



**Thornhill Capital**



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### **Intellectual Property Rights in China**

The Chinese intellectual property system is relatively new. Although some contend that intellectual property (IP) in China was first recognized in the Tang Dynasty (A.D. 617-906), the rules associated with this period merely placed restrictions on the unauthorized use of books, symbols, and products associated with the emperor as a method of promoting imperial control and power, rather than in promoting science and the arts. In fact, the legislation of intellectual property by the Chinese government started only recently. It wasn't until 1980 that China sought membership in the World Intellectual Property Organization (WIPO) and, soon after, in 1983, initiated its first trademark law. This was followed in 1985 with the issuance of the country's first patent law and in 1990 with the establishment of copyright laws. China's recent establishment of intellectual property laws therefore contrasts sharply with the United States, which enacted its first patent law in 1790, and with Europe, which had a patent law first instituted in Venice in 1474, and in Britain in 1623.<sup>1, 3</sup>

For nearly 4,000 years, China's understanding of intellectual property was associated with the imperial court, emperors, guilds, or the state. Conflicts during this time were most often decided by family heads, village





elders and guild leaders.<sup>5</sup> Unlike most countries, which have a body of law that addresses intellectual property rights (IPR), China's establishment of laws governing IPR simply didn't begin until the 1980's.<sup>2</sup> What early understanding of intellectual property China did have was obtained from China's main trading partners, the former Soviet Union and its satellites, where there was a belief that individual inventions or creations belonged to all members of society. According to Professor William P. Alford, both the former Soviet Union and China had underlying ideologies which provided them fundamentally parallel views. If an individual's invention was noteworthy and responsible for significant advances, the inventor would receive a monetary reward tied to the savings realized by their invention while the state would have the right to exploit and disseminate it.<sup>5</sup>

The former Soviet Union's view of intellectual property is best illustrated by a 1944 quote from Karl Marx:

*Even when I carry out scientific work, an activity which I can seldom conduct in direct association with other men, I perform a social, because human, act. It is not only the*

*material of my activity – such as the language itself which the thinker uses – which is given to me as a social product. My own experience is a social activity. For this reason, what I myself produce, I produce for society, and with the consciousness of acting as a social being.*

Early Chinese views on intellectual property reflected its deep-seeded beliefs in the teachings of Confucius. Confucius taught that, in the transmission of culture, intellectual creation is fundamentally a product of the larger society from which it merged. Confucian culture thereby encouraged learning through copying the works of others.<sup>6</sup> China's early position on intellectual property is best illustrated by a popular saying during the Cultural Revolution (1966-1976):

*Is it necessary for a steel worker to put his name on a steel ingot that he produces in the course of his duty? If not, why should a member of the intelligentsia enjoy the privilege of putting his name on what he produces?*<sup>5</sup>

China's conflict with other countries on intellectual property began shortly after Deng Xiaoping's announcement of China's open door policy in December 1978. Deng



realized that Western technology and investment was needed in order to transform China. Therefore, he opened China to Western investment by first creating four special economic zones, with tax incentives, in southern China. Within a short period of time China recorded record economic growth with a great many foreign companies commencing operations throughout the country.<sup>4</sup>

In parallel with this rapid economic expansion and inter-action with the outside world, China had to rapidly adjust to the business practices and customs of foreigners. One of the many adaptations they'd have to make would be to understand the rights and obligations associated with the intellectual property of foreign companies. In the 1980's IP was new to almost all Chinese companies. During this period the Internet wasn't prevalent, foreign books on intellectual property were seldom translated into Chinese, and intellectual property wasn't an area of focus for a majority of Chinese companies. The focus at this time, instead, was in obtaining technology from the West in order to stimulate the economy and increase national productivity. This was an enormous task given that interaction between Western and Chinese companies was new. In addition, there was no

historical precedence regarding contracts, business structure, or a great many of the other standards for business that we now take for granted. Business and government leaders at the time, in the West and within China, didn't always take into account the underlying IP obligations associated with these new business arrangements. They were, instead, focused on establishing a beachhead that would allow Western business practices and technology to flow into China while at the same time allowing foreign company's access to China's manufacturing and consumer markets.

For the Chinese, there was virtually no prior knowledge of how IP worked and, if there was, it was ignored in favor of producing a profitable enterprise.

According to The Honorable Randall R. Rader of the United States Court of Appeals for the Federal Circuit, who is an honorary professor at Shanghai University, there's been a lack of understanding in China of private property as an individual right beyond the mere pragmatism of economic regulation. China lacks the cultural and historical roots for widespread acceptance of property concepts. In fact, for intellectual property law enforcement



to be effective, China as a whole must understand the benefits of incentives for innovation and creation as well as the benefits of private property itself.<sup>3</sup>

Moreover, intellectual property infringement has a significant impact on the global economy. It's estimated that IPR infringement costs European manufacturers one out of five dollars they earn in China. Globally, experts estimate that 10% of world trade is based on fakes and stolen IP, causing \$477 billion USD in damage.<sup>7</sup>

## Enforcement

From the late 1970s, until China joined the World Trade Organization (WTO) in 2001, the United States relied on the threat of trade sanctions, non-renewal of most favored nation status, and opposition to China's entry into the WTO to get China to strengthen its protection of U.S. intellectual property rights. However, once China joined the WTO, the U.S. lost this leverage. Instead, China, as a member of the WTO, is now subject to the Trade-Related Aspects of Intellectual Property Rights agreement (TRIPS Agreement). For members of the WTO, TRIPS provides that intellectual property disputes among member nations are

to be settled through the mandatory WTO dispute settlement process. Although this process can prove to be lengthy, the United States now has formal procedures to negotiate, resolve disputes, and arbitrate with the Chinese government.<sup>16</sup>

Outside of the WTO, and the U.S. court system, there are several types of enforcement actions available to those who want to pursue legal remedies in China against IP infringers. These are:<sup>2</sup>

- Administrative Actions
- Civil Litigation
- Criminal Action
- Mediation
- Cease and Desist Letters
- Customs
- Trade Fairs

**Administrative Actions:** Ninety percent of IP infringement in China has historically been handled through administrative agencies. This is not only an economical approach to IP enforcement, as administrative action is usually cheaper than judicial means, but it also requires a lower threshold of evidence than the People's Courts. Administrative actions also serve to send a message to other potential infringers in the market, as well as taking action to stop the current infringement.



However, administrative actions also have inherent disadvantages. Fines tend to be low, local authorities may not have the resources to accept administrative cases, and local governments may be protective of companies within their jurisdiction that create employment and tax revenue.

**Civil Litigation:** Civil lawsuits are becoming much more prevalent in cases involving IPR violations. According to Rebecca Ordish and Alan Adcock, who have a substantial amount of experience involving intellectual property challenges in China, courts are becoming increasingly transparent, with proceedings now open to the public as well as to foreigners. Previously, foreigners needed special permission to attend a court proceeding.

One contentious issue to be aware of is the use of trap purchases. In obtaining evidence of infringement, the purchase of a sample of your product that is offered for sale is generally accepted as valid by the courts. However, placing an order with the infringer, where he offers to supply the product, but does not have it in stock, may be an issue with the courts.

It's also important to note, when

initiating a lawsuit in China, that there's no rule that the loser must pay all legal costs for the preliminary phase related to the collection of evidence, the procedure itself, or reimburse the winner of the civil lawsuit. Normally, each party bears its own legal expenses. Civil litigation is improving in China, but it's still not perfect.<sup>7</sup>

**Criminal Action:** The number of criminal prosecutions within China for IP infringements is small. The threshold for individual criminal liability is a turnover of illegal products over \$6,000 USD or a profit of greater than \$4,000 USD. If these thresholds are exceeded, the infringer can face imprisonment. If the infringer is a multiple infringer, counterfeiting two or more trademarks or rights, then the thresholds are reduced to \$4,000 USD or a profit of greater than \$2,670 USD. The threshold for companies is \$18,000 USD.<sup>6</sup>

Infringers tend to get around these thresholds by using multiple locations where the quantity of goods stored is below these thresholds and where shipping orders are also kept below the thresholds. In determining the value of counterfeit goods authorities usually use either the price for which the product is actually



sold, the quoted price, or actual price at which a product is sold as determined by an investigation. In rare instances, where no other method of determining value is available, the actual price of the genuine product will be used to establish the value of the counterfeit goods.

**Mediation:** This can be particularly effective, as it gives the other party a means of saving face as well as resolving the dispute. Although mediation may not be acceptable to all parties, it's proven to be particularly effective where there's been a prior business relationship in place. Mediation has been utilized in China for quite some time and is culturally accepted as a method for resolving disputes.

**Cease and Desist Letters:** Normally we would consider this an ineffective method for resolving a dispute in China. This letter is probably more likely to end up in the trash bin, rather than be taken seriously. However, cease and desist letters do have a number of useful purposes. They're most effective in China when your rights may not be very strong and when you want to let the infringer know that you're watching them. A cease and desist letter is also used where the

quantities of goods produced by the infringer is low and doesn't justify an administrative raid, or where you don't have evidence of illicit manufacturing, but can view your infringed goods on the web or in a catalogue. It's also used as a method for initiating negotiations with the infringer.

**Customs:** When you're trying to prevent your infringed products from being illegally manufactured and exported out of the country, it's important to work with the Customs authorities. In doing this you'll need to record your rights with customs, put in place a verification and bond payment process, and provide training for customs officials in situations where copyrights and patents are an issue. Customs tends to be more efficient in regards to trademarks, as these are the easiest for them to recognize. Recognizing copyrights and patents is more difficult and customs officials usually have to be trained in order for this to be effective. Providing training for customs officials is therefore critical for anyone seeking to stop the export of products that infringe on one's copyrights or patents.

In the event that customs does seize goods that are suspected of infringing on your IPR, you'll have



three days to verify whether these goods have been authorized. Customs also requires a bond for products seized in the event that these products are found to be lawful and, as a result, the other party suffers a financial loss as a result of the seizure. This bond needs to be in place within three days. A bank guarantee will also suffice in place of a bond.

**Trade Fairs:** You'll often find infringers at trade fairs openly promoting your goods. Historically, when this happened, infringed parties were almost powerless to act at the trade fairs. However, in 2006, China introduced a new law titled: Measures Regarding Intellectual Property Rights Protection at Exhibitions and Trade Fairs. This law provides that, for fairs lasting greater than three days, the fair organizer must establish a Complaint Office to examine suspected IP infringements. The Complaint Office, upon receiving an indication of a potential IP infringement, must then transfer, within 24 hours, the details of the complaint to relevant authorities. The authorities will then decide whether or not to take appropriate action. If action is taken, the authorities can seize and destroy goods, as well as impose fines. If an exhibitor is found guilty of infringing twice, they will be

banned from further exhibitions.

## Chinese Lawsuits

Most of us tend to focus on foreign lawsuits against Chinese individuals and companies (there were 66,000 IP-related cases in 2011, up 37.7% from 2010).<sup>12</sup> However, many U.S. firms are now being accused by the Chinese of infringing on their intellectual property rights. According to attorney Dan Harris, many foreign companies don't believe that China has effective laws governing IP nor that Chinese companies file lawsuits. Both assumptions are wrong. Chinese companies take advantage of a foreign company's inexperience in these areas when a foreign company fails to register its intellectual property in China and the Chinese entity, instead, registers the IP in its own name. The net effect is that the Chinese company has taken the foreign company out of its desired market. In addition, many companies believe that China's system for protecting domestic IP is ineffective. Therefore, when a company commences operations in China it may not thoroughly investigate whether it's infringing on the IP of a Chinese company. As an example, a foreign company hires a Chinese contractor to engage in a cooperative



design or perform manufacturing. Sometime later the foreign company learns that it has infringed on the IP of a Chinese company and that the potential damage claims may be significant. In either situation, registering one's IP in China, as well as checking for potential domestic infringement, is essential.<sup>13</sup>

China has increasingly realized the value of intellectual property as patents are a key part of the government's plan to make the country less dependent on manufacturing. The government realizes that future competitiveness is not only due to innovation, but also due to the creation of international standards around existing intellectual property. As a result, China's State Council wants to regulate the process of turning a patent into a standard.<sup>7</sup>

Historically, 90% of all patents are owned by highly developed countries, especially in telecommunications, semiconductors, pharmaceuticals, and computers. Western countries hold 70% - 90% of all patents. In comparison, 90% of all Chinese companies have no patent rights at all and 60% do not even have a trademark. This is one of the reasons the Chinese government has been insistent on technology transfers as a condition of doing

business within China and why they're accelerating their emphasis on domestically generated IP.<sup>7</sup>

China's central patent office is now the busiest in the world. The Chinese government has established a goal of 2 million patent applications per year, beginning in 2015. By comparison, the U.S. Patent and Trademark Office received 530,000 patent applications in 2011. But these numbers don't take into account the quality of the patents with Chinese patents often of low quality, but still enabling them to take action against foreign and domestic firms. In fact the European Union Chamber of Commerce indicated that China has overhyped its patents as many did not represent true innovations.<sup>11</sup>

The cost for filing a patent in China, with up to ten claims, including official fees and China patent agent fees, is approximately \$1,650 USD. This does not include translation costs. In addition, after the application has been approved, there is a registration fee of approximately \$150 USD and a first annual fee of \$110 USD that must be paid.<sup>7</sup>

## **Protecting Intellectual Property**

So how does one protect





intellectual property in China? The answer – there's no perfect way to protect yourself in China. But there are procedures you can put in place that will protect your intellectual property to varying degrees. These include: <sup>14</sup>

- Label information within the company as confidential or IP sensitive;
  - Place sensitive IP data in secure rooms, locked cabinets, or safes;
  - Educate employees as to the sensitive nature of the IP and train them on physical security measures and document storage;
  - Prioritize your IP and perform a risk analysis to determine what information, if lost, would hurt your company the most. Once this is done develop protection plans according to the value of the IP;
  - Install software tracking tools for tracking documents and other IP;
  - Be proactive. Put yourself in the place of someone who wants to obtain your IP and determine the best way for them to get access to the information, then adjust your protection accordingly;
- Be cautious in the data you release. Often, in order to make a sale, information is released to a potential customer touting the advanced nature of your company's product. Sometimes this information may be placed on your company's web site demonstrating how the company's current product is a generation ahead of competitors. IP thieves are smart, especially in China. Be cautious in the data you release.

## The End Result

We've just examined a number of actions that can be taken, by a company or individual, against infringers. But what about instances where the infringement is obvious? For example, walk into Silk Street, a large multi-level shopping center in Beijing, and you can buy anything from a fake Mont Blanc pen to a knock off Louis Vuitton wallet (\$4). Moreover, you can walk into tens of thousands of other shops throughout China and you'll find similar name-brand merchandise that has been counterfeited and is being sold to the general public. So where's the government enforcement in these instances? More to the point, since the infringers are located in a five



story building in the center of Beijing, why has the government chosen not to act? Since most believe that enforcement is the key to obtaining and ensuring intellectual property compliance, as well as obtaining compensation from infringing companies and individuals, the lack of enforcement for such obvious infringement raises a great many questions since it's a given that, if the Chinese government decided to crack down on intellectual property infringers, the problem would stop. After all, the Chinese government is the proverbial eight hundred pound gorilla. Once it decides to act, no one stands in its way. Therefore, one would tend to believe if there's more government enforcement, then there should be less infringement, right? <sup>6</sup>

Not necessarily. As with most things in China, the answer is not simple, nor is it straight forward. Instead, it's very Chinese. According to Martin K. Dimitrov, the main problem with the current enforcement structure in China is that there are two types of enforcement: high-quality enforcement and low-quality enforcement. Both exist because of China's IPR bureaucracy which, in many instances, can be decentralized and provide jurisdictional ambiguity. In a centralized bureaucracy, with

high-quality enforcement, Beijing can compel local governments to enforce laws and regulations by imposing budgetary constraints and / or administrative punishments. The government calls the shots.

If an infringer is operating within an area controlled by the central government, and the government has knowledge of the infringement and has chosen not to act, then there's obviously a reason for the government's inaction. The most common reasons for failure of the central government to act are that, by acting against the infringer, there would be a loss of jobs, social discontent, and/or unemployment caused by the termination of sales by the infringing company. Another reason might be that the owner of the infringing entity is politically connected with the central government. For whatever reason, the central government doesn't always choose to act against infringers.

Take Silk Street, for example. In February 2009, 29 stalls within Silk Street were temporarily shut down as a result of the efforts of IntellecPro, a Beijing firm specializing in intellectual property rights and representing five luxury-brand manufacturers that sued Silk Street for trademark violations.



IntellecPro's clients – Burberry, Louis Vuitton, Gucci, Prada, and Chanel – first sued Silk Street four years previously. In a court-mediated agreement Silk Street's managers shut down the offending Silk Street vendors, six to eight at a time, for up to a week.

While a one week suspension might seem to be unconscionably light by our standards, it was viewed quite differently by the Chinese. Sharon Lafranier wrote in the New York Times that, after the announcement of the one week closures, Silk Street vendors stormed IntellecPro's offices for six days while guards kept them at a distance from the IntellecPro staff. One vendor, a Ms. He, demanded to be compensated for her losses and asked for a public apology.

While most Westerners would believe that the suspension was inconsequential and accomplished nothing, the Chinese were angry that the government took any action at all. George Wang, manager of Silk Street, summed it up best: The five brands are saying *you're not doing a good-enough job in protecting our intellectual property rights*. And the vendors are saying that *you are going overboard in protecting intellectual property rights*.<sup>10</sup> The

central government, in trying to maintain social order, yet wanting to appear to support foreign IPR, will usually support some action against the infringers, especially if news of the infringement appears in the foreign press. But, in our opinion, the harshness of the judgment is such that it will cause social discord. Since social harmony is at the top of the government's list, permanent or lengthy enforcement of IPR that creates social unrest is not likely to happen. Harsh enforcement, by the central government, of IPR on local and provincial governments is likely to occur only when it goes against national policy.

Not all bureaucracies in China are centralized – not everyone works for the central government. In fact, the farther down the administrative hierarchy you move, the weaker the influence of the central government, and the greater the influence of the provincial and local governments.<sup>6</sup> This is where local bureaucrats live and pick up their paycheck. Therefore, while Beijing may establish a policy, for example, forbidding the manufacture of fake golf clubs, the local government may in fact want to encourage it. It's to their advantage to encourage any manufacturing within their jurisdiction that contributes to employment and



the payment of taxes. And, overall, they don't care what they manufacture.

Counterfeiting luxury goods, with a lack of regard for IP, is big business in China. In fact, China is the largest counterfeiter of luxury goods worldwide with 75% - 85% of the fake goods in France and Italy coming from China. In the United States in 2010, China accounted for 76% of all counterfeit goods. These imports are hard to detect as goods are produced in one location, while the labels are produced in another, and they're then sent separately to their foreign or domestic location where they're attached.<sup>10, 15</sup>

According to Minxin Pei of the Carnegie Endowment for International Peace, the counterfeiting industry accounts for 8% of China's GDP. Therefore, the production of counterfeit goods, and use of unlicensed IP by Chinese companies, is responsible for employing a substantial number of people throughout the country as well as making a significant contribution to local tax revenues and the national GDP.<sup>8, 9</sup>

In summary, we don't believe that the counterfeiting of goods or the infringement of IP will ever stop in

China. There are five primary reasons why we expect violation of intellectual property to continue:

- The large number of Chinese employed in its production
- Maintenance of social harmony through employment of a substantial workforce
- Substantial revenue to provincial and local governments and their officials
- Contribution to China's GDP
- Penalties for IP violations are not significant
- Most IP infringers face civil rather than criminal penalties

If the local or provincial governments were to close down infringing companies it would result in large-scale unemployment, loss of tax revenue, and possible social unrest and instability. These negative economic and political repercussions are simply unacceptable to the local, provincial, and central Chinese governments. This results in insignificant punishment to go with the crime, providing little to no deterrent to continued infringement.

Additional information on intellectual property rights in China can be obtained by e-mailing the authors at [info@thornhillcapital.net](mailto:info@thornhillcapital.net).



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