

# Global Intellectual Property Asset Management Report

Covering e-commerce, corporate intellectual property management and related licensing  
Formerly known as *Global eCommerce Law & Business Report*

January 2006  
Volume 8,  
Number 1

## Intellectual Property Rights Protection in China: Litigation and Economic Damages

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Intellectual property rights (IPR) have historically not received strong protection in the People's Republic of China (China).<sup>1</sup> Recently, however, as a result of external pressures and internal economic objectives, China is moving closer to the IPR practices and standards found in Western nations. A growing economy, more sophisticated laws and increased attention to enforcement have led to IPR infringement cases being brought before Chinese authorities in increasing numbers.

Despite this progress, cases are not yet being brought in sufficient numbers nor under existing law are fines and damages awards large enough to deter infringement or compensate IPR owners for losses. The imposition of administrative penalties by enforcement agencies does not provide adequate incentives to infringers to modify or alter their behaviors and practices. Nor do they adequately compensate for the harm done to the owners of the IPR by infringers.

In addition to the imposition of administrative penalties, China's IPR laws contain provisions for awarding economic damages to individuals and companies in the event their IPR have been infringed. Although the laws have been designed to comport with major international agreements, the laws do differ in certain areas with those found in many Western countries. For example, in some instances, total damages which may be recovered are capped. Even where they are not capped, in most cases damage awards and fines are low in comparison with those in other countries. Damages are compensatory and not punitive and may not exceed the infringer's gain. Determining the precise amount of the infringer's gains is difficult due to evidence rules in China. As a result, damage amounts may be understated significantly.

While limiting damages can reduce the risk of excessive damage awards unrelated to economic harm, it can also constrain awards to levels well below the actual economic damages incurred. Caps and by extension, damages, that are too low impose real economic costs on the economy in addition to lacking sufficient deterrent value.

In some cases it may even create incentives for infringers to take calculated risks. Although China has moved in recent years to develop IPR laws and policy to strengthen the rights of IPR owners and to enforce those rights, the country is still in transition and is not yet on par with countries in other Western nations.

### Balancing IPR Protection and Economic Growth in China

Introducing IPR protection in a developing country frequently proceeds through a predictable series of events, beginning with little or no IPR protections and markets characterized by imitation rather than innovation, and moving to markets with well-designed and enforced IPR and characterized by higher degrees of domestic innovation. There are, however, conflicts and challenges which may face a country in making the transition.

It is interesting to consider that perhaps China is at the crossroads in making the transition from an imitative to innovative economy. IPR laws and enforcement procedures are more or less in place but embracing them fully may present difficult choices. At present, despite strong laws to protect IPR, in some areas and markets the promise of short-term gain is strong and continues to compromise the laws' effectiveness and, by extension, long-run growth.

China has traditionally imported more technology than it exports and has maintained a low level of IPR



protection and enforcement compared with other industrialized countries. It now appears to seek the benefits of a strong IPR regime. This, however, may involve incurring short-term costs. These may include: high administrative costs of implementation and enforcement; costs associated with labor shifts from infringing activities to others; and potential for monopoly pricing. These costs may create short-term disincentives for enforcing and upholding IPR laws.

Low-cost imitation of technology and products rather than innovation and invention of new products is common in China. One of the short-term benefits of such practices for a developing country is more production and consumption of goods and services. The country may thus view more stringent IPR as having the potential to compromise its economic production and consumption.

**Over the past two decades, China has steadily developed an infrastructure to protect IPR, due in some part to pressure from the US, the European Union and other interested parties.**

If better IPR enforcement translates to higher prices in China and the transfer of royalties overseas, the incentive of Chinese authorities to enforce IPR laws and of citizens to observe them may be blunted.

There are other problems associated with partial or weak enforcement and observation of IPR laws. Partial and potentially inefficient work-around solutions may emerge. For example, to safeguard against the risk of infringement, companies that sell into China products with high levels of intellectual property content may need to impose restrictions on the number of people who have access to those products. Similarly, companies may restrict the number of people who can work on a particular component or the conditions under which it may be serviced. To protect against IPR infringement and abuses, Chinese researchers seeking access to foreign technology in some cases may find that it is only possible to gain access to that technology by taking out licenses and through the intermediation of "intellectual property exchanges," organizations established to provide controlled access to intellectual property through licensing from foreign vendors.<sup>2</sup>

Limiting access to technology and other efforts to manage the potential for infringement may help to address some of the problems with IPR abuses and violations. However, they are an imperfect solution. While these practices may be privately optimal as a means to curb infringement, in the case of high technology, pharmaceuticals, medical devices and other sectors, they may be overly restrictive and constrain the dissemination

of important technologies and processes, which may be economically inefficient and socially undesirable.

## **Legislative and Legal Frameworks for IPR Protection in China**

Over the past two decades, China has steadily developed an infrastructure to protect IPR, due in some part to pressure from the US, the European Union and other interested parties. Notable progress includes: joining several international agreements to protect intellectual property;<sup>3</sup> drafting and promulgating domestic IPR laws; and, establishing specialized courts,<sup>4</sup> registration procedures, enforcement processes and training programs.

In November 2001, China joined the World Trade Organization (WTO). Since joining the WTO, China has further strengthened its legal framework and amended its IPR laws and regulations in compliance with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). The TRIPS agreement is particularly significant, as it specifies strong minimum standards for the protection and enforcement of copyrights, patents, trade secrets, trade and service marks, and indicators or geographic appellation. The result is extensive, though not complete, harmonization of national IPR regimes among countries that are party to the WTO Agreement.<sup>5</sup> Indeed, China's membership in the WTO may have had a greater impact on IPR enforcement than on any other business issue.<sup>6</sup> Although the legal framework is not fully developed compared with other industrialized nations, these activities suggest that Chinese IPR institutions and laws may be slowly converging toward international standards.

### **IPR Law Enforcement**

Despite significant progress in developing a comprehensive legal framework, shortcomings in IPR law enforcement in China continues to limit the law's effectiveness. Various factors serve to compromise enforcement. For example, the desire to avoid the short-term economic costs described in previous sections. Corruption and local protectionism can also handicap enforcement efforts, as can limited or insufficient resources and training available to enforcement officials, and lack of public education regarding the economic and social impact of IPR violations.<sup>7</sup>

### **Administrative Enforcement**

Prosecution and enforcement of IPR violations in China may proceed along one of two tracks. The first and most common is the administrative track. In most cases, administrative agencies may not award compensation to an IPR holder. They may, however, fine the infringer, seize goods or equipment used in manufacturing infringing products, and obtain information about the source of goods being distributed.

## Examples of Recent Damage Awards of IP Cases in China

Companies	Type of Case	Violation	Damages (US \$)
<p>DEFENDANT: <b>Fineart Corp.</b> (based in Taiwan)</p> <p>PLAINTIFF: <b>Beijing Hanwang Technology</b></p>	Copyright	Defendant copied Plaintiff's software and sold online	\$361,000
<p>DEFENDANT: <b>Shanghai Zhongle Film &amp; Television</b></p> <p>PLAINTIFF: <b>Discreet (a Canadian division of Autodesk)</b></p>	Copyright	Defendant used and exploited software without authorization	\$60,000 awarded (\$120,824 claimed)
<p>DEFENDANTS: <b>Beijing Central Press Union Technology;</b> <b>Tianjin Minzu Culture CD</b></p> <p>PLAINTIFF: <b>Microsoft</b></p>	Copyright	Defendants made 59,000 CDs with pirated Windows XP	Beijing paid \$9,600 fine and "illegal turnover" of \$1,250. Tianjin paid \$1,200 and \$70.
<p>DEFENDANTS: <b>Huaqi and Fuguanghi</b></p> <p>PLAINTIFF: <b>Netac Technology Co.</b></p>	Patent	Defendants infringed on Netac's USB flash memory drive patent, producing millions of dollars in alleged losses.	\$120,000 awarded (\$490,000 claimed)
<p>DEFENDANTS: <b>Beijing JiaTu Wine Co. Ltd;</b> <b>JiangXi Happy Wine &amp; Foodstuffs</b></p> <p>PLAINTIFF: <b>China National Cereals, Oils &amp; Foodstuffs (COFCO)</b></p>	Trademark	Defendants used COFCO's trademarked brand and image on their wine products	\$1,876,050 awarded (\$12 million claimed)
<p>DEFENDANTS: <b>Bonneterie Garment (Shensen) Co.;</b> <b>Yiwu Kinyipai Garment Co.;</b> <b>Li Zupeng</b></p> <p>PLAINTIFF: <b>Benneteroe Cevenole SARL (of France)</b></p>	Trademark	Violation involved trademark infringement over the name Montagut	\$93,000
<p>DEFENDANT: <b>Beijing Metals and Minerals Import and Export Co.</b></p> <p>PLAINTIFF: <b>Nike</b></p>	Trademark	Defendant attempted to export more than 100,000 imitation Nike clothing items to Russia	\$20,000
<p>DEFENDANT: <b>Shanghai Xingbake Coffee Co. LTD</b></p> <p>PLAINTIFF: <b>Starbucks Corporation</b></p>	Copyright	Judge ruled that Xingbake's unauthorized use of Starbucks and the Chinese translation Xing Ba Ke constituted trademark infringement. "Xing" translates as "star" and Ba Ke has a similar sound to "bucks." The judge also ruled that Chinese company's logo, a circle with white characters on a green background, infringed Starbucks' similar green and white logo.	\$61,900

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Administrative fines are generally low and vary from case to case. Information regarding the amount of fines is usually not made public, making it difficult to assess their effectiveness, though it is generally agreed that they are quite ineffective.<sup>8</sup> There are a number of other deficiencies with administrative action. Not only is the patent owner inadequately compensated, and fines too small to deter future infringement or put the offender out of business, an investigation may not be instigated as a result of local protectionism, lax enforcement, or a lack of resources. A lack of coordination between administrative offices may also make uniform protection of IPR difficult.

## Judicial Enforcement

Companies can pursue judicial (civil actions) in various Chinese courts. Though small companies may continue to prefer to pursue administrative action, the number of IPR cases pursued through the court system is likely to increase as a result of recent changes to the laws designed to strengthen them and provide more guidance and transparency to those pursuing such remedies.<sup>9</sup>

**Determining the precise amount of the infringer's gains is difficult due to evidence rules in China. As a result, damage amounts may be understated significantly.**

At present there is no US style of discovery; documents and evidence available for building a case is usually quite limited. Reliance upon damages experts – accountants, economists and other analysts – is permitted by law to both plaintiff and defendant, though it generally does not occur. Damages claimed are typically relatively simple, straightforward calculations. For example, the IPR owner may be awarded the amount of revenue the plaintiff would have earned in the infringement period based on previous sales or the amount the infringer earned as a result of the illegal sale. Generally courts will award some portion of case-related costs to a successful plaintiff, but it is unlikely that full costs of pursuing the case will be recovered. It is rare for a defendant who is successful in defending his or her action to recover costs.<sup>10</sup>

Both fines and economic damages claimed and awarded, even at the extremes (largest damage awards have not exceeded US\$2 million and most average around US\$100,000), are low compared to those found in the US and other industrialized countries. Fines are much lower. In many cases, fines and damages provide little deterrent and are merely considered a cost of doing business.

In a notable recent ruling by a Standing Committee of the National People's Congress (NPC), beginning in May

2005, lay judges (or juries) may be used in civil and criminal cases, including IPR cases.<sup>11</sup> This ruling gives lay judges, also known as "people's jurors," equal standing with judges in executing their duties in courts. A panel of both professional judges and lay judges (typically on a three-member bench) will determine first instance cases with significant social influence or upon the request of litigants. Lay judge candidates must have a junior college degree or higher, and must serve for terms of at least five years. They are entitled to appropriate payment from the courts for attending hearings. People's jurors have been part of China's legal system since 1954. However, before 2005, there were no rules or guidelines explaining their role. Thus, although jurors are not new to China's legal system, their roles and functions until now have not been clearly defined, which inhibited their ability to contribute to the quality of the judicial assessments or decisions. While criminal prosecutions are possible under IPR law, they are not yet commonplace.

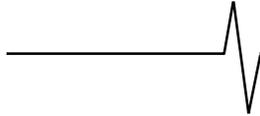
## Strategies for IPR Protection in China

As more intellectual property owners seek protection for their ideas through the Chinese system and experience the benefits of protection and enforcement firsthand, they may conclude that it is in their interest to have IPR laws strongly enforced and to uphold those laws themselves. Increasingly, Chinese companies are pursuing legal remedies to challenge IPR owned by not only other Chinese companies, but by foreign companies as well. In limited instances, foreign companies are bringing suits against Chinese defendants.<sup>12</sup> Although there has yet to be an IPR case tried in China between two Western interests, experts agree that the day may not be far off.

## Legal Action in China

Despite the difficulty and cost of pursuing legal action in IPR cases in China, many companies, both Chinese and non-Chinese, are choosing to do so. Fines and damages have in most cases not been sufficient to compensate the party being infringed or even to offset the costs of pursuing the case. Nevertheless, although awards are trivial in comparison with those found in the US and other Western nations, many Chinese and non-Chinese firms are opting to pursue cases through the Chinese system. Their reasons for doing so are varied. In many cases, the IPR owner may at least obtain an injunction against further infringement. Even without the possibility of meaningful damages, there may be other strategic reasons for pursuing action, such as seeking to protect a market or an existing revenue stream.

Chinese companies are beginning to use preemptive patenting strategies. China follows a first-to-file system for patents, which means patents are granted to those that file first even if the filers are not the original inventors. This practice is consistent with activity in other parts of



the world, including the European Union, but differs from the US, which recognizes the first-to-invent rule. Using the first-to-file aspect of the law to their advantage, some Chinese companies are preemptively patenting foreign inventions that have been patented outside of China. Foreign companies will presumably attempt to challenge such patents and will, in the future, take steps to patent in China in a timely manner. In the meantime, these preemptive patenters have developed an interest in maintaining a strong IPR protection regime in China.<sup>13</sup>

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### Legal Action Outside China

Preemptive patenting is not only being practiced in China. Chinese firms seeking to export into foreign markets, particularly within the European Union, may find themselves challenged by first-to-file claims. Foreign firms in countries where these rules pertain are also pursuing pre-emptive patenting, trademarking and copyrighting to head off the threat of competition from Chinese companies and products in their home markets. European multinational companies have preemptively registered the trademarks of major Chinese enterprises in their respective countries. This can effectively block potential Chinese competitors from using their own brand names when they begin selling in markets outside of China.

Foreign companies whose IPR has been infringed in China may be reluctant to file cases there, where the laws are new, courts may lack experience handling such cases, costs to prosecute are high and unrecoverable, fines and damages are low, and enforcement is unreliable. As one alternative strategy, non-Chinese companies are filing lawsuits in their home countries. Technology companies and other multinationals are using their own court systems to bring IPR cases against Chinese competitors in their home countries. In many cases, desire on the part of the Chinese companies and the Chinese government to export into Western markets is sufficiently strong that they will be willing to comply with Western standards. As China's export of machinery and high-technology products to the US increases, facing an IPR lawsuit in the US may be an unattractive proposition. It could mean an injunction to stop exporting products to the US, and the threat of potentially high damages.

### Conclusion

IPR violations may ultimately have negative effects on the broader Chinese economy by discouraging investment and imposing costs upon those companies attempting to offer goods and services. As China becomes a major player in the world economy, it likely will strengthen its commitment to upholding and enforcing international IPR. Chinese laws and regulations are converging with international standards. Patent, trademark and copyright applications are being filed in growing numbers and damages and fines are increasing. However, violations continue to be widespread.<sup>14</sup> Work remains to be done if China is to accord with other major economic powers in the area of IPR protection, particularly in the area of enforcement and damages. □

<sup>1</sup> For a detailed historical examination, see, for example, International Intellectual Property Alliance, "2004 Special 301 Report, People's Republic of China"; Chynoweth, Graham J. "Reality Bites: How the Biting Reality of Piracy in China is Working to Strengthen its Copyright Laws," *Duke Law & Technology Review* 3 (2003); Miller, Charles L. "A Cultural and Historical Perspective to Trademark Law Enforcement in China," *Buffalo Intellectual Property Law Journal*, 2, 103 (Summer 2004).

<sup>2</sup> Mike Clendenin, "Piracy Battle on Silicon Sea," *EETimes*, (August 23, 2004).

<sup>3</sup> China has joined nearly all major international IPR conventions, including the World Intellectual Property Organization in 1980; the Paris Convention in 1984; the Madrid Protocol and the Washington Convention in 1989; the Berne Convention and the Universal Copyright Convention in 1992; the Geneva Phonograms Convention in 1993; and the Patent Cooperation Treaty in 1994. China also adheres to several other conventions governing specific industries or disciplines, such as the Revised International Convention for the Protection of New Varieties of Plants.

<sup>4</sup> China has established special IPR courts in several provinces and cities to ensure that experts familiar with IPR laws and regulations may hear and preside over the cases. For more information, see (<http://www.chinaiprlaw.com/English/courts/fujian.ht>)

<sup>5</sup> Sumner J. La Croix and Denise Eby Konan. "Intellectual Property Rights in China: The Changing Political Economy of Chinese-American Interests," Working Paper No. 02-1 (January 2002), p. 20.

<sup>6</sup> See, for example, one survey conducted by the US-China Business Council, Membership Priorities WTO Survey, Sept 7, 2004, (<http://www.uschina.org/public/documents/2004/09/wtosurveyfindings.pdf>)

<sup>7</sup> For further discussion, see Maskus, Keith E., Sean M. Dougherty and Andrew Mertha, "Intellectual Property Rights and Economic Development in China," *Intellectual Property and Development: Lessons from Recent Economic Research*, eds., Carsten Fink, Keith E. Maskus, World Bank and Oxford University Press (2005), p. 296; and Sumner J. La Croix and Denise Eby Konan. "Intellectual Property Rights in China: The Changing Political Economy of Chinese-American Interests," Working Paper No. 02-1 (January 2002).

<sup>8</sup> International Intellectual Property Alliance, "Special 301

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Report, People's Republic of China" (2004), p. 40.

<sup>9</sup> In its recent report, the International Intellectual Property Alliance, the IIPA remarks upon the growing sophistication and effectiveness of the IPR courts throughout China and the fact that Chinese rights holders and US rights holders are using the civil system more frequently "Special 301 Report, People's Republic of China" (2004), p. 43.

<sup>10</sup> Wong, Alison. "The Life Sciences Patent Battle." *Managing Intellectual Property* (2004).

<sup>11</sup> Alexandra Harney, "Jurors to Judge Copycat Trials," *Financial Times* (1 March 2005); Li, Liu and Cao Li "Jurors to Help Decide Court Verdicts," *China Daily* (25 April 2005); see also (<http://www.law-lib.com/law>; (<http://www.law-lib.com/lawyer>)

<sup>12</sup> As an example, US chipmaker Intel sued the Chinese network equipment maker Shenzhen Donjin Communication Technology Co. Ltd in January 2005. Intel accused Donjin of illegally including Intel software in its products. Donjin claimed their product design is intended to facilitate compatibility; users of Intel's communications cards can switch to Donjin's products without needing to alter their existing programs. Intel requested a permanent injunction, barring Donjin from manufacturing or selling the products in question. Intel said its losses due to Donjin's infringement have reached US\$7.96 million and is claiming the same amount in compensation. The sum is equal to Donjin's annual revenue. Donjin countersued, accusing Intel of engaging in illegal monopolistic practices, alleging that Intel software was so closely tied to its hardware it prevented

customers from using the software in third-party hardware. Further, the lawsuit suggested that Intel's suit was strategic; an effort to limit the market share of its Chinese rivals in the computer technology integration market. Donjin's suit seeks a ruling forcing Intel to end monopolistic practices. ("Intel Launches Legal Battle Over IPR," *China Daily*, January 25, 2004; Reuters, "Chinese Firm Sued by Intel Hits Back with Own Suit," 5 April 2005).

<sup>13</sup> Spurgeon, Brad, "Pirates File Patents To Beat The System: The New Chinese Counterfeit Game," *International Herald Tribune*, (November 15, 2004)

<sup>14</sup> For example, piracy rates remain above 90 percent across copyright industries. International Intellectual Property Alliance, Special 301 Report, People's Republic of China (2004), 31.

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