China presents great opportunity, risk for IP

GUEST COLUMN

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Is your mailbox full of Viagra spam? In 2001, hoping to stem losses to overseas pirates, Pfizer launched a counteroffensive against knockoff manufacturers of its famous blue pills. Believing itself victorious after it uncovered dozens of Chinese companies churning out counterfeits, Pfizer was blindsided when the pirates fought back.

They sued Pfizer.

Last July, in an amazing turn of events, Chinese courts sided with the pirates. Seventeen manufacturers immediately jumped on the bandwagon and obtained government protection to continue counterfeit operations.

Corporations beware. The history of outsourcing to China is filled with similar stories. As more American companies turn to China for manufacturing, IP protection has become a top priority.

China's enormous and inexpensive production potential is hard to ignore for even the smallest companies. When setting up Chinese deals for multibillion-dollar corporations or startups with just five employees, one thing holds true: Stay informed and vigilant to protect vital assets. Still, the risk is great.

WHY OUTSOURCE?

The simple answer is profit, but it's not the only answer. Organizations outsource noncore processes to focus and reinvigorate their business. Outsourcing also allows companies to provide higher-quality operations, faster and cheaper, than they can internally. By outsourcing computer services, for example, a company can immediately apply cutting-edge applications with minimal capital, design and training.

In recent years, India has held top honors for IT outsourcing. However, developments in China may enable it to surpass India within the next five years. These developments include lower labor costs, an enormous and diverse labor pool (50 million new workers annually), a larger pool of technical workers, and a robust high-tech infrastructure. China has that magical combination of being high on the technology chain while maintaining extremely low labor costs. As a bonus, the Chinese government provides substantial investment incentives for companies with advanced technologies.

Although China has fast-tracked its legal framework for IP protection, China's reforms have outpaced its enforcement capabilities. Furthermore, Beijing's ability to enforce IP regulations is hampered by local resistance to change, particularly when local authorities sense that change will take power out of their hands. Consequently, companies engaged in Chinese outsourcing cannot rely on Chinese laws, instead relying on an arsenal of secondary measures to protect their rights.

Perform a comprehensive review of your technology and IP before outsourcing. Companies must know what they own and what they license from third parties before deciding what to bring to China. Vital intellectual property should not be brought to China if its loss would be catastrophic.

DUE DILIGENCE

Painstaking investigation of potential outsourcing partners is imperative. Visit the outsourcing facilities to see first-hand the employees, equipment and quality-assurance systems. Who owns and runs the Chinese company must be clear and all supply and distribution networks verified. Request customer referrals, review employment contracts, and determine employee retention rates. Because poaching employees is a popular method of stealing technology, use restrictive covenants.

All outsourcing arrangements should include clear provisions regarding IP use and ownership. It is critical to clarify who owns IP that is developed during the outsourcing relationship. Until recently, Chinese licenses often transferred ownership to licensees following a limited license period. Unless a license specifies otherwise, Chinese partners may assume they take ownership of the licensed asset. Prepare a separate license agreement specifically addressing use of IP and technology.

Many outsourcing companies work for multiple customers in the same industry. For this reason, negotiate specific restrictions on use of technical plans, market data, company information and corporate strategies. These restrictions must include practical and meaningful penalties for violations.

Finally, protect vital assets with concrete security measures. Technical documents should be housed in secure restricted environments. Distribution processes must include password protection and need-to-know practices. Information should be compartmentalized so that unauthorized parties cannot reconstruct key assets.

DISCOURAGED?

Don't be. Enormous opportunities can be had through outsourcing, as evidenced by the success of companies such as Motorola Inc., Wal-Mart Stores Inc., and Microsoft Corp. And despite Pfizer's debacle, it maintains a Viagra manufacturing plant in Dalian, China. While many organizations could benefit from outsourcing, most are still behind when it comes to preparing themselves for the risks. Ultimately, proper preparation with seasoned advisers can make the difference between cash or catastrophe.

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