The landscape of change in China

As China speeds towards becoming an innovation-based economy, foreign businesses have no choice but to engage with the Chinese IP system. However, uncertainties in the efficacy of that system mean that due diligence is more vital than ever for rights holders

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The IP landscape in Asia, particularly China, is changing. On one side of the equation, foreign businesses are moving to invest in real R&D in China and are consequently moving from filing in Asia only when there was a key strategic need to adopting a "must file in Asia" strategy for all major developments. On the other side of the equation is China's unprecedented commitment to becoming an innovation-based economy by 2020, as a consequence of which domestic R&D and patent filings are set to grow significantly.

As a result of these changes, enforcement mechanisms in China – of which foreign companies have historically been suspicious – will be thrust further into the spotlight. Focusing on patents, this chapter looks at the current enforcement landscape, the impact of the new patent law, how companies can prepare themselves to operate within the legal environment and what perils lie ahead for those not adequately prepared.

China's intentions

The 11th Five-Year Plan endorsed in 2006 by the National People's Congress, China's top legislature, and the State Council's Medium to Long-Term Plan for Science and Technology Development issued the same year, set ambitious objectives to develop China from a manufacturing economy to an innovation-based economy by 2020. No one should doubt the intent or the ability to achieve this. Accompanying these plans is the State Council National IP Strategy, published in 2008, and a raft of opinions and directives issued by the relevant ministries and provincial governments. The evidence is all there to show that change is underway.

China, as a country of origin, is already the sixth largest filer of Patent Cooperation Treaty (PCT) applications globally. The number of applications originating in the country has nearly quadrupled since 2004. At this rate China will overtake France and Korea by 2012 to become the fourth largest filing country, behind only the traditional powerhouses of the United States, Japan and Germany. For the first time ever, the single largest filer of PCT applications last year was a Chinese company, telecoms giant Huawei.

Major research from the European Commission predicts that by 2025 the United States and Europe will have lost their scientific and technological supremacy to Asia, particularly China. Between now and then, China and India are expected to double their current share of the world's R&D, accounting between them for more than 20% of the global total.

Looking within China, the picture of change continues. Thus far in 2009, for the first time Chinese companies have overtaken foreign companies as grantees of Chinese invention patents; a switch that will surely never be reversed.

In 2007 it was estimated that just 1% of Chinese companies made any kind of patent application, whether for an

invention patent, design patent or utility model patent. China has already taken steps to support domestic filers and, as recently as October 2009, the Ministry of Finance established a special fund to subsidise Chinese companies making foreign patent applications through the PCT system. The ministry will offer up to Rmb100,000 (approximately $14,600) for applications made by small and medium-sized domestic enterprises, and public and scientific research institutions. With such support and encouragement coming from the state, the figure of 1% referred to above is destined to increase rapidly.

Foreign uncertainty

The State Council's National IP Strategy and the Supreme People's Court Opinion on its implementation raise several important questions for foreign rights owners. There is, for example, much talk of supporting the development of innovation among domestic enterprises. Will these domestic enterprises include foreign-invested enterprises and R&D centres with foreign interests located in China, or will they be limited to purely local Chinese companies? Another concern is the emphasis in the State Council Plan on eight core technology areas. Given the Supreme People's Court Opinion as well, will this mean that foreign companies competing in these areas will receive unfavourable treatment? These questions and others are yet to be answered, but they emphasise the importance to foreign companies of due diligence and preparedness when bringing IP to China.

Against that domestic picture, there also remain grave uncertainties within foreign companies about the value and enforceability of IP in China. In a 2009 survey of European businesses, 86% considered IP enforcement mechanisms to be inadequate or very inadequate, despite commitments in recent years made by the Chinese state to protecting IP.

As the West slowly climbs out of the global financial crisis, China is rebounding rapidly and getting back on track to exceed its ambitious gross domestic product growth objective of 8% in 2009. On the back of that, foreign direct investment is returning with renewed energy. After 10 months of decline, August and September saw consecutive monthly increases in China's foreign investment on a year-on-year basis. China remains a key destination for foreign money as businesses look to China for growth, both as an R&D resource and simply as a market.

Increasingly, this leaves foreign businesses with little or no option: engage with the Chinese IP system or be left behind. But engagement does not mean jumping in blindly; with uncertainties in the IP regime remaining, due diligence remains crucial.

Putting both sides of this picture together, it is clear that China will inevitably become a key battleground for IP in the next decade. As the number and complexity of IP disputes look set to rise inexorably, two big questions arise. First, are the enforcement systems in China, and specifically the civil courts, up to it? Second, what can IP owners do to prepare for the fight?

Below, we consider these questions in more detail by looking at the product patent landscape in China. As indicated above, we are already seeing businesses move from a strategic-only patent filing strategy for China — where filings were traditionally made to protect manufacturing operations — to a must-file strategy of the kind adopted for other mature markets. For this reason, we fully expect that patents will be the hot topic in the developing debate.

Current enforcement picture

The number of IP disputes in China is already growing at a consistently rapid pace — up from 17,800 civil IP trials in 2007 to 24,400 in 2008 — and that growth is set to continue.

Currently, most disputes are purely domestic, with cases involving foreign companies making up less than 4% of the total. That percentage is slowly rising and as the importance of China to foreign investors increases, we can expect to see even more foreign rights holders choosing or needing to become more engaged with civil IP proceedings, which in turn is likely to increase international scrutiny of the system.

Perceptions of the Chinese civil litigation system are often negative, with many businesses believing that there is simply no certainty of outcome to civil proceedings. However, data generated by Rouse's civil IP litigation analysis platform CIELA (available at www.ciela.cn) provides a clear insight into how the system operates and takes much of the guesswork out of IP litigation and litigation strategies. Before considering how foreign rights holders can best prepare themselves for battle, let us look at some hard data.

China's commitment to IP is huge. There are now specialist IP chambers in

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cities all over the country. CIELA has analysed all published decisions since 1st January 2006 from the 77 most significant IP chambers in the 31 most significant cities – more than 7,500 IP judgments to date. Some surprising headline figures have emerged.

On average, across all IP rights in all courts, rights holders win (obtain a finding of infringement) in more than 85% of all cases, with a first instance decision, on average, being handed down six months after the case is filed. In almost 80% of those cases, the court also grants an injunction. These are significant figures, which should encourage even the most cautious litigator.

Damages remain a key area of contention: damages awards in China are generally lower than those in more developed jurisdictions. In 2006, average damages awarded to rights holders across all published IP decisions were Rmb68,895 (approximately $10,000), and the average since then has fallen. In 2008, average damages were only Rmb32,000 (ie, less than half the 2006 figure).

Regional differences in enforcement

Looking at the courts of individual cities, particularly those most often relied on by foreign rights holders (ie, Beijing, Shanghai Nanjing, Guangzhou and Shenzhen), important differences begin to emerge. Overwhelmingly, the Beijing courts have the most experience, with the Shanghai courts coming in second. This affects the decisions emanating from those courts in a number of ways.

Three key measures of courts are win rates, average damages awards and the likelihood that first instance decisions will be overturned on appeal.

Win rates in Beijing and Shanghai are equal, with 84% of rights holders successful, but the rate for these cities is lower than the rates for Nanjing and Guangzhou (88%) and Shenzhen (a remarkable 93%). Arguably, this reflects the fact that the more complex cases are being brought before the Beijing and Shanghai courts, rather than that the other courts have a clear rights holder bias.

As regards damages awards, the Beijing and Shanghai courts are notably more generous, averaging Rmb56,000 and Rmb60,000 respectively, compared to Nanjing (Rmb47,000), Guangzhou (Rmb43,000), Shenzhen (Rmb41,000), and the national average (Rmb55,000).

With regard to the frequency with which decisions are overturned on appeal, again we see clear distinctions. In Beijing and Shanghai, an appeal court is likely to overturn a first instance decision in only 6% and 7% of cases respectively, figures which compare favourably with – Shenzhen at 13% and Guangzhou and Nanjing at 23%.

With China's flexible jurisdiction rules giving significant freedom to forum shop, it is important that these differences in venues be appreciated and understood, so that forum options can be explored fully and the most appropriate forum chosen.

Focus on patents

Looking more deeply into invention patents and the court's attitude to infringement claims, we begin to see a clear divergence even between the Beijing and Shanghai courts. The analysis generated by CIELA indicates that Shanghai is a distinctly more pro-patentee venue. Win rates and average damage awards in Shanghai (71% and Rmb108,000) are materially higher than those in Beijing (61% and Rmb82,000). However, proceedings in Shanghai are significantly slower (13 months for first instance decisions, compared to eight months in Beijing). So if your objective is to obtain a final injunction as quickly as possible, you should look elsewhere and perhaps consider Nanjing, which has the same win rates on average, awards higher damages and delivers first instance decisions in just six months.

Developing patent strategies in China

All this points to the importance of choosing your venue carefully. However, there are many other issues to consider when developing your patent strategy.

The remainder of this chapter looks at four key areas for foreign companies preparing to operate in China: the significance of utility model patents; key changes in the new patent law; lessons from recent history; and the critical role of evidence.

Utility model patents – learning from the Chinese

China's Patent Law is modelled to a large extent on that of Germany. For product inventions, it provides for utility model patents (with only a 10-year term of protection), as well as "full" invention patents (with a 20-year term). Utility model patents:

- Are not available in relation to processes or methods.
- Are not substantively examined before grant (they undergo only a procedural examination pre-grant).

- Are granted relatively swiftly (often between nine and 12 months from filing, as opposed to the typical three to four years it takes for invention patents).

However, the disparity between the filing rates for foreign and domestic companies for utility model patents in China is stark. In 2008, domestic companies applied for and were granted more than 99% of all utility model patents; foreign applicants were granted just 1,506 out of over 175,000 granted in total.

There may be many reasons for the disparity, but when considering the benefits of utility model patents (many) against the burdens (few), it is clear that foreign businesses are a long way behind the curve in this crucial area. The simple fact is that foreign companies should seriously consider filing utility model patent applications in China for all their significant product developments.

Utility model patents are inexpensive to apply for, are not substantively examined, have lower thresholds for inventiveness, are registered quickly and enjoy a presumption of validity that makes them hard to ignore. Add in the fact that China allows applicants to double patent (ie, to file applications for both an invention patent and a utility model patent in respect of the same invention at the same time, dropping the utility model patent only when the invention patent is granted), and it is clearly critical that foreign companies reassess their filing strategies in China and shift their thinking regarding utility model patents from "Why?" to "Why not?".

New Patent Law – impact on patent strategies

The new Patent Law, which came into force on 1st October 2009, introduces welcome changes aimed at preventing the misuse of patents. Two of the key developments are the introduction of an absolute novelty standard for inventions (previously, foreign prior use was not relevant), and the introduction of a prior art defence (ie, that the allegedly infringing technology falls within the prior art and hence does not infringe). Together, these changes should reduce the threat to foreign rights holders of so-called junk patents (ie, patents – typically utility model patents – obtained in China on the back of others' foreign technologies and frivolous infringement claims based on them); but it certainly does not change the need for preparedness and due diligence.

These changes are intended to support the drive for independent innovation – that is, to challenge domestic companies to invest in true R&D rather than simply piggybacking on the innovation of others. With the low inventiveness threshold for utility model patents and the support that the whole system is now providing for domestic patent filers, we should not expect the volume of applications (in particular, applications for utility model patents) to drop; rather, we should expect the quality of the applications, and hence the competition, to increase, again emphasising the need for sound due diligence.

Lessons from recent history – how to avoid the *Chint v Schneider* nightmare

Much has been written about the record-breaking US$48 million damages awarded to Chinese company Chint against the French group Schneider for infringement of its utility model patent. It has been suggested that the decision was wrong or that the courts were out of control. However, the fact that Schneider ultimately withdrew its appeal and settled for US$23 million suggests that it was a well-considered, defensible decision at first instance, with both the finding of infringement and the level of damages award being supported by the evidence.

Some changes in the Patent Law reduce the risk of foreign companies finding themselves in a Schneider position – for instance, compensation may no longer be calculated on the basis of the entire profit from the sale of a product that includes the patented technology, but should instead be calculated on the basis of that percentage of the profit that is attributable to the patented technology itself. However, the fundamentals remain the same and the single most important lesson to be learned is that utility model patents are ignored at one's peril.

When launching a new product in China, thorough freedom-to-operate searches are critical. Pre-emptive invalidation proceedings should also be considered for any existing patents that represent a material threat. The new prior art defence can be relied upon to defend against an infringement claim for an obviously bad patent, but it will always be preferable to knock the patent out and remove the threat for good. As before, invalidation proceedings cannot be brought before the court considering the infringement claim; parallel proceedings must be brought in the State IP Office. With no guaranteed stay of infringement

proceedings pending resolution of an invalidation application, an unprepared defendant can be faced with an unwelcome finding of infringement, which, even if not enforceable pending an appeal, can wreak havoc on distributors and customers.

Evidence, evidence, evidence

The importance of documentary evidence to a Chinese court cannot be underestimated. It has much greater weight than oral evidence and, for lawyers with a common law background, this requires a substantial readjustment in the approach to evidence gathering.

With the introduction to patent law of absolute novelty and the prior art defence, clear supporting documentary evidence of prior use or relevant prior art will be crucial offensive and defensive weapons. This will be the case particularly for claims of infringement of a utility model patent, which will not have been subjected to substantive examination. Given the stringent notarisation and legalisation requirements for foreign evidence to be admitted in Chinese proceedings, it will be necessary to consider adopting a proactive evidence-gathering strategy.

Take the example of attempting to establish prior disclosure of an invention on the basis of prior use at a trade fair outside China. Simply producing a sample of the product offered at the fair attached as an exhibit to a witness statement or affidavit describing exactly what occurred will not be sufficient. The Chinese court will expect to see evidence captured independently, ideally by a notary public, whose statement of events with an accompanying sample will then need to be legalised. If this is not done at the time of the disclosure, it may be extremely difficult to obtain sufficiently robust evidence retroactively and a potentially good defence to infringement, or counterclaim for invalidity, may be lost.

A protection strategy based simply on the existence of appropriate registered rights is increasingly inadequate. When contemplating what protection to put in place, sound supporting evidence for key arguments should be seen as a vitally important element to be obtained proactively wherever possible.

Conclusion

China is emerging from the financial crisis as an end market that cannot be underestimated and remains a key source of production for most companies. In addition, it is now competing as a viable location for R&D, in terms of both low-cost innovation and increasingly "real" R&D. ■

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