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For most businesses, intangible assets represent more than 50% of the value of the enterprise. The most significant group of intangible assets are those protected by intellectual property such as inventions, designs and brands. Since they form such a large part of the overall value, their management as financial assets is important to the success of the business.

Businesses that actively manage their IP as a financial asset outperform their peers by up to 30%. They do so by maximising the effectiveness of investment in the business, driving performance in areas that produce the best return, managing operational risk and minimising tax risk. They may also use their IP assets as security to obtain various forms of funding. Moreover, there are opportunities to gain strategic advantage in relation to the sale or purchase of a business.

A good IP management strategy enhances the ability of the business to raise funding by managing the issues that affect valuations of IP assets.

Understanding the financial value to the business of specific IP assets is of particular importance when moving into a new market – product or geographic – because there will be new risks as well as opportunities.

China presents some special challenges and practical steps to protect the value of IP assets are often as important as legal ones.

This guide aims to explain how IP assets matter from a financial perspective and assess how to manage them to the greatest business advantage.

1. Manage Return on Investment and Improve Performance

Where there are several IP assets, knowing the comparative return on investment of each one allows the overall business strategy to focus on those that will give the best return. It also means that the risk to the viability of the business if certain IP rights are lost can be assessed. This is important in deciding how to structure your commercial relationships and operations in China.

Funded by:



As with tangible assets, measuring the return on investment requires knowledge of their monetary value and of the amount of investment made in them over a given period. Ascertaining individual IP assets consists of identifying the technology and brand in each separate product and any brand that is used for more than one product.

Example

Company A develops, manufactures and sells a range of state-of-the-art, prestige digital radios. Its proprietary technology gives it a competitive advantage. Its 'house' brand has a reputation for innovative products. Its IP assets will be:

- *the 'house' brand*
- *the technology and design of each radio in its range and its name*



2. Provide Security for Financing

IP assets can be used to provide security for a wide range of methods of raising funds. China has been at the forefront of the use of patent mortgages and a variety of fund-raising structures are readily available from Chinese financial institutions as well as European ones.

The range of fund-raising options includes:

- 1) Providing security for existing bank borrowing.** It is not unusual for a company's

IP to be covered by the general charge taken by its bank but at a nominal or nil value. Valuing it separately often increases the value of the security covered by the charge. This can be used either to increase the borrowing or to reduce the interest charged on it. If the IP assets are to be used for another form of security it will be necessary to get them released from any bank charge. This will be easier if they are included at only a nominal value;

- 2) Providing security for new debt.** This can be to support new bank borrowing for cashflow or for longer-term debt to fund investment in new products or markets. Lending against IP assets is a specialised form of lending usually carried out by dedicated teams within larger lending organisations or by smaller specialist lending houses;
- 3) Patent (and other IP) mortgage.** A patent mortgage is one form of lending against patents or other IP assets. The significant difference between this and security under a charge is that a mortgage will usually transfer title to the lender immediately on default. It is a well-established form of lending by some Chinese banks who may have more familiarity with it than their international counterparts;
- 4) Creating a vehicle for raising equity.** If IP assets are owned by a company created for that purpose and generate a royalty income then shares can be issued in that company to raise new equity finance;
- 5) Securitisation (bond issue).** An alternative to issuing shares in an IP holding company is to use the company's assets as security for a bond issue in the market. This is more likely to be an attractive option for medium-sized

businesses with brands or technology that is reasonably well-known in its own market-place;

- 6) Secure assets to benefit a third party.** A further use of an IP holding company is to provide security to benefit a third party such as the company's pension fund or a new venture on the same group of companies.

IP assets are often undervalued in company accounts. However, identifying and valuing them can result in a worthwhile increase in the value that existing lenders will put on them as security for current lending. This can be very useful in a credit crunch.

A portfolio of IP assets (such as the bundle of patents protecting the various inventions relating to Company A's radios and trademarks protecting its brand names) is much more attractive than a single IP asset as it spreads the risk for any lender or investor.

The acceptability of IP assets for fund-raising will depend to a considerable extent on:

- What valuation is put on them
- Whether they are owned by an appropriate entity.

The considerations that impact on valuation include whether the IP assets are:

- Clearly identified
- Consolidated in one ownership rather than dispersed across the group
- Protected from insolvency risks associated with operational activities
- Protected by appropriate registrations
- Subject to a structured enforcement

programme

- Licensed to group businesses and/or third parties to generate an income stream
- Being used to increase the profitability of the business.

Example

Company A decides to raise additional equity finance. It creates a company ('Special Purpose Vehicle' or 'SPV') to hold the IP assets. The SPV grants licences to the operating company to use the IP. The SPV now owns a valuable asset that produces an income stream and is protected from operational risks. It then sells 30% of the shares in the SPV to a private equity house.

3. Taxation

The main areas where IP assets have special effect on the tax that a business has to pay are:

- Many countries have special tax regimes to encourage innovation – either generally or in specific sectors such as environmentally sustainable technology ('EST'). China encourages both EST and indigenous (i.e., Chinese-registered) IP so there may be tax advantages in carrying out research and development in China. These must be balanced against other tax, legal and operational considerations;
- IP rights are often used by different parts of a business, whether separate companies in a group or overseas divisions. It is common for this to be done on an informal basis rather than under written licences. Each part of the business that is using the IP must pay an arm's-length licence fee to the part of the business that owns it. Failure to do so can result in the tax authorities adjusting the tax

payable for the current and earlier years. This is known as ‘transfer pricing’ and China has rules that are similar to those in force in the EU;

- Most countries charge a tax on the transfer of IP rights. In China, business tax is charged on transfers within the PRC and withholding tax on transfers outside the PRC.

Example

In the examples above, Company A is the operating company. It pays arm’s length royalties to the SPV for the IP licences. The payment is made as an intra-group transfer so there is no additional net cost to the business. This meets the requirements of the various transfer pricing regimes and so it incurs no additional tax liability for its ongoing trading.

Note: There may be a liability to pay an exit charge on transferring the IP assets to the SPV although this is unusual within a group of companies if both the operating company and the SPV are incorporated in the EU. It is more likely that there will be a charge if the SPV is to be created in a tax-favourable jurisdiction.

4. Structuring Business Arrangements in China to Protect IP Assets

Many businesses want to do business in China but are concerned that establishing manufacturing or other operations there may result in them losing their IP assets. The concerns tend to centre around their designs, inventions or methods being copied. This could be a serious problem not only in Asia but back in their home markets as well if the copied products are exported and sold there.

This risk can be managed by getting to know potential Chinese partners and doing business only with those who are trusted and also by structuring commercial relationships to ensure that no one person or company

has knowledge of all the elements essential to a product. Where possible those IP assets that are core to the success of the business should be split into separate operations. Each operation can then be carried out with a different business partner and using different Chinese employees so that no one person (or company) has the full knowledge of all the technology.

Another approach to managing this risk is to keep the operations relating to the most important IP in Europe and to use only the less valuable or older IP assets in China.

In any event, it is vital that management of Chinese operations is closely supervised by someone whose primary loyalty is to the main business and who is capable of checking what is happening on the ground on practice.

Further details of how to handle technology transfers are in the China IPR SME Helpdesk publication: “Technology Transfers to China: Guidance for Business”.

5. Drawing Up an IP Strategy

A well-managed IP strategy makes a significant difference to the valuation of a company’s IP assets. A valuer will assess the economic impact of the IP on the company’s business. Although there are several different valuation methodologies, all take account of the risk to the IP. A realistic IP strategy that is documented and demonstrates effective support for the overall business strategy will always enhance the



ultimate valuation figure for the IP.

The IP strategy reinforces the overall business strategy and will change as the business moves through different stages of its development. It will often also differ from one market to another as the business will be at different stages of its life-cycle in each. The balance of which IP rights are most useful and so should get priority in investment and management time will vary accordingly.

For example, in establishing a new market, registration of trademarks and patents, designs or copyright to protect the product is likely to be more significant than enforcement against infringers. Once a business is established, enforcement is likely to take a higher priority. Where it seeks to increase market share compared with its competitors, then the focus may well be on defending litigation.

It is essential that the management of the company is involved in drawing up the IP strategy and understands how it will support the business objectives. The key people to be engaged are the chief executive, finance director, tax advisor, general counsel, chief technology officer and chief operating officer.

The IP strategy should be reviewed whenever the business strategy changes and at least once a year.

6. Components of an IP Strategy

It is essential to have protection and enforcement strategies. It is usually too expensive to put the ideal amount of protection in place at once. Building the protection portfolio over a period of time may be more feasible. It should be designed to give the highest priority to protecting the IP assets that are key to delivering the business strategy.

Other arrangements are critical to effective IP protection and centre around relationships and behaviour with employees, business partners and other commercial contacts.

a. Protection

The maxim 'register it or lose it' applies to IP with even more force in China than elsewhere.

Special points that are important in China and differ from Europe are:

- Products should always be given a Chinese name – otherwise the market will do so. Trademark registration is required for the Chinese name, the European name and its translation into Chinese characters – so for each name there are three basic registrations required rather than just one;
- China operates the 'first-to-file' system for trademarks so earliest possible registration is vital;
- PRC, Hong Kong and Macau are separate territories for the purposes of IP registration and consideration should be given to the need for protection in each territory;
- Any copyright that is significant to the business should be registered with the National Copyright Administration. This is voluntary but in practice it is much harder to enforce copyright that has not been registered;
- Software created in China must also be registered prior to enforcement. Registration is voluntary for foreign software but again it facilitates enforcement;
- Trademark licences must be recorded with the PRC Trademark Office within three months of entering into them.

Example

Company A does not have patent protection in China

for its earliest patents which still have several years to run in Europe. As the information is already publicly available, it has no protection in China. However, its more recent developments are the subject of patent applications which it pays to extend to China under the Patent Co-operation Treaty ('PCT'). It has applied for PRC, Hong Kong and Macau trademark registrations to cover its products and Internet use under the main brand name in its European, Chinese character and Chinese name. Next year it plans to add trademark registrations for the names of the individual radio sets; and the following year it will also cover the main brand name for advertising and promotional materials. It has domain name registrations for all three versions of the names of both the main brand and individual radio sets.

Details of how to register patents and trade marks can be found in the IPR SME Helpdesk publication "Patent & Trademark Protection in China".

b. Enforcement

There are three main routes to enforcement: administrative, civil litigation and criminal. All are increasing in effectiveness rapidly but the picture remains inconsistent across China.

Although foreign companies often prefer to use the civil courts in Beijing and Shanghai, the plaintiff success rate is higher in other courts and the backlog lower. Judges in Guangzhou, Shenzhen and Nanjing have increasing IP experience and the special High Tech Zone court in Chengdu is gaining in reputation.

There are relatively few criminal prosecutions for IP infringement and they usually follow a raid or seizure by Customs.

The administrative route is the most popular and is generally effective in clear-cut infringement cases. There have been recent moves to improve enforcement standards including a co-operation agreement between the nine provinces and regions of

the Pan-Pearl River Delta.

At major trade fairs local administrative bodies cooperate to provide a rapid enforcement service at the fair itself. This may be of limited use in practice since it only covers the site of the fair and not the places where infringing product is being manufactured, distributed or sold. It may be more worthwhile to use the fair as an opportunity to obtain evidence for use at a later stage.

There is also an established system for recording trademarks and registered copyrights with the General Administration of Customs. Customs then have the power to detain suspected infringing goods at the port.

Details of special procedures available to enforce patents and trademarks at some trade fairs can be found in the IPR SME Helpdesk publication "IP Strategy for European SMEs at Trade Fairs in China" and of how to use customs procedures in "Guide to Using Customs to Protect Your IPR in China".

Example

Company A knows that its main risk in setting up manufacturing operations in China is that its products will be copied and put on the market in the EU. As it does not wish to sell in Asia, it concentrates its enforcement efforts on customs enforcement in China and the EU and on civil proceedings for infringement in relation to any imported goods found in the EU. It



also runs a low-cost cease and desist programme in China.

c. Management of relationships and behaviour

Chinese law recognises confidential business information as protectable. While there are some statutory implied rights that arise in relation to employees and business partners, it is not a good idea to rely on them.

All employment contracts should contain express confidentiality clauses and provide for the ownership of IP developed by the employee.

Similar provisions should be in all contracts with business partners including manufacturers and agents, whether private or state. It is particularly important to make sure that ownership of any tooling, machinery or equipment that embodies IP remains with the business and that the partner is prohibited from copying it or using it for any purpose other than that authorised by the business.

A non-disclosure agreement should always be entered into before any confidential information is provided to another person. The key to enforcing these is that the confidential information is properly identified in the document.

Where information is confidential, it should be treated carefully and marked 'CONFIDENTIAL'. It should be kept in a secure place where only those who need to see it and have signed an appropriate confidentiality undertaking can have access to it. Employees and others who see it should be told at the outset that it is confidential and then reminded regularly.

Example

Company A knows that its technology is vulnerable because its earlier patents do not cover China. Only its older radios and one component of the more recent models use those patents. It decides to licence

a Chinese partner to distribute all but its newest model in China. It then sets up a joint manufacturing operation with its Chinese partner for the older sets and the single component. It sets up an entirely separate manufacturing operation in another province for the more recent sets but still manufactures one key component that cannot be reverse-engineered in Europe for assembly at the second Chinese factory.

Checklist of Practical Steps/Considerations

- 1) What is the overall business strategy?
- 2) Which IP assets are essential to driving the business forward?
- 3) Are the key assets protected by registration?
- 4) Should the R&D function be in China or in Europe?
- 5) Can manufacturing/processing operations be structured so that no Chinese partner has access to all IP necessary to replicate your business?
- 6) If some IP cannot be protected in China, is it worth getting practical support for its protection by licensing a Chinese business to use that part?
- 7) Are the IP assets owned by one company in the group and licensed to the others?
- 8) Is the ownership structure of the IP appropriate for any planned use as security for raising finance?
- 9) Have the tax risks been assessed and the optimum structure for the business strategy put in place?

The China IPR SME Helpdesk provides free, confidential, business-focused advice relating to China IPR to European Small and Medium Enterprises (SMEs).

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Training: The Helpdesk arranges training on China IPR protection and enforcement across Europe and China, tailored to the needs of SMEs.

Materials: Helpdesk business-focused guides and training materials on China IPR issues are all downloadable from the online portal.

Online Services: Our multi-lingual online portal (www.china-iprhelpdesk.eu) provides easy access to Helpdesk guides, case studies, E-learning modules, event information and webinars.

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