Conducting Business in China

An Intellectual Property Perspective

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INTRODUCTION

The intellectual property (IP) practice has evolved in this new globalization age. For the past three decades, China has become one of the world's most important growth markets. With a population of more than 1.3 billion people, obviously, China has become an important source of economic opportunity for U.S. businesses.

China's rapid economic transformation, however, has presented both opportunities and challenges to many U.S. companies. IP conflicts in Sino–U.S. business transactions are on the rise, and U.S. companies are keen on extracting maximum IP values in China-related cross-border transactions.

This book discusses doing business in China from a practical and common sense IP perspective. Traditionally, many U.S. companies perceive Chinese companies as likely IP infringers instead of potential business partners. This book introduces a new approach aimed to create win–win situations, while offering specific advice on how to leverage technology and IP assets for profit, and minimizing potential risks for U.S. companies and their Chinese counterparts.

To my parents, Yihua Chen and Zhaoguang Mei,
who have always supported and believed in me.

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CHAPTER 1

IP Practice in the New Global Economy

The intellectual property (IP) practice has evolved in recent years from both legal and business perspectives, as the businesses become more globalized and economies in different countries become more interdependent on each other. The global economic landscape has been reshaped by China's breakneck economic growth in the past three decades. In 2010, China overtook Japan as the world's second largest economy behind the United States, expanding its GDP by about 10 percent to $5.88 trillion despite the global recession.[1] The rise of the Chinese economy, along with the largest consumer base, will continue to generate countless opportunities for U.S. companies doing business in China.

In this new global economy, IP practitioners and business executives must rethink their IP practices. Many old questions need new answers. For example, what is the value of IP to a company? How does a company's IP management impact its business operations? How can a company effectively utilize its IP to gain competitive business advantages? Although there are no easy answers to these questions, this book explains how China can be a part of IP solutions to many companies, whether they are large or small, multinational or domestic.

1. Theunis Bates, *China Surpasses Japan as World's No. 2 Economy*, AOL NEWS, Feb. 14, 2011, *available at* http://www.aolnews.com/2011/02/14/china-surpasses-japan-as-worlds-no-2-economy/.

In the legal sector, the IP practice, both transactional and contentious, has become more multinational. For example, the Patent Cooperation Treaty (PCT), an international treaty administered by the World Intellectual Property Organization (WIPO), makes it possible to seek patent protection for an invention simultaneously in different countries by filing an international patent application.[2]

Since 1978, PCT filings have gradually gained popularity. In 1994, when China became a contracting state to the PCT, WIPO received 34,104 PCT applications.[3] In 2010, WIPO received about 164,300 PCT applications, a 480 percent increase in filings from 1994.[4] Despite challenging global economic conditions, China filed 55.6 percent more PCT applications in 2010 than 2009, and was ranked fourth in terms of the number of PCT filings, behind the United States, Japan, and Germany.[5] Chinese companies, ZTE Corporation and Huawei Technologies, Co., Ltd., had 1,868 and 1,528 PCT applications, respectively, published in 2010, and were ranked in the top five PCT applicants along with Panasonic Corporation (2,154 PCT applications), Qualcomm Incorporated (1,677 PCT application), and Koninklijke Philips Electronics N.V. (1,435 PCT applications).[6]

Even for contentious IP matters, optimal solutions often require global strategies. As companies protect their inventions worldwide by filing for patent protections in different countries, patent litigation can turn into a global warfare. Hypothetically, when a company sues its competitor for patent infringement in the United States and seeks an injunction to stop the competitor from selling competing products in the United States, the company may also choose to sue its competitor for patent infringement in China, where the competitor's products are manufactured. In this manner, the company manages its litigation risks in the United States by hedging the bet in China. In other words, even if the company loses the lawsuit in the

2. World Intellectual Property Organization, Patent Cooperation Treaty (PCT) (1970), http://www.wipo.int/pct/en/treaty/about.html (last accessed July 18, 2010).

3. Press Release, World Intellectual Property Organization, the Patent Cooperation Treaty (PCT) in 1994 (Jan. 31, 1995).

4. World Intellectual Property Organization, *PCT Yearly Review 2010* at 3 (May 2011).

5. *Id.* at 12.

6. *Id.* at 20.

United States, it may win the lawsuit in China under Chinese patent law to stop the manufacturing of the competing products, thus potentially obtaining the same business goal—stopping the competitor from selling competing products in the United States.

Conversely, the competitor, when facing a patent infringement lawsuit brought by the first company in the United States, could proactively sue the first company for patent infringement in China, where the first company's products are also manufactured. In this manner, the competitor manages its own litigation risks by creating leverage. For example, if the competitor loses in the United States, but prevails in China to stop manufacturing of the first company's products, neither company may be able to sell its products in the United States and each would then be more willing to reach a business compromise to settle their dispute.

As a practical example, after Fairchild Semiconductor and its subsidiaries lost multiple patent infringement lawsuits in the United States brought by Power Integrations, Fairchild filed a patent infringement lawsuit in China in 2010, seeking a permanent injunction preventing the sale, manufacture, or use in China, or the importation into China, of Power Integrations' products alleged to infringe Fairchild's four Chinese patents.[7] This move does not really come as a surprise. Nowadays, most IC chips are made in China anyway, so if Fairchild prevails in China, Power Integrations would lose business globally, including the U.S. market.

In the business world, IP has been a part of corporate America's business strategies as early as the 1980s, and has been gaining popularity since the late 1990s. Arguably, Texas Instruments was the first major U.S. company to integrate intellectual property into its core business strategy.[8] In the 1980s, Texas Instruments survived the market invasion by Asian semiconductor manufacturers.[9] At the time, cheap Japanese and Korean memory chips flooded the U.S. market, driving prices down and putting U.S. firms out of business.[10] In

7. Press Release, Fairchild Semiconductor, Fairchild Semiconductor Files Patent Lawsuit Against Power Integrations in China (Mar. 2, 2010).

8. Lei Mei, *IP Stimulus Plan for Detroit's Big 3*, IP LAW 360, Feb. 20, 2009.

9. *Id.*

10. *Id.*

response, Intel exited the memory chip market, followed by Motorola and National Semiconductor.[11]

Texas Instruments' survival, however, was primarily attributable to the effective utilization of patents against Asian companies.[12] Before Texas Instruments, many companies used patents in much the same fashion as kids trading baseball cards.[13] Texas Instruments, lead by a patent attorney named Melvin Sharp, decided to sue its Asian competitors with patent litigation.[14] For months, Texas Instruments' team of patent attorneys and engineers painstakingly analyzed all its patents on memory chips and its competitors' products.[15] In the end, Texas Instruments sued many of its Asian competitors in a federal district court and before the United States International Trade Commission (ITC).[16] The rest is history: Texas Instruments received about $1 billion in royalties over the next five years and, more important, Texas Instruments recreated a level playing field for competition in the memory chip market.[17]

Since the beginning of the twenty-first century, more and more companies are realizing that IP can be a potent competitive weapon and a source of unexpected revenues.[18] Richard Thoman, then-CEO of Xerox Corporation, stated that his focus was IP and that he was convinced that "the management of intellectual property is how value added is going to be created at Xerox.... Increasingly, companies that are good at managing IP will win. The ones that aren't will lose."[19] Business analysts noted several advantages of IP: (1) establish a proprietary market advantage, (2) protect core technologies and business methods, (3) boost R&D and branding effectiveness, (4) anticipate market and technology shifts, (5) improve financial

11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.*
18. Kevin G. Rivette & David Kline, *Discovering New Value in Intellectual Property,* HARV. BUS. REV. 2 (Jan.-Feb. 2000).
19. *Id.*

performance, (6) outflank competitors, (7) exploit new market opportunities, and (8) reduce business risks.[20]

As the economy becomes more and more globalized, IP practitioners and business executives must rethink IP practice in the new global economy. Obviously, a company should consider a global strategy in IP management, especially with respect to China.

As the Chinese economy continues to grow, China is trying to build an economy that relies on innovation rather than imitation, in other words, "Created in China" instead of "Made in China," as a national strategy.[21] To achieve that goal, China calls for drastically increasing the number of Chinese patents that Chinese companies obtain.[22] China's State Intellectual Property Office (SIPO) published a document entitled "National Patent Development Strategy (2011–2020)" in November 2010, discussing broad economic objectives as well as specific targets to be attained by 2015, including two million annual patent filings by 2015.[23] By contrast, patent filings in the United States totaled slightly more than 480,000 in the 12 months ending in September 2010.[24]

Therefore, China must be a part of global IP and business strategies for any company that does business, directly or indirectly, in China.

This book provides a comprehensive guidance on how to conduct business in China from an IP perspective. Different from the conventional approach that criticizes China for its deficiencies in IP protection, this book takes a pragmatic approach to propose a win–win solution for both U.S. companies and Chinese companies within the existing Chinese business, legal and political environment.

Chapter 2 introduces China's IP system and trade regulations. Chapter 3 describes business and legal cultures in China, including practical tips of dos and don'ts. Chapter 4 analyzes recent IP conflicts in Sino–U.S. business transactions with case studies in the CD/DVD, digital TV, telecommunications, and chemical/pharmaceutical

20. *Id.* at 4–9.
21. Steve Lohr, *When Innovation, Too, Is Made in China*, N.Y TIMES, Jan. 1, 2011.
22. *Id.*
23. *Id.*
24. *Id.*

industries, and trend in IP conflicts. Chapter 5 covers different ways to extract IP values in cross-border transactions, focusing on China-centric IP practice, and identifies deficiencies in the traditional business model. Chapter 6 discusses business implications of international IP practice with case studies of several landmark IP cases in China involving foreign companies. Chapter 7 provides guidance in developing IP strategies for structuring successful business deals for both China-inbound and outbound transactions. Finally, Chapter 8 provides an overview of the future of China-related IP practice.

CHAPTER 2
China's IP System and Trade Regulations

I. INTRODUCTION

In 2010, the People's Republic of China became the world's second largest economy after the United States.[1] China's economy has grown to more than 90 times its size since its late president Deng Xiaoping endorsed free market reforms in 1978.[2] In 2010 alone, inbound foreign direct investment into China surpassed $100 billion, and

1. Theunis Bates, *China Surpasses Japan as World's No. 2 Economy*, AOL NEWS, Feb. 14, 2011, *available at* http://www.aolnews.com/2011/02/14/china-surpasses-japan-as-worlds-no-2-economy/.
2. Kevin Hamlin & Li Yanping, *China Overtakes Japan as World's Second-Biggest Economy*, BLOOMBERG NEWS, Aug. 16, 2010.

investment overseas by Chinese companies in nonfinancial sectors totaled $59 billion.[3]

As the largest exporter and second largest importer of goods in the world,[4] China offers a tremendous number of opportunities for U.S. companies doing business and profiting in China. To take advantage of such opportunities, one must understand the transformation of China in the past three decades and the evolution of Chinese law and regulations.

II. RISE OF THE CHINESE ECONOMY

When the Chinese Communist Party took over the control of China in 1949, China's economic system became communist. In 1978, however, President Deng Xiaoping approved the free market system, and subsequent economic reforms have generated significant and steady growth in investment, consumption, and standard of living. Since 1978, hundreds of millions have been lifted out of poverty, as China's poverty rate fell from 53 percent in 1981 to just 8 percent in 2001.[5]

As a country with a history spanned over five thousand years, China has generally implemented reforms in a gradual fashion. Contrary to the conventional view, China's economic growth does not overly depend on exports; rather, China's economic growth has come from both huge state investment in infrastructure and heavy industries and private sector expansion in light industries.[6] In recent years, China's economy is driven not by exports but by domestic investment, which accounts for over 40 percent of gross

3. Owen Fletcher, *China December FDI Growth Eases; 2010 FDI Passes $100 Bln Mark*, Dow Jones Newswires, Jan. 17, 2011.

4. Jean-Paul Rodrigue, World's Largest Exporters and Importers, 2009, http://people.hofstra.edu/geotrans/eng/ch5en/conc5en/leadingtraders.html (last visited Feb. 5, 2011).

5. The World Bank, Fighting Poverty: Findings and Lessons from China's Success, http://go.worldbank.org/QXOQI9MP30 (last visited Feb. 5, 2011).

6. *An old Chinese myth: Contrary to popular wisdom, China's rapid growth is not hugely dependent on exports*, The Economist, Jan. 3, 2008.