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IP protection emerges as top trade concern with China

by Tom McCann

David A. Blackburn knew something was wrong when his company's Latin American sales started dropping for no apparent reason.

"At first we didn't understand. The region had always been a very predictable revenue source for us. Then we discovered that a Chinese company was counterfeiting our product," said Blackburn, president and CEO of Thomas G. Faria Corp., a Conn.-based maker of instrument panels for motor vehicles and boats. He uncovered the counterfeiting in the late 1990s. "They went so far as to print our name, address and catalog number on the fake instruments. We've lost approximately 10 to 12 jobs so far and \$1 million in annual revenue, which means a lot for a small company.

"The worst thing is, we still don't know how to stop them," he said.

China has quickly become an intellectual property headache for American companies entering its fast-growing economy. Local IP lawyers who represent international companies in the region are struggling to devise ways to protect their clients' assets.

The country is an irresistible lure with its cheap workforce, well trained engineers and market of 1.5 billion people craving Western products. But U.S. corporations also have lost billions of dollars from trademarks copied and product secrets stolen by Chinese competitors taking advantage of the country's lax IP system.

The U.S. Department of Commerce estimates that American

companies lose between \$20 billion and \$24 billion annually because of global piracy and counterfeiting, and that China is the source of more than two-thirds of those pirated goods. Incidents have included everything from phony Callaway golf clubs to Intel computer chips and fake pharmaceutical drugs. Other flashpoints in recent months have

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involved China's revocation of Pfizer's Viagra patent and a Chinese car manufacturer allegedly copying the design of a General Motors car, the Chevy Spark.

In recent weeks, U.S. officials have described intellectual property theft as the No. 1 concern in trade talks with China, pushing what are often arcane IP issues onto front pages of newspapers and into the wider public consciousness.

"We have never seen a problem of this magnitude in world history. There's more counterfeiting going on in China now than we've ever seen anywhere," said Daniel C.K. Chow, a professor at Ohio State University's Moritz College of Law who specializes in Chinese IP issues. "It is woven into their culture. They can make sophisticated fake products almost as soon as the real ones go on the market and can sell them for half the price. Entire villages and

local economies are supported by it, and pirates receive heavy local protection. Companies face an almost impossible battle, and I see it only getting worse."

Chicago IP attorneys say they encounter such problems on a regular basis with their clients. They said that while there is no easy solution, companies can use the Chinese government and the still developing court system to at least stem the tide of the worst violators. Another defense is to make sure no secrets get out in the first place.

"We've seen everything: Books copied without honoring the copyright, software stolen, products reverse engineered and sold under a different name. There are prototypes coming out of Silicon Valley now where they know the product is going to be stolen the minute it gets to China for production," said William A. Spence, senior counsel at Freeborn & Peters and head of a practice group that has four lawyers doing IP work in China.

"Once the secrets get stolen, you have few ways to fight it. So we advise our clients to have IP on their minds from the moment they enter China.

"You keep divisions separate and design components divided so not all the technology is in one place. It creates some inefficiencies, but it's much safer," Spence said. "You also make sure you're paying very good wages to keep the employees around as long as possible. You build in a bonus system tied to performance and retaining the IP within the organization. Even then, practically speaking, it's hard to keep the technology secret for more than four or five years."

Spence said China is a unique case because the country is so vast and intellectual property is still an infant concept there.

“With India, we never had a problem with IP because they had an English common law tradition. In China, they first legally recognized intellectual property in about 1985,” said Spence, who also taught law at East China Law School in Shanghai. “In 1994, I remember one of our professors had to go to Beijing because the government wanted to know why the West cared so much about this issue. We’re starting there from the ground up.”

China now has all sorts of IP laws on the books, especially after the country was accepted into the World Trade Organization in 2001. But getting the government to enforce those rules is another matter, Spence said.

“China has a court system to turn to, but it’s hard to get an injunction. It takes a long time, and there’s no telling whether you’d be successful. Courts often side with the Chinese company. Fines and penalties also are very low,” he said. “A better alternative is going straight to the Chinese government and getting a raid. There are three different administrative offices that can do that, and it’s actually pretty quick and easy. You hire a private investigator, present them with some evidence and within seven to 10 days they raid the market or warehouse and confiscate the goods. No one goes to jail, but at least the product is taken away.”

Robert W. Sacoff, an IP partner at Pattishall, McAuliffe, Newbury, Hilliard & Geraldson, has done a lot of trademark protection work in China. He said you can spend tons of money getting a Chinese court order to shut down a factory, just to find the same people doing it again in another location.

“You have to coordinate your response. You need to be aggressive, take court actions and police raids whenever possible, but all within budgetary limitations. You go to court only when the matter is serious enough and involves enough of a commercial threat to warrant it,” Sacoff said. “Sometimes you can



Yufeng Ma

just approach the offender and negotiate a settlement without going to court. They’ll readily admit it. Often they don’t see what they’re doing is wrong. Often the police don’t see what they’re doing is wrong.”

Chow said U.S. companies have also been able to work effectively with Chinese customs officials to stop some counterfeit merchandise from entering and leaving the country. Like the administrative raids, it requires that companies build relationships with the government and understand how things in China get done.

“The rule of law hasn’t quite sunk in yet. The most important part of business there is personal relationships and knowing whom you’re working with,” Chow said. “You need to have experienced local counsel on the ground.”

Chow cautioned companies to thoroughly vet any local security firms they hire in China.

“For tech companies, you can build relationships with local academics, and through them with the government,” Chow said. “You really need to do your homework.”

American responses

Blackburn of Faria Corp., the instrument panel maker, isn’t the only American executive worried about the problem. He is one of dozens of executives and corporate counsel speaking at a March



William A. Spence

conference in San Francisco to discuss strategies to enforce their IP rights in China. Other companies represented include Eli Lilly & Co., Hewlett-Packard Co., Ericsson Co., Kraft Foods Inc. and S.C. Johnson & Son Inc.

Edward G. Lance, corporate counsel for S.C. Johnson in Racine, Wisc., said his company sells everything from Ziploc bags to car fresheners and Saran wrap in China. He has faced several Chinese trademark infringements on the brands.

“It’s a very tough problem, but China is a market we simply cannot ignore. Companies just have to be constantly on guard, educating their subsidiaries to understanding the law and running constant investigations and monitoring,” Lance said. “We subscribe to a trademark monitoring service that keeps track of people registering marks similar to ours. We have our subsidiaries periodically go out and investigate in known counterfeiting markets. You need to recognize the IP you need protected, get it all registered in the right places, and be aggressive.”

Lance said he has seen improvement in China in recent years. S.C. Johnson successfully stopped a Chinese company from copying its car air-freshener design, and he said the wait time for officials to take action has been shortened.

“The law is nowhere near where I’d like it to be, and for industries

like pharmaceuticals and DVDs its much worse, but it's getting better. You need to take a very proactive approach," Lance said. "The Chinese government is under constant pressure to improve its system."

The U.S. government is on the forefront of that effort. In January, then-U.S. Commerce Secretary Donald Evans visited China to push the government to boost its IP enforcement.

"China has got to start putting people in jail. It's time for China's leaders to forcefully confront the problem," Evans told reporters in Beijing. "The facts are that piracy and counterfeiting in China continues to increase."

Donald J. Silvert, an IP lawyer at Brinks Hofer Gilson & Leone who specializes in biotech firms, has seen IP pirates' reverse engineering skills first hand.

"I represent a company that was working on improving the production of a very profitable chemical they used in a product. They couldn't quite get it done, and these two gentlemen from a Chinese company walked in the door. We had never contacted them, and they said they could produce the chemical in China," Silvert said. "We said we'd get them to produce a sample, and one of them just takes a vial out of his pocket. It's our chemical, and it's perfect. We eventually hired the company, but technically, that was infringement."

Yufeng Ma, an IP associate at McAndrews, Held & Malloy who focuses mostly on patent work, has law degrees both from Peking and

Vanderbilt universities. He said the problem of IP theft is deep, but he sees room for optimism.

"People think there's absolutely no IP protection there. [They think] it's just on paper. But I've seen several court rulings favorable to U.S. companies. They're gradually understanding that IP protection is important for their own national interests," Ma said. "As Chinese companies enter the U.S. market, they are getting sued in U.S. courts. Cisco Systems took this route, as well as U.S. DVD companies. A Taiwanese chipmaker recently won \$175 million against a Chinese competitor for patent infringement. This is a new development."

Ma said China just passed a law that would make it easier to prosecute counterfeiters and imprison them for up to seven years, and that its intellectual property courts and judges are getting more standardized and professional. In February, McAndrews, Held & Malloy hosted one such Chinese IP judge, who came to learn more about the U.S. IP system.

"We are gradually getting better and better. Our government has made great efforts since 2000 to bring our courts up to international standards," said Liesheng Huang of The Intermediate People's Court of Foshan Guangdong Province. "We strive to be objective and fair toward any American company. That is what we want, too."

Spence also said he has seen real progress in the court system.

"Before the last few years, the judges were mostly retired Army officers with no legal training and a

lot of cronyism. Now judges are required to be trained in the law, which sounds surprising to the rest of us," Spence said. "Some of the country's best judges are now doing IP cases, and the system seems to be working much better."

Ma said China is just beginning to respect world IP standards because they are beginning to develop their own technology and seek patents and copyrights themselves. He said Chinese entrepreneurs are beginning to have a stake in the system.

Chow of Ohio State, however, doesn't see the culture of rampant counterfeiting and piracy going away any time soon.

"I don't believe the argument that China will all of a sudden obey its IP laws. They have no motivation for it, and the government has little motivation for it. The Chinese economy thrives on counterfeiting," Chow said. "U.S. companies are always complaining, but it mustn't cut into their bottom line as much as they say it does or they wouldn't continue to be in China."

Ma monitors the IP of several U.S. software, pharmaceutical and manufacturing companies in China, and he gives the nation five to 10 years to bring its standards up to snuff, although he admits most of his colleagues don't share his sense of optimism.

"We all watch the system closely, look out for any changes positive or negative, and adjust to better protect our clients," Ma said. "In five to 10 years, I say we'll all be much more comfortable doing business."★