is a strategic need
- Conduct careful due diligence when distributing, licensing, forming a company, or acquiring a target in China
- Develop a strategy for enforcing the company's IP in China

Acquiring IP Assets in China

It is imperative to remember that time is of the essence when securing the protection of IP in the Chinese market, and both U.S. and Chinese regulations need to be considered. Companies must assess where IP assets might be vulnerable, and seek protection for those assets. The sooner a company can assign an applicable IP protection tool — whether patent, trademark, copyright, or trade secret — to each of its innovations, the better. If a company fails to take adequate steps to protect its IP, it risks having valuable information fall into the public domain — or into the hands of competitors or counterfeiters.

Conducting Careful Due Diligence

When preparing to enter into a deal or collaboration with a China-based enterprise and assessing potential companies in China positioned for receiving technology, it is vital to secure counsel who are familiar with the Chinese business climate and investigative due diligence process.

It also is essential to understand a potential partner's business model and strategies as well as to define the role that the U.S. company's assets will play in the realization of those strategies. Additionally, investigative due diligence on potential management and shareholders in China may be challenging — such information can be frustratingly opaque — but it is essential to understanding and evaluating the risks involved in the enterprise.

Enforcing IP

IP protection tools are effective only when actively enforced in line with a company's realistic expectations. Although China has improved its laws for the protection of IP, the Chinese market presents unique difficulties with respect to procedures, presence, and enforcement efforts. Careful consideration of Chinese and U.S. laws should be made when approaching issues of enforcement.

Common Myths About the Chinese Legal System

Experience is essential to the effective navigation of China's evolving legal system. Chinese business and IP laws are changing rapidly and more closely aligning with Western law, but that transformation is far from complete. U.S. companies need to consider the impact that Chinese law will have on their business

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dealings with China and must be able to differentiate legal reality from myth. Common myths about the Chinese legal system include the misconceptions that:

- Case law is binding
- There is discovery
- Litigation is lengthy and expensive
- Arbitration is cheaper than litigation
- Judges are selected from experienced legal practitioners
- Foreign companies are treated unfairly

Case Law Is Binding
Case law is not binding in the Chinese court system. Case law provides useful precedent and persuasive support for an argument, but the legal process in China relies more heavily on statutes, regulations, and legislation.

There Is Discovery
There is very little discovery under Chinese law, and potential litigators should not rely solely upon the courts to collect evidence from the other side. Additionally, there are no depositions; it is essential to collect as much evidence as possible to support a case before taking recourse to the courts.

Litigation Is Lengthy and Expensive
Disputes typically conform to a strict six-month time limit; appeals usually last three months. Disputes may take slightly longer if a case involves a foreign party or a complicated patent. Additionally, it does not cost millions of dollars to litigate in China. In the United States, the process of discovery can result in countless legal fees, but the absence of discovery in China reduces those fees and the overall cost of litigation.

Arbitration Is Cheaper Than Litigation
Arbitration in China requires payment to a dedicated arbitration body, which may not be equipped to handle some mechanisms that a court can handle (e.g., preliminary injunction, evidence preservation, or property preservation). If a party wishes to arbitrate through a specific mechanism, it must go to court.

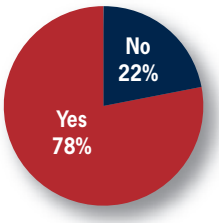
Judges Are Selected From Experienced Legal Practitioners
Judges in China once were selected from an entirely inexperienced population, but the situation has been improving, as new judges now must pass a unified national bar exam. In China, experienced judges tend to go into private practice because legal practitioners are rewarded more economically than sitting judges.

Foreign Companies Are Treated Unfairly
It is suggested that this myth may be a product of the media. While many outlets report on unsuccessful IP deals in China, few companies choose to publicize their successes.

A Business Reality: Lost in Translation
One very real area of concern involves cultural differences between China and the United States, which can lead to critical misunderstandings. These can be avoided or overcome by using careful and simple language in all documents and communications. It therefore is important to use experienced counsel, fluent in both the language and the culture of China.

Polling Question*

Do you typically have a supplier or distributor agreement with your supplier or distributor in China?



Legal Issues to Consider

To learn legal lessons on the ground carries great potential risks. The protected integrity of a company's brands, trademarks, patented technologies, and key business models depends upon a thorough understanding of potential risks and possible recourse. The following issues, taken from the experience of U.S. business executives in China, illustrate real-life situations that demand legal consideration.

- A U.S. company's former distributor is copying a product in China, and it is rumored that the former distributor has filed a patent application in China based upon this product. Patents have not been filed by the U.S. company to cover the product, and its Chinese trademark applications are pending.
- A former licensee in China has continued to use IP after the license expired.
- Through connections in the Chinese market, a Chinese licensee/distributor now produces extra products bearing a U.S. company's trademark, selling poor-quality products at a 40-percent reduction.
- A U.S. parent company registers IP in China and licenses the IP to China-based operations, but questions the efficiency of that licensing model.

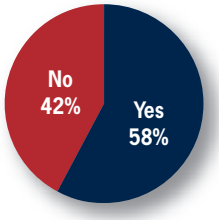
** All polling results are based upon the number of respondents to each question rather than the total number of participants in the Web conference.*

- A U.S. company is concerned that a technology company in China — one with whom it is exploring a potential partnership — has not maintained suitable IP records.
- While working with a state-owned enterprise (SOE) on a joint venture in China, a U.S. company is uncomfortable with the fact that the Chinese government requires the transfer of all up-to-date technology to the Chinese party and that future improvements must be shared with the Chinese party.
- A U.S. company is concerned about whether it can obtain the unencumbered right to technology developed by universities and research institutes in China.
- A U.S. company debates whether to issue a cease-and-desist letter to local companies suspected of IP infringement.
- A U.S. company is concerned because its top engineers in China recently quit and started a competing business.
- A U.S. company is concerned that an SOE in China is infringing the company's IP and would like to approach the SOE for a license.

In a rapidly evolving business relationship, it can be challenging to anticipate every possible point of friction. But it is possible to be prepared. An understanding of the above issues — and an understanding of how to mitigate or avoid them — can help a U.S. company ride smoothly over unanticipated bumps.

Polling Question*

Are you able to have a noncompete agreement with your China-based employees?



IP Protection in Commercial Transactions

Determining proper IP protection mechanisms in commercial transactions requires careful consideration of contracts and agreements as well as business practices in China. IP protection should suit short-term goals as well as long-range goals.

It is important for U.S. companies to perform related due diligence and establish a solid relationship with Chinese business partners, regardless of the chosen investment vehicle. Typically, a U.S. company may expand into China through either a contractual arrangement or a foreign investment enterprise (FIE) such as a joint venture or wholly foreign-owned enterprise.

IP Protection in Contractual Arrangements

Three commonly used contractual arrangements, which differ in purpose and scope of protection, may be considered:

- Direct sale or distributorship agreement
- Supply agreement
- License agreement

Direct Sale or Distributorship Agreement

A direct sale or distributorship agreement is most appropriate for a U.S. company hoping to sell or distribute its products through a Chinese partner. U.S. companies entering into a direct sales or distributorship agreement should:

> Obtain ownership of IP by registering in China (i.e., secure a design patent or trademark that includes both the English brand and the Chinese translation of the brand and ensure the translation has a positive connotation to foster public appeal)

> Take anti-counterfeiting measures such as the use of special chemicals in the manufacturing process

> Prepare a confidentiality and noncompete agreement with the distributor or sales partner

Supply Agreement

A supply agreement is appropriate for a U.S. company hoping to find a source to manufacture its products or parts. U.S. companies entering into a supply agreement should:

> Control the manufacturing process by dividing steps in the process among different suppliers and sourcing key components of the process from different manufacturers

> Ensure the agreement provides the U.S. company the right to monitor and control the use of its IP

> Limit the manufacturer's use of the technology for the specific purpose of the company's product

> Prepare a confidentiality and noncompete agreement with the supply partner

License Agreement

License agreements require special consideration because of Chinese and U.S. technology import and export laws. When transferring technology to China, U.S. export control laws should be considered. In China, technologies are divided into three categories:

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- Prohibited: Technologies that cannot be imported into or exported out of China
- Restricted: Technologies whose import and export must be approved by the relevant governmental authority prior to their import or export, and the applicable technology transfer agreement must be submitted to the relevant governmental authority
- Permitted: Technologies that can be imported into or exported out of China without prior governmental approval, but the relevant technology transfer agreement should be submitted to the relevant governmental authority

Because a technology classification determines whether or not technology can cross the Chinese border, U.S. companies must classify technology according to these categories before approaching a potential business partner to avoid the risk of disclosing confidential information.

Companies also should be aware that, according to Chinese law, improvements to licensed technology belong to the party making the improvements. Ownership of these improvements cannot be transferred absent adequate consideration. It is therefore critical for the U.S. party to negotiate rights to improvements before transferring the technology to China.

In order for technology transfer agreements to be enforceable in China, certain mandatory provisions of Chinese law must be satisfied. Transferors should structure any contractual agreements carefully to ensure the agreement complies with these provisions.

IP Protection in an FIE

When establishing an enterprise in China, it is important to consider the broad issues influencing business reality and practice in China. Businesses should consider:

- Confidentiality concerns: In addition to a well-drafted confidentiality agreement, the U.S. company should clearly mark the information provided to its Chinese partner
- Tailored, thorough general and IP due diligence that takes into account the practical reality in China
- Different options for transferring IP rights to an FIE, including capital contributions or licenses
- Special considerations for employee noncompete agreements: Under the new labor contract law, the agreement length cannot exceed two years, and an employer must pay a post-termination noncompete fee for the noncompete agreement to be enforceable
- Establishing detailed policies and procedures to protect IP rights, and educating employees about such policies and procedures

Summary

It is expected that China will offer U.S. companies and investors a broad range of business opportunities during the next several years. Although the market promises opportunity, conducting business in China can present serious hazards to the unprepared.

Companies should view IP protection as a valuable tool that provides a competitive advantage in business partnerships. Companies are advised to take a full inventory of internal IP before approaching a potential partner in China, and to consider how that IP should be protected. A well-designed contractual agreement or investment enterprise can maximize the production or distribution of a U.S. product. With experienced counsel to provide essential foresight and assistance, success is very possible.

InsideCounsel and Foley & Lardner LLP look forward to your participation in the next installment of The Web Conference Series for Corporate Counsel. Visit **Foley**.com/webconference for details on the upcoming "Resolving IP Disputes" program.

Please visit **Foley**.com/webconference for more information or to experience a recording of the "Doing Business in China — Strategic Considerations and Effective Approaches to IP Protection" conference.

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