

# China, IP Protection and Trust

## Considerations in Choosing a Chinese Business Partner

By

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- Whom can I trust?
- How can I protect my intellectual property (IP)?
- Which processes do I keep here and which do I shift to China?



China-bound technology companies, keen to protect their intellectual property (IP), sooner or later arrive at the question, “How do I know which Chinese counterparts I can trust?” This—and the companion question, “How will those counterparts know that they can trust me?”—bedevil executives in small-to-medium enterprises contemplating entry into China's burgeoning technology markets. With so much of their value riding on IP, yet so much promise in the Chinese market, companies are understandably cautious in selecting partners. What they often overlook, however, is that Chinese companies are similarly cautious in selecting foreign partners (in some cases, for reasons which date back several centuries).

## Roots of Chinese Capitalism

“China’s capitalism was formed at a time when there was not much rule of law, and certainly not commercial law,” observes Michael Brownrigg, partner in Chinavest, a venture capital firm which has worked with entrepreneurs and invested in companies seeking to capitalize upon the growth of Greater China since 1983. “If you do business with a stranger in the United States, you have a set of assumptions that you bring to that transaction: you place an order with Land’s End, a little company in Maine with no commercial presence, and you send your credit card information ahead of time, yet you know that you can send that product back if you don’t like it. Every one of the steps in that transaction requires a legal underpinning, so that if you are unhappy, you can then take your concerns to an impartial court for arbitration. That’s the way our capitalist system has grown up, but that didn’t exist in China.”

“Culture is different between China and United States—never underestimate that,” reminds Zhong Jianhua, Consul General of the PRC in Los Angeles. “China’s economy came from a state-planned economy, which is very different from a market economy. Though we are trying to hard to build a Chinese-style market economy, old habits die hard. According to Chinese heritage, which is totally different from that of the United States, the government oversees everything. This comes not only from communism, but also from 2,000 years of culture. Sometimes the officials look upon all these companies and enterprises in their territory as their children. They want to do everything for their children, even choose their partners. They even want to recruit employees for the foreign companies in their vicinity.”

As contrasted with other countries emerging from state-run economies, China’s is a continental economy. “It is what the U.S. was in the 1960’s,” says Brownrigg. “Although there are various dialects, it is one language, it is one country, and it is going to have one market, unlike Eastern Europe. Another difference from Eastern Europe has to do with reforms begun under Deng Xiaoping in 1979, which started with the peasants. Entrepreneurship began from the bottom up in China, not from the top down, not from plutocrats receiving state assets.”

What is the face, then, of a Chinese-style market economy? “Capitalism in China is a very personal thing, and it’s being done by the twenty-year-olds,” notes Lawrence Prior

III, Chief Marketing Officer of Lightpointe, Inc., designer and manufacturer of optical transmission equipment using free-space optics technology. Prior contrasts the evolution from planned economies in Eastern Europe, with “more holidays than we can count, workers’ councils, and a very deliberate, conservative approach to engineering” to “the condominium village in Huawei, filled with eight thousand crazy, young engineers who want to conquer the world.”

## How Can I Protect My IP?

“The first question is whether you’re protecting software or hardware,” says Brownrigg. It’s easier in China to protect hardware. So, when we have software companies in our portfolio that want to go to China, we almost always try to figure out a way to wrap the software in hardware, whether that’s burying the software in an ASIC or incorporating a board in a box. The other aspect to this approach is that most Chinese enterprises are quite happy paying for boxes—indeed, overpaying for boxes. They typically underpay for software. They don’t like licenses, they don’t like royalties, and per-seat, per-user fees are tough. So you have the twin advantage in shipping a box rather than software.

“China’s legal system for IP protection is among the best in the world, but it’s enforcement system still has a lot of work ahead. I had a friend at Microsoft eight years ago when they were debating whether to go into China, and I told him, ‘What do you mean debating whether to go? You’re already here. You’re just not making any money.’”

Palm, Inc., has a similar take on software versus hardware, according to Angel Mendez, Sr. Vice President of Global Operations. “There are many things that we do not allow our OEM partners in China to control. We manage the subtier supplier relationships, for example: things like processors, display technology, wireless silicon memory, increasingly certain things in our plastics and metals. The touch and feel of the product and the simplicity and usefulness that have brought Palm success is something we hold sacred, and we would never outsource it. Laying out a board and figuring out where to place a resistor, is not our core competency, so we have outsourced some—in fact, a good deal—of our hardware design to the OEMs.”

Adds Brownrigg, “The strategy we try to adopt with our companies is to keep core IP here in the US. But if you are in any sector in which functionality, features and usability are important, all that work is done in China extremely efficiently. So in a couple of our companies we have far faster turns-to-market with new features and new applications on top of core IP that we keep right here in the U.S.”

## For Everything Else, There's Trust

So, to reprise the assumptions we in the West bring to a transaction, how do you do business with strangers? By any measure and in any context, it's a matter of building trust.

"I look at trust in two ways," says Lightpointe's Prior. "Number one: What's predictable behavior? Can I understand what that is and what it will do to my business? You grow that over time as you learn more about a potential partner. Number two: What can two companies do for each other when they're in business together, and something goes bump in the night (i.e., problems arise)?"

"It's less about the concern of stealing IP than that you need to change something to satisfy some specific customer. When it comes to the whole issue around IP, we always made sure we were not core to their business. To keep high value in the relationship, you use everything in the world with legal documents, you try to design everything into the product that you can, you try to keep innovating to stay ahead of the curve. However, we want to be valuable enough that they partner with us, but not so valuable that suddenly we replace their core business.

"Trust is incredibly important, and the example I use is that we closed our deal in March, just when SARS broke out, so we did our product launch in China during the three months of the SARS epidemic. We sent over our head of Customer Service, who was the only tall guy in China with a mask on. After a few weeks, he called us and said, 'It's fine, we're OK, and the project is going well.' But what I learned months later is that we were the only visitor to our partner's facility in three months' time. It was risky for us, but we really went over the top in commitment to the customer.

"I have news for you," warns Brownrigg, "and this is bad news if you don't like to travel: you cannot buy trust. Your company cannot buy trust. Hiring the son of the manager doesn't bring trust. Trust is established by time, by meeting and sitting down over those endless dinners where a lot of American businessmen leave frustrated, wondering why it took the whole dinner to get to the point about business. That's part of doing business in China. And you have to ask yourself whether you have the time to devote in the first instance, to that investment."

Palm's Mendez says that his company has reaped the benefits of the trust that their Chinese suppliers placed in them. "Palm has been through a pretty broad transformation over the last few years. After a successful IPO followed by a spectacular crash and huge inventory write-offs, a new management team took over in 2001. China played a critical role in our recovery in the first phase, which was putting Palm back on track, which we think we've done. Trust has really been the lynchpin of our relationships there. When some of our Chinese suppliers took us on as customers a couple of years ago, we were weak, and it's taken a lot of great, great work with them. The relationship

has allowed us to launch products like the Zire, our US\$99 product. No other PDA had been able to go to that price point, and we sold over one million units in four and a half months, the fastest growth of any PDA product in history of the category.

“After all the contracts are done and the IP protection is in place with the supplier and the customer, trust is personal. It’s people. At the end of the day, if you don’t do what you say, it doesn’t matter. It doesn’t matter how good your IP protection is or how good your partner is at complying with it, if they don’t trust you, they just don’t trust you, and it’s personal. I don’t know how to fix that, other than to be careful what you send over there, and who’s in charge of what people.”

There is no magic wand to wave, then, to ensure trust with our Chinese partners, just as there is no quick way to convince customers of the quality of our brand. We need to suspend the credo of our industry—“better-faster-cheaper-more secure”—if success in China is really that important to us. It can be a tough lesson for Western, and especially American, companies to change their focus from *transactions*, built on SSL and credit card numbers, to *relationships*, built on lengthy visits with their Chinese partners and the ensuing bond of trust.

## Next Steps

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