

Licensing Intellectual Property in China

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I. INTRODUCTION

Licensing is a viable method for many intellectual property (“IP”) owners to monetize their IP rights. While IP licensing practice is well developed in the United States, China remains a mysterious frontier for many IP owners. Even for large corporations that have developed successful licensing programs in

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China, changes in China's legal and political landscape may catch them off guard.

For example, Qualcomm Inc., a San Diego, California-based company, designs and develops wireless communications products and services relating to wireless communication standards such as CDMA, GSM/GPRS/EDGE, 3G, 4G, and LTE, and then licenses portions of its IP portfolio to other companies.² In the 2014 fiscal year, Qualcomm's worldwide revenue was about \$26.5 billion,³ half of which came from China.⁴ Qualcomm reportedly makes about two-thirds of its profits from licensing fees.⁵

On February 9, 2015, Qualcomm announced that it would pay a \$975 million fine after the Chinese government found that Qualcomm's IP licensing program violated China's anti-monopoly law.⁶ As a part of the deal, Qualcomm agrees to license its IP to the companies selling products in China only at a discount.⁷ Despite the setback, observers believe that "the Chinese market — and the potential for profit — is just too big for companies to ignore."⁸

This article will first explain why the Chinese market is important, even for the IP owners who have no intention to make or sell products in China. It will then discuss current IP licensing models in China and describe the types of licensing programs that are successful in China. Finally, this article will provide recommendations for developing IP licensing strategies in China.

² Yahoo Finance, *Qualcomm Inc., Profile*, <http://finance.yahoo.com/q/pr?s=QCOM+Profile> (last visited Mar. 14, 2015).

³ Qualcomm Inc., Annual Report (Form 10-K) (Nov. 5, 2014).

⁴ *Id.* at 9.

⁵ Jonathan Sidener, *Qualcomm, Broadcom Settle Patent Lawsuit*, U-T SAN DIEGO (Apr. 27, 2009), *available at* <http://www.utsandiego.com/news/2009/apr/27/1b27qcom23113-qualcomm-broadcom-settle-patent-laws/>.

⁶ Paul Mozur & Quentin Hardy, *China Hits Qualcomm with Fine*, NY TIMES (Feb. 9, 2015), *available at* http://www.nytimes.com/2015/02/10/business/international/qualcomm-fine-china-antitrust-investigation.html?_r=0.

⁷ *Id.*

⁸ *Id.*

II. WHY CHINA?

IP practice has evolved in recent years from both legal and business perspectives. As the businesses become more globalized, economies in different countries become more interdependent on each other. The global economic landscape has been reshaped by China's breakneck economic growth in the past three decades.

Since China joined the World Trade Organization ("WTO") in 2001, China has become one of the world's most important growth markets.⁹ With a population of more than 1.35 billion people, China has become an important source of economic opportunity for U.S. businesses.¹⁰ In 2010, China overtook Japan as the world's second largest economy behind the United States, expanding its GDP by about 10 percent despite the global recession.¹¹ The rise of the Chinese economy, along with the world's largest consumer base, will continue to generate countless opportunities for U.S. companies doing business in China.

While China continues to battle isolated piracy and counterfeit problems, the Chinese government has taken steps to protect IP rights, recognizing the importance of IP protection in order to promote the Chinese economy. For example, on June 5, 2008, China's State Council issued an outline of the national IP strategy "for the purpose of improving China's capacity to create, utilize, protect and administer intellectual property, making China an innovative country and attaining the goal of building a moderately prosperous society in all respects."¹² Recognizing that "intellectual property system is a basic system for developing and utilizing knowledge-based resources," China has been gradually

⁹ U.S. Int'l Trade Comm'n, Investigation No. 332-514, CHINA: INTELLECTUAL PROPERTY INFRINGEMENT, INDIGENOUS INNOVATION POLICIES, AND FRAMEWORKS FOR MEASURING THE EFFECTS ON THE U.S. ECONOMY (USITC Pub. 4199, 2010))

¹⁰ *Id.*

¹¹ Theunis Bates, *China Surpasses Japan as World's No. 2 Economy*, AOL NEWS, (Feb. 14, 2011), available at <http://www.aolnews.com/2011/02/14/china-surpasses-japan-as-worlds-no-2-economy/>.

¹² STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA, OUTLINE OF THE NATIONAL INTELLECTUAL PROPERTY STRATEGY (June 5, 2008).

improving its IP laws and regulations and setting up enforcement efforts.¹³ According to the Chinese government, implementing the national IP strategy “will facilitate China's opening up further to the outside world, thereby leading to a win-win situation between China and the rest of the world.”¹⁴

The strategic goal is to make China a country with a comparatively high level of the creation, utilization, protection, and administration of IP rights by 2020.¹⁵ The Chinese government has also pledged to step up its efforts to protect IP rights by cracking down on IP infringement such as piracy and counterfeiting.¹⁶

Therefore, the current legal and political environment in China creates prime opportunities for IP licensing in China. Even for U.S. patent owners who have no intention to make and/or sell products in China, China could still be an important source of IP royalties. For example, regarding patent rights, since U.S. patent owners presumably already spent resources to develop inventions, it certainly makes sense for them to apply for Chinese patents considering the importance of the Chinese market. U.S. patent owners then would have an option to license the Chinese patent rights to Chinese companies to extract additional values out of these inventions. Naturally, developing IP without a China-oriented strategy is essentially leaving money on the table.

III. CURRENT IP LICENSING MODELS

A. Two Types of IP Licensing

Generally speaking, IP licensing may be categorized in two types: *ex ante* and *ex post* licensing. *Ex ante* licensing refers to IP transactions that occur as part of a technology transfer agreement before the licensee has obtained the technology through other means.¹⁷ *Ex post* licensing refers to IP transactions where licensees have developed or obtained independently of the patent owner.¹⁸

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *The Evolving IP Marketplace: Aligning Patent Notices and Remedies with Competition*, FED. TRADE COMM'N, 7-8 (Mar. 2011).

¹⁸ *Id.* at 8.

The policy behind the IP system, especially the patent system, is that innovation benefits the society in general through the development of new products, processes and services that improve lives and address unmet needs.¹⁹ Thus, the goal of the patent system, is to promote innovation by giving patent owners the right to exclude others from making, using, or selling a patented invention for a certain number of years (e.g., 20 years in the U.S.).²⁰ By preventing copying by others who might drive down prices, the patent system allows innovators to recoup their investment in research and development (“R&D”) during the patent term.²¹

Therefore, *ex post* licensing can distort competition in technology markets and deter innovation.²² The lack of an *ex ante* license including technology transfer may result in duplicated R&D effort.²³ If a company has invested in products using the technology, the patent owner can use that investment as negotiating leverage for a higher royalty than it could have commanded *ex ante* when the alternatives still are an option.²⁴ The increased uncertainty and higher costs associated with *ex post* licensing can deter innovation by others.²⁵

Understandably, Chinese companies typically resist efforts of *ex post* licensing, while encourage *ex ante* licensing. Therefore, IP owners should consider *ex ante* licensing, taking advantage of China’s national priority of converting China’s manufacturing-based economy into an innovation-based economy by 2020.²⁶ Indeed, all levels of the governments in China, from the central government to the provincial governments to the municipal governments, have policies and plans in place, from favorable tax

¹⁹ *Id.* at 1.

²⁰ *Id.*

²¹ *Id.*

²² *Id.* at 8.

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.*

²⁶ LEI MEI, CONDUCTING BUSINESS IN CHINA: AN INTELLECTUAL PROPERTY PERSPECTIVE 171 (2012).

incentives to government subsidies, to attract hi-tech companies with right technology to set up operations in China.²⁷

B. Patent Licensing Models

In terms of patent licensing, patent owners have used various licensing models in China. Typically, patent owners either license their patents through patent pools or individually. Generally speaking, a patent pool refers to a patent portfolio consisting patents (typically standard essential patents) from multiple patent owners. Alternatively, a patent owner may license its own patent or patent portfolio individually outside of a patent pool.

Some well-known patent pools actively licensing patents in China include MPEG LA,²⁸ which runs patent pools relating to standards such as MPEG-2 (for imaging processing) and ATSC (for digital TVs) standards, and One Blue,²⁹ which runs a patent pool relating to the Blu-ray technology. Individual patent owners actively licensing patents in China include Thomson, Philips, InterDigital, Qualcomm, and Dolby. Some patent owners may choose to participate in a patent pool for one technology and at the same time license their own patent portfolios individually for another technology.

C. Deficiencies in Current Licensing Models

The current licensing models have some deficiencies. To be successful in China, IP owners must recognize the problem with the current licensing models in light of unique aspects of China's economic model and legal system.

First, most of the licensing programs originated in the United States or Europe, not in China. Therefore, while IP owners may be able to force a licensee to take a license using well-developed litigation systems in the United States or through border-

²⁷ *Id.*

²⁸ See generally MPEG LA, <http://www.mpegla.com/main/default.aspx> (providing an overview of MPEG LA's patent pool and intellectual property licensing operations).

²⁹ See generally ONE BLUE, <http://www.one-blue.com/> (discussing blu-ray and similar IP licensing).

seizure procedures in Europe, it is more difficult for IP owners to use litigation to force a licensing deal in China. For example, damage awards from Chinese courts are typically very low, and litigation costs in China are much lower than the costs in the United States. Therefore, litigants have less incentive to settle early and take a license in patent lawsuits in China. As a result, many IP owners are unable to effectively license their IP to Chinese companies in China.

Second, since many Chinese companies are merely manufacturers of products and have low profit margins, they may not be able to afford IP royalty rates that were set for the U.S. or European market. In fact, high IP royalties have destroyed some Chinese industries. Conversely, it also hurts IP owners because they lose out on potential royalties when potential licensees are either out of business or refuse to take a license.

For example, when a worldwide DVD standard was adopted in the 1990s, the initial consortium split into two groups: the 3C group consisting of Philips, Sony and Pioneer (and later LG) and the 6C group consisting of Toshiba, Hitachi, JVC, Time Warner, Matsushita and Mitsubishi.³⁰ The 3C and 6C groups negotiated with the China Audio Industry Association (CAIA), which represented about 400 DVD and video CD player manufacturers, for two years and reached licensing agreements in 2002.³¹ Chinese DVD manufacturers started to pay royalties of \$5 or 3.5% per DVD player, whichever was higher, to the 3C group; and \$4 or 4% per DVD player, whichever was higher, to the 6C group.³² Along with other assorted royalties paid to MPEG LA, Dolby, Thomson and other patent owners, total license payments added up to a hefty \$15 to \$20 per unit.³³

³⁰ Powerdatarecovery.com, DVD FORUM, <http://www.powerdatarecovery.com/cd-dvd-resources/dvd-forum.html> (last visited May 14, 2015).

³¹ Yizhen Feng & Jialu Li, *Agreement Between Chinese DVD Companies and the 6C Group After Two Years Negotiation*, XINHUA NEWS (May 8, 2002).

³² Mike Clendenin, *Taiwan Joins Chinese Effort on Proprietary DVD Format*, EE TIMES (May 24, 2002).

³³ *Id.*

The Chinese DVD manufacturers complained that a fixed royalty was no longer justified as prices continued to fall.³⁴ At that time, DVD players made in China usually sold under \$100 overseas, generating almost no profits for Chinese manufacturers with the added royalty payment.³⁵ Many mainland Chinese DVD player manufacturers stopped exporting to the United States as a result, and China's DVD player exports dropped significantly.³⁶

The demise of the Chinese DVD industry is a cautionary tale for IP owners who try to license their IP to Chinese companies. To have sustainable success, IP owners must carefully design and implement their IP licensing programs in China.

IV. DEVELOP A CHINA-ORIENTED STRATEGY

A. Develop Chinese Patent Portfolios

As explained earlier, the Chinese government encourages *ex ante* technology transfer. To enhance the value of an IP portfolio, patent owners should acquire Chinese patents either through filing Chinese patent applications or acquiring Chinese patents or companies having desirable Chinese patents.

Generally speaking, the costs for drafting and filing patent applications in China are merely a fraction of the costs in the United States. Therefore, if a U.S. company or inventor already incurred expenses in R&D for an invention and in for filing U.S. patent application, it would make sense to also file a patent application in China. For example, the Patent Cooperation Treaty ("PCT"), an international treaty administered by the World Intellectual Property Organization ("WIPO"), makes it possible to seek patent protection for an invention simultaneously in different countries, including China, in a cost-effective manner, by filing an "international" patent application.³⁷

³⁴ *See id.*

³⁵ *6C Seeks Patent License Fees from Chinese DVD Companies*, ECONOMIC REVIEW (Mar. 21, 2002).

³⁶ *China Q3 DVD Player Exports Down Nearly 30%*, PACIFIC EPOCH (Nov. 10, 2004).

³⁷ World Intellectual Property Organization, Patent Cooperation Treaty ("PCT") (1970), *Available at* <http://www.wipo.int/pct/en/treaty/about.html> (last accessed July 18, 2010).

B. Understand the Chinese IP System

Since China's strategic goal is to make China a country with a comparatively high level of the creation, utilization, protection and administration of IP rights by 2020, China has pledged to step up its efforts to protect IP rights by cracking down on IP infringement.³⁸ Presently, copyright and trademark enforcement is relatively effective, but crackdown on patent infringement and trade secret theft are still challenging in China.

Specifically regarding the Chinese patent law, the major obstacle, from a patent licensing perspective, is that damages for patent infringement are simply too low and/or too difficult to prove. The Chinese patent law provides that damages for patent infringement "shall be determined according to the patentee's actual losses caused by the infringement."³⁹ If the actual losses cannot be ascertained, damages "may be determined according to the benefits acquired by the infringer through the infringement."⁴⁰ If the court cannot determine actual losses of the patentee or the benefits acquired by the infringer, damages may be determined according to reasonable royalties.⁴¹ In the event that neither the losses of the patentee, nor benefits of the infringer, nor reasonable royalties can be ascertained, a court may consider multiple factors and determine the amount of compensation within the range from 10,000 RMB (about \$1,600) to 1,000,000 RMB (about \$160,000).⁴²

The Chinese patent law, however, does allow injunctive relief against infringing entities.⁴³ A patent owner may use injunctive relief as leverage to force an infringer to take a patent license.

Another encouraging sign is that China established three specialized IP courts in Beijing, Shanghai and Guangzhou in

³⁸ STATE COUNCIL OF THE PEOPLE'S REPUBLIC OF CHINA, OUTLINE OF THE NATIONAL INTELLECTUAL PROPERTY STRATEGY (Jun. 5, 2008).

³⁹ Patent Law of the People's Republic of China, art. 65 (2008).

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*

⁴³ *See id.* at art. 11.

November 2014.⁴⁴ The newly created specialized IP courts should further improve the Chinese IP system and create a better legal environment for IP licensing and enforcement in China.

C. Structure Licensing Deals Creatively

To create a successful IP licensing program in China, IP owners must structure IP licensing deals creatively. As discussed early, *ex ante* licensing are welcomed and encouraged by the Chinese government and Chinese companies. The more successful licensors are those IP owners who have a long term vision and are willing to offer a low upfront fee and then take more royalties when the products are commercialized.

Ex post IP licensing, however, continues to be problematic. One key obstacle, as explained earlier, is the royalty rate. There should be a balance in terms of setting an appropriate royalty rate for Chinese companies.⁴⁵ On the one hand, if the royalty rate is too low, the patent owner is not getting reasonable value for the invention.⁴⁶ On the other hand, if the royalty rate is too high, it carries risks of potentially destroying the entire manufacturing industry in China and indirectly encouraging counterfeiting activities.⁴⁷

Due to antitrust concerns, many IP owners use reasonable and non-discriminatory (RAND) terms, which often has a fixed royalty rate schedule for all licensees.⁴⁸ Chinese companies, however, resist the fixed royalty rates as applied to them, due to the large volume of the products subject to the license, which leads to large royalty payments.⁴⁹ Coupled with the relatively low profit margins as manufacturers, Chinese companies' profits could be

⁴⁴ See Skip Fisher & Deanna Wong, *Specialized IP Courts in China are open for business*, HOGAN LOVELLS LIMEGREEN IP NEWS (Jan. 15, 2015), <http://www.limegreenipnews.com/2015/01/specialized-ip-courts-in-china-are-open-for-business/>.

⁴⁵ LEI MEI, *supra* note (25*), at 122. 122 (consider *supra*) (2012).

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.* at 122-13.

⁴⁹ *Id.* at 123.

erased if they pay high royalty rates.⁵⁰ As a result, licensing negotiations with Chinese companies can be a lengthy and frustrating process.⁵¹

To address this problem, IP owners should be more flexible in terms of structuring licensing deals. For example, royalty rates could decrease as the volume goes up. This still may comply with the RAND terms, since the licensees in the same category are treated the same.⁵² IP owners may even consider lowering the royalty rates for all worldwide licensees in order to bring the Chinese companies into the licensing program.⁵³ This could actually increase overall licensing revenues because the volume of the licensed products would be much larger by including Chinese companies' products.⁵⁴

Additionally, it may be helpful for foreign IP owners to partner with a relevant Chinese government agency or a relevant trade association or organization to assess the licensing market in China and to address potential concerns.⁵⁵ Chinese government agencies and trade associations know the best way to approach individual companies in China and they have the knowledge that is often critical for foreign IP owners to close licensing deals in China.⁵⁶ In the long term, foreign IP owners may also need to enlist the help from Chinese government agencies and trade associations to ensure compliance of the licensing terms by the Chinese companies.⁵⁷

Overall, constructive approaches, rather than confrontations, should be the first option for IP owners who try to monetize their IP in China.

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.*

V. CONCLUSION

Despite the challenges U.S. companies face in licensing IP rights in China, the Chinese market is too important and too lucrative to ignore. With careful planning and execution, U.S. companies can and will achieve success in their IP licensing programs in China. In turn, it will benefit companies and consumers — both Chinese and American — by reducing costs through improved technology and streamlined R&D efforts. There is “a win-win situation between China and the rest of the world.”⁵⁸

⁵⁸ STATE COUNCIL OF THE PEOPLE’S REPUBLIC OF CHINA, OUTLINE OF THE NATIONAL INTELLECTUAL PROPERTY STRATEGY (June 5, 2008) (consider *supra*).