

The state of IP valuation in China

Although the number of entities offering IP valuation services in China is on the rise, quality is patchy. For companies – domestic and foreign – that need to ascertain IP values for deal making, litigation or anything else, this poses serious challenges

By **Bill Elkington**

I have mentioned in previous articles in *IAM* that my company, Rockwell Collins, is going through a change in the way we manage intellectual property – from how we do IP transactions to how we think about IP value to how we manage our IP-based products, such as software and software-enabled subscription services. However, these changes are minuscule compared to the changes in thinking, law and financial practice that are taking place in China.

Among the significant areas of change in China is its approach to IP valuation and its use of IP valuation in the formation and sustainment of corporate entities, in the regulation of corporate entities to ensure competitiveness and in the apportionment of damages in cases of infringement and misuse or misappropriation.

One of my first encounters with IP valuation in China was an engagement that my company had with a large, US-based multinational accounting firm there. The head of its IP valuation practice in the country had participated on the body that had been setting the standards for how IP valuation would be done in the formation of joint ventures between Chinese and western companies.

I remember our first and only in-person meeting well. In fact, it was unforgettable.

The notable individual informed me that his firm would not, under any circumstances, endorse an IP valuation that was based on the cost method. He was not interested in sorting out the facts driving the joint venture transaction that we were working on. He was not interested in examining the context, the interests of the players, their relative market power. He was interested in discussing only one thing – the income method.

I find that the income method can be very useful and appropriate when one or more parties is contributing intellectual property to a joint venture, but the parties to the venture must – at a minimum – see the formation of such a corporate entity principally as a useful way to make money, rather than as the only way to satisfy a government requirement. In other words, for the income method to be applicable, both parties must come into partnership freely. In this particular case, my company and its Chinese counterpart were exploring the formation of a joint venture in order to meet a government requirement.

Thankfully, I subsequently found an excellent Chinese firm – not a big multinational accounting firm – that specialised in IP valuation. Together, after carefully examining the facts and the context of the transaction, we concluded that in the particular circumstance that Rockwell Collins was dealing with, given all of the relevant facts driving the transaction, the cost method was the most reasonable and defensible choice.

After speaking with a number of colleagues who have developed joint ventures in China and who have been licensing intellectual property into China for many years, I learned that there has recently been a general movement among Chinese asset evaluation firms towards the use of the income method and away from

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the cost and market methods when they do IP valuation. The explanation that I was given was that this was the method that the big multinational accounting firms preferred. It was considered the more educated and sophisticated way to go.

I don't know whether this explanation is generally correct or not, but as I asked my friends their thoughts on the matter, it occurred to me that there may be others who have the same concerns. There may be others who are doing business in China who want to understand better what is happening with IP valuation, how people think about it and how it may be changing.

In an attempt to research this question further, I have assembled a group of remarkable and articulate economists, IP valuation experts and attorneys – both inside and outside of China – to answer my questions. All are actively engaged in doing, researching, litigating or teaching IP valuation in China, or in providing advice to firms concerned with IP value in China. They can therefore be relied upon to give us current information on what is happening in this dynamic field.

Just to be clear, when I and my panellists in this article refer to 'intellectual property,' we mean intellectual property in its broadest sense: anything that is protected or protectable under IP law. We emphatically include proprietary information and know-how or trade secrets in this.

And when we refer to 'China,' we are referring to the People's Republic of China.

What I and they have to say are our own personal views and do not necessarily reflect the views of our employers or our employers' customers or clients.

Our panel is as follows: Paul Jones, an IP attorney based in Toronto, with a substantial Chinese practice; Fei Deng, a partner with Edgeworth Economics; Guo Feng, a senior partner with the law offices of JingWei in Beijing; Ji Yicheng, a professor at the College of Economics in Xiamen University; and Liu Wutang, the general manager of Liancheng Assets Appraisal Company Ltd and the general manager of Lianchengchuangxin Innovation Intellectual Property Agency Co Ltd.

What is your role in IP valuation in China? What has your experience been? Where on the spectrum of possible IP valuation activities do you operate?

Paul Jones (PJ): In my practice, IP valuation is relevant primarily when planning litigation to enforce IP rights (or the liability from infringement), or when

advising on negotiations for a licence agreement. For litigation, we need to know not only what the intellectual property might be worth, but also the specific types of evidence that we will need to prove the value. As in other civil law systems, there is no discovery in China, in contrast to Canada and the United States. There is not even documentary discovery, in contrast to England. And evidence is not introduced through oral testimony; rather, it is introduced through the submission of documents – preferably documents that have been verified by a third party, such as a notary. Similarly, in estimating IP value (licence negotiations notwithstanding), it is better to focus on things that can be easily measured and proved. There are also IP valuations that are necessary for the formation of joint ventures, but I don't see much of that. Firstly, joint ventures are less popular these days, as they represent an older, more regulated way of doing business. So I discourage clients from using them unless a joint venture is required to operate in a restricted industry or unless the nature of the business venture demands a joint venture, such as when the investment needed is high and the risk needs to be shared. Secondly, joint venture formation needs a lot of negotiation with the local authorities; so I ask the local Chinese firm to deal with these issues.

Fei Deng (FD): As an economist, I assist clients in evaluating IP assets in both non-litigation settings – such as licensing, M&A and the formation of joint ventures – and litigation settings, such as quantifying economic damages in IP infringement disputes. I am also an expert in the economics of antitrust, where IP valuation can be important as well. One area, for example, is in the antitrust review of mergers, where the parties' IP portfolios are evaluated to assess whether their combined portfolios would give them too much market power in the relevant technology market. Another area is in the analysis of claims of IP misuse, such as tying and exclusive grant-backs. I practise in both China and the United States.

Guo Feng (GF): I am a senior partner with the law office of JingWei in Beijing, where I have been engaged in IP legal protection and asset feasibility assessments for many years. I am also an invited expert of the IP Assets Valuation Promotion Project of China's State IP Office (SIPO). I have participated in the revision of laws and regulations concerning intellectual property in China, and I have developed and promoted the IP Mortgage Financing Project

Participants

The participants answering Bill Elkington's questions in this roundtable are:

- Paul Jones, an IP attorney based in Toronto, although over 60% of his law practice is related to China and most of his clients are from outside Canada.
- Fei Deng, a partner with Edgeworth Economics. She is an economic expert practising in both the United States and China, providing consulting advice and expert analysis for clients encountering antitrust and IP issues in either jurisdiction.
- Guo Feng, a senior partner with the law offices of JingWei in Beijing, who has been engaged in IP legal protection and asset feasibility assessments for many years.
- Ji Yicheng, a professor at the College of Economics in Xiamen University and a part-time professor and doctoral supervisor at the Intellectual Property Research Institute of Xiamen University, where he guides doctoral and postgraduate students majoring in IP management.
- Liu Wutang, the general manager of Liancheng Assets Appraisal Company Ltd and the general manager of Lianchengchuangxin Innovation Intellectual Property Agency Co Ltd.



Paul Jones, Toronto-based IP attorney
 “IP valuation plays a critical role in the formation of joint ventures where one of the parties contributes intellectual property to the joint venture as its capital contribution”

in China since 2003, working closely with China IP valuation institutions and banks.

Ji Yicheng (JY): I am a professor in the College of Economics at Xiamen University, and I am also a part-time professor and a doctoral supervisor at the Intellectual Property Research Institute of Xiamen University. I have developed a course for postgraduates called “Study of Intangible Assets Valuation”, as well as a course for doctoral students called “Study of Intellectual Property Valuation”. I have lectured on an array of issues related to IP valuation to groups including the Fujian Intellectual Property Bureau and the China registered asset valuers. In addition to publishing my own research on valuation topics, I have contributed to numerous studies and publications.

Liu Wutang (LW): I am a nationally recognised IP strategy expert and vice director of the Intangible Assets Appraisal Professional Committee of the China Appraisal Society. The China Appraisal Society is the standards-setting body in China for accounting standards and asset appraisal standards, including IP valuation. I am an adjunct professor at the Central Finance University, chief drafter of the Intellectual Property Asset Assessment Criteria, chief drafter for the National Securities and Futures Commission of the Ministry of Finance, and central cultural assets management office chair for the assessment of evaluation experts.

I often give lectures, speeches and seminars at SIPO, the Ministry of Finance, the Ministry of Science and Technology, the China Appraisal Society, the China Entrepreneurs Association, the Hong Kong Productivity Council, the National Accounting Institute, local provincial and municipal IP evaluation offices, national banks and other organisations.

Is IP valuation regulated in some way? Are there standards for assessing IP value? If there are standards, how is their application regulated or governed, if at all?

FD: There are mainly two regulations issued by the government that serve as guidance and provide rules for patent valuation. One is “Asset Valuation Standards for Intangible Assets”. The other is “Guidelines on Patent Asset Valuation”. Both of these regulations became effective 1st July 2009. There is a similar set of regulations for valuation of other IP assets.

GF: China has successively issued IP valuation guidance documents, including

the following: “Notice of Several Problems Concerning the Ministry of Finance”; “SIPO Strengthening IP Asset Valuation Management”; “Asset Valuation Criteria”; “Asset Valuation Criteria – Intangible Assets”; “Guidance Suggestions on Patent Asset Valuation”; “Guidance Suggestions on Copyright Asset Valuation”; and “Guidance Suggestions on Trademark Right Asset Valuation”. Such regulatory documents have been developed in order to establish management criteria for IP valuation, as well as to provide systematic approaches to IP valuation.

Generally speaking, valuation of intellectual property continues to be done using the same valuation methods employed for tangible assets (ie, cost method, income method and market method). This is because unique and recognised theories and methods suitable for IP valuation have not been completely determined. Use of the cost method entails estimating the historical cost or the projected future cost of developing the intellectual property. Using the income method entails estimating the profit that can be created by an enterprise using the intellectual property in the future. Using the market method entails finding comparable IP transactions involving comparable IP assets of comparable value to assess what the market has already judged similar intellectual property to be worth.

To support their IP-based corporate financing business, banks ask asset valuation companies to comprehensively consider the marketable value of the intellectual property, the degree that the IP asset can contribute to the company’s operating income and the potential liquidation value of the intellectual property should the enterprise fail. Therefore, the IP value that banks ordinarily ask valuation institutions to provide is a risk-adjusted value – the value of the intellectual property should its owning enterprise go into financial distress. This value is, of course, less than the marketable value of IP in a non-distress situation. And at the same time, banks expect asset valuation companies to provide a calculation of the intellectual property’s reasonable value to the lending institution, assuming the successful use of the intellectual property by the owning company. This value is regarded as the reference value and is the primary basis for banks making credit extension decisions.

Furthermore, considering that an IP right is, ultimately, a kind of legal right, when banks refer to valuation results and accept

How important today is IP valuation in China? What is its role? Is it critical or tangential with regard to the orderly and predictable management of intellectual property in the Chinese economy?

Paul Jones: In contrast to what people outside China might perceive, the Chinese government actually places great importance on the development of indigenous innovation and intellectual property. It takes a long-term view and hopes that one day China will be an innovative society that produces a lot of the world's intellectual property. I realise that this is a different sense of the word 'valuation' from the meaning used here, but it is where the discussion of the role needs to start. One of the problems with IP enforcement in China is proving direct damages. There may be a role to play in the future for IP valuers as expert witnesses in the courts, to prove damages.

Fei Deng: Accurately valuing IP assets is very important to a firm's business operations anywhere in the world, including in China. However, it is my observation that IP valuation in China is still in its infancy. There is a huge variation in terms of the quality of analyses performed. Some are as sophisticated and scientific as those you see in the United States; some are less so. Some companies place substantial weight on IP valuations; others do not.

Guo Feng: According to China's related laws and regulations, IP valuation is necessary when one of the following situations happens:

- One or more entities or individuals establishes a company or a limited liability company and IP assets are used as contributed capital.
- An entity or individual attempts to obtain financing by pledging intellectual property.
- An administrative unit conducts an IP auction, transfers intellectual property from one entity to another or substitutes intellectual property for another asset;
- A state-owned public institution or a state-owned enterprise restructures, merges, divides, invests, transfers, substitutes or conducts an auction involving intellectual property.

Therefore, IP valuation plays an important role in guaranteeing that economic activities can operate normally. Obtaining financing is especially difficult for small and medium-sized enterprises (SMEs). IP valuation can therefore be a key factor in providing financing for SMEs.

It is difficult for SMEs to obtain financing when they are at the beginning of a new venture or when they themselves are just starting up, due to a lack of valuable tangible assets, poor ability to mitigate risks, poor resilience to fluctuations in the surrounding economy and the unavailability of mortgages or other loan structures. But many SMEs own a rich treasury of independent innovations; in other words, intellectual property is the core of their core value and at the heart of their competitiveness. Intellectual property therefore becomes the only kind of asset on which to base an

application for bank financing.

The IP pledge or mortgage loan has become an important way to solve the financing problem of SMEs in China. When a bank accepts an IP pledge loan application, it first asks its preferred asset valuation institution to value the pledged intellectual property. The bank then asks examiners to approve the valuation result and to verify the credit line, interest rate, credit extension limit and other credit conditions for clients, by comprehensively considering the valuation result, the company's operating and competitive situation and other factors.

We can see that IP valuation plays an important role in bank credit extension to SMEs, and the valuation result is therefore regarded as an important basis for credit extension access. At the same time, IP asset quality is also closely related to the amount of valuation accorded to the IP asset. If the value is not fair (eg, if it is too high), the bank might be unable to be made whole in the event that the borrowing enterprise fails and ownership of the IP asset must be transferred from the failed enterprise to the bank and from the bank to another enterprise.

Ji Yicheng: It is extremely important to value intellectual property in China. IP value is related to the whole process of IP creation, protection, management and use, and the implementation of national IP strategies. It also provides the basis for essential economic communication with other countries, and can be the basis for

intellectual property as a loan guaranty, they will want to confirm that the subject intellectual property is suitable to the intended purpose, legal ownership is clear and the purported legal right is in fact enforceable. In other words, the legal standing and defensibility of the intellectual property determines the value of intellectual property, and it also bears upon the credibility and reasonability of valuation results.

JY: In China, there are rules and regulations governing the techniques, processes and methods used in the valuation of IP. For example, the China Appraisal Society formulated and issued the following guideline documents: "Asset Valuation Standards-Intangible Assets" in 2001 and 2008; "Guidance Suggestions on Patent Asset Valuation" in 2008; "Guidance Suggestions on Copyright Asset Valuation" in 2010; and "Guidance Suggestions on Trademark Right Asset Valuation" in 2011. The China Appraisal Society also published

explanations of "Assets Valuation Standards-Intangible Asset" and "Guidance Suggestions on Patent Asset Valuation". The China Appraisal Society also translated and published "IVS2007" and "IVS2011".

These standards, rules and regulations provide extensive practice requirements for those doing IP valuations.

IW: IP valuation in China is regulated and guided by SIPO and the China Appraisal Society. These institutions have built an excellent framework for IP valuation through the development of key regulatory documents such as the following: "Asset Valuation Standards for Intangible Assets"; "Guidance for Patent Asset Valuation"; "Guidance for Trademark Asset Valuation"; and "Guidance for Copyright Asset Valuation". These standards documents were written and edited by experienced practising IP valuation professionals, based on their own rich assessment practice. These standards are scientific and instructive, and



Fei Deng, partner, Edgeworth Economics
"IP transactions and protection of intellectual property will increase, as will the demand for IP valuation"

economic cooperation with other countries. Valuation of intellectual property is a scientific and reasonable way to promote the practical use of intellectual property, to provide a motive for strengthening IP protections, to arouse enthusiasm for innovation and to promote transnational economic and financial communication that will push enterprises at home and abroad to successfully implement new enterprises, new ventures and new corporate structures.

Since the country has entered the knowledge economy era, intellectual property and IP valuation are playing more important roles than ever before. Valuation of intangible assets answers numerous financial measurement and accounting problems, so demand for such services will only increase. The role of IP valuation in the economy will therefore, at some point, surpass the role of tangible asset valuation. Theoretically speaking, IP valuation in the Chinese economy plays an important role in managing intellectual property in a normative and ordered way. Intangible asset valuation is commonly considered to be a difficult task around the world. So far, IP valuation in most countries is in a preliminary phase. Some countries and institutions do not pay enough attention to it. Therefore, in general, IP valuation plays a secondary role in practice. With the implementation of a national IP strategy for mainland China, IP valuation is therefore playing an extremely important role.

Liu Wutang: Today in China, IP valuation is playing an important role in

economic activity. Since the reform and liberalisation policy, the central government has encouraged a great deal of foreign capital to come into the country to establish Sino-foreign joint ventures and Sino-foreign cooperation companies. Under the usual model of these Sino-foreign entities, the Chinese side provides low-cost land resources, human resources and preferential tax policy, and the foreign side provides advanced technology and intellectual property. The foundation for the successful establishment of these entities is to value the advanced technology and intellectual property accurately, and then to allocate the equity ownership and profit reasonably.

Thus, effective IP valuation is vital for successful establishment of these undertakings. And, in fact, reasonable IP valuation has helped to establish many Sino-foreign joint ventures and Sino-foreign cooperation companies. For example, Asphaltgesellschaft Richard Felsing International GmbH provided its patented invention (US Patent 5,137,946: "Process for Preparing a Bituminous Binder Modified with Plastic for Building Materials") as an asset contribution to establish a Sino-foreign joint venture: Shenzhen Novophalt Asphalt High Technology Company Ltd. Liancheng, which is a professional IP valuation institute established by the Patent Office, evaluated the economic value of this patent. The valuation report became a fundamental basis for the financial investment of the Chinese client. Finally, Liancheng's professional valuation of this IP asset made the development of this Sino-

foreign joint venture successful. It is not unique. With the help of Liancheng's professional evaluation reports, Fuzhou MaiGeNaiTaiKe Company, Sunrise Capital Partners International Co Ltd and Emerson Electric Corporation have successfully established joint ventures in China with their technology as a significant asset investment.

In financing activities in China, IP valuation is also very important. There are three types of risk created by IP mortgages (bank loans provided to SMEs on the basis of IP value): valuation risk, legal risk and liquidation risk. Together, these risks are an impediment to the development of IP mortgages. However, as IP valuation improves, more and more professional IP valuation institutes, such as Liancheng, are appearing, which solves the problem of valuation risk – the major risk involved with issuing IP mortgages.

As IP law and contract law and their enforcement improve, and as IP exchanges appear in China, conditions for vigorously promoting IP mortgages are likewise improving. In 2006 a methodology for creating IP mortgages named "Bank + IP Valuation" was introduced by the Beijing Intellectual Property Office, along with agencies such as Liancheng. Since this methodology was popularised in Beijing, it has been taken up and used in other significant cities in China, such as Guangzhou and Wenzhou. So far, using this methodology, Chinese banks have made accumulated loans of more than Rmb6 billion (around US\$1 billion).

they effectively standardise IP valuation work across all appraisal companies. Moreover, the China Appraisal Society checks up on the valuation reports of asset valuation institutions to ensure conformance with these published standards.

In the formation of cooperative contracts, such as joint ventures and joint development agreements, how important is IP valuation in China?

PJ: IP valuation plays a critical role in the formation of joint ventures where one of the parties contributes intellectual property to the joint venture as its capital contribution. The voting rights in an equity joint venture are based on the capital contributions; so in the event of a future dispute, it is important that the IP valuation be accurate. The joint venture also needs to be approved by the relevant government agency.

FD: Only by evaluating its IP assets

properly can a firm establish the proper value of its contribution to the joint venture or the joint development. In addition, the valuation performed when the written contract is developed and negotiated can be used as critical evidence if a dispute arises in the future. If that is not done right at the contract development stage, it is likely that it will create problems down the line. However, as mentioned above, the weight that Chinese companies place on IP valuations and the quality of IP valuations that are performed in China vary substantially at this point in time.

GF: Corporate law governing equity joint ventures stipulates that when establishing companies, shareholders can value intellectual property as capital. Intellectual property, when employed as a non-currency financial contribution, should be evaluated and a set price should be established that is not over or underestimated. The IP value cannot surpass 70% of the company's

registered capital, when such intellectual property is contributed in exchange for shares in the company.

JY: In China, the valuation of intellectual property is important to the signing of cooperative contracts, because in cooperative developments between two or more companies, intelligence accompanied with capital is also brought into mainland China, which presents issues of IP valuation. Today, foreign corporations often will not choose to develop a Sino-foreign joint venture, because by law, any intellectual property modified by the joint venture becomes owned by the joint venture – even when the modification to the intellectual property contributed by the foreign partner is minor. Instead, foreign corporations will choose to establish a wholly owned subsidiary or to buy an existing company in China. So valuation of foreign intellectual property contributed to joint ventures is becoming less frequent.

LW: IP valuation plays an important role in Sino-foreign joint ventures. When intellectual property is treated as a financial contribution of a foreign company, and when Chinese state-owned assets are contributed, for example, valuation will be critical. IP valuation is important both in the formation stage of joint ventures and in the dissolution or termination stage, since IP valuation at the beginning will be the basis of the IP valuation at termination.

In cases of IP infringement, IP misappropriation, IP misuse and antitrust and anti-competitive behaviour, how important is IP valuation in China?

PJ: For IP infringement and misappropriation, enforcement in the courts requires some proof of direct damages to claim compensation. As Article 65 of the patent law puts it: “The measure of damages for infringement of a patent shall be based on the actual losses incurred by the right holder as a result of the infringement. If the actual losses are difficult to determine, the measure of damages may be determined based on the benefits derived by the infringer.” This article also provides for damages to be determined by multiples of reasonable royalties. So there is considerable room for expert testimony from an IP valuator. However, these amounts will all be based on Chinese transactions

As the current value of the renminbi is still quite low in relation to the US dollar, usually the amount of damages that are

likely to be proved and awarded is quite low, and as a practical matter, it is more important to obtain an injunctive order. So I have actually, with the agreement of my client, written down the amount of the damages in litigation because we wanted the judges to focus on the infringement issues and the prohibition order. In the future, as the value of the renminbi relative to the US dollar rises, this is likely to change.

In China, IP misuse arises under Article 55 of the Anti-monopoly Law, and to date there have been no cases in which valuation evidence was relevant. The State Administration for Industry and Commerce (SAIC) is working on guidelines for determining IP abuse, but they have not yet been officially released for consultation and there is significant internal disagreement on their content. There are also provisions for the invalidation of technology contracts on anti-monopoly grounds; but again, at present, the cases are limited.

FD: In terms of IP infringement, while there have been a few cases with significant damages awards, most damages awards have been quite small, suggesting that damages awarded in court proceedings so far might not fully compensate for infringement. One reason for this is that the legal structure in China has not been conducive to IP owners proving grounds for damages claims. For example, there is no formal discovery process, so it is difficult to obtain reliable data on the infringer’s sales – let alone the other information that would be necessary to calculate a reliable estimate of damages. However, it appears that this situation may change when the revised patent law takes effect, since Article 61 of the revised patent law includes a specific provision on discovery.

As for IP misuse in the antitrust setting, because the Anti-monopoly Law has been in effect for only four years and some of the important government guidelines – including those on intellectual property and antitrust – are still in the drafting stage, there have been no investigations by the antitrust agencies or private legal actions that have addressed anti-competitive conduct with respect to intellectual property or other forms of IP misuse. However, this is an area of great concern to multinational corporations, which fear that they may be at risk of being found to have ‘misused’ their intellectual property in pursuing conduct that is lawful in the United States and Europe (eg, a unilateral refusal to license).

GF: IP valuation is an important basis for verifying the compensation amount for damages when one of the following behaviours happens: IP infringement, IP



Guo Feng, senior partner with law firm JingWei, Beijing
 “IP valuation plays an important role in bank credit extension to SMEs”

misappropriation or IP misuse. Therefore, IP valuation exerts an important impact on protecting intellectual property and maintaining the lawful rights and interests of the licensee.

JY: I agree: in China, valuation plays an extremely important role in IP protection against infringement, misappropriation, misuse, antitrust and anti-competitive behaviour. Protecting IP requires not only that cautionary measures be taken in advance, but also that there be adequate legal, administrative and economic means to restrain and punish infractions. In cases where criminal behaviour exists and where criminal legal responsibility can be assigned, I believe that we should use economic means to dispose of most cases. In other words, I think that we should use IP-value-based punishments, valuing each specific infraction in accordance with the IP valuation. Those that shall stress the importance of IP valuation should be the judge, administrative officers and officers of the Economy Management Department.

IW: IP valuation plays an important role in quantifying damages in IP infringement. As IP valuation in China improves, more and more cases need a third party to evaluate the intellectual property. In recent years, Liancheng has generated dozens of asset valuation reports for famous Chinese companies, such as Lenovo and Haier. IP valuation plays an important role in such cases, in which damages need to be assessed.

My understanding is that for some purposes in China, IP valuation must be done by central-government-licensed IP valuation companies only. How does a company get licensed to do IP valuation? What must it do to obtain and maintain such a licence? And what kinds of situations require an IP valuation from a central-government-licensed IP valuation company?

FG: That is a misunderstanding. In China, all companies should set up and handle registration formalities according to legal conditions and procedures, and only then have they established legal standing. The legal requirements for establishing this status vary from company to company. For example, the requirements for establishing pharmacological development and manufacturing companies and retail companies are different. Furthermore, government laws and policies regulate the routine business activities of companies which are legally established. Considering the speciality and importance of IP

valuation, the law requires IP valuation companies to be managed in unique ways. As long as companies are meeting these conditions and requirements, they can legally establish themselves and operate without obtaining the permission of the central government.

JY: I agree. There is a misinterpretation here. In China, IP valuation can be performed only by central-government-licensed IP valuation companies.

Again, IP valuation is considered to be a difficult task around the world. Generally, large-scale companies or IP valuation service professional institutions, such as Liancheng Assets Appraisal Company Ltd, are more capable and better equipped to engage in IP valuation than are small valuation institutions.

On the other hand, many state-owned enterprises in China are divided according to investment level into central state-owned enterprises, provincial state-owned enterprises, county state-owned enterprises, city state-owned enterprises and county state-owned enterprises. The central and local state-owned assets supervision and administration commissions (SASACs) of the State Council manage the state-owned assets at governmental level. Their management functions include asset valuation and management of state-owned assets. They generally screen valuation institutions that have corresponding asset valuation qualifications, and assess the competence of asset valuations performed by such enterprises. Also, they determine which valuation institutions are qualified to do each kind of valuation work at each governmental level.

As far as I know, there are no valuation institutions that specialise exclusively in IP valuation. The regulation, administration and licensing of asset valuation institutions (including tangible assets and intangible assets) are performed by the Ministry of Finance and the China Securities Regulatory Commission (CSRC). The departments of finance at the provincial and municipal level also have authority over asset valuation work that relates to corporate activity at their level and in their areas of responsibility.

If a company wishes to engage in asset valuation (including tangible and intangible asset valuation), it must have asset valuation competence. It can apply for a licence in asset valuation for securities purposes from the Department of Finance and the CSRC, or for a general asset valuation licence (this qualification can also enable the company in question to value intangible assets, including IP value) to the

provincial Department of Finance or to independent-plan municipal governments. Such enterprises can obtain such a licence after being approved.

After practising by obtaining central or local administrative licence qualification, the asset valuation institutions must be supervised and managed by the China Appraisal Society and its local representatives. There is an annual inspection requirement, as well as a continuing education expectation of 40 hours of accredited instruction per person. Asset valuation companies can maintain their licence as long as they maintain their professional competency, operate legally, pay taxes according to the laws, practise asset valuation in good faith and do not seriously violate their professional code of ethics. Any asset valuation company with a central government licence (which means that it is licensed to value assets in a regulated securities context) can be entrusted to value intellectual property.

LW: IP valuation can be done by central-government-licensed IP valuation companies. If the number of certified public valuers (CPVs) and the registered capital of a company meet the required standards, the company can obtain a licence. Passing an annual inspection is the only way to maintain the valuation licence. If IP valuation is needed, a client can engage an IP valuation company to undertake this. Liancheng Assets Appraisal Co, Ltd, which was established in 1994 and has operated in the IP valuation space since then, is the most famous appraisal company in the IP valuation field in China.

My understanding is that the treatment of IP value by the courts in China is variable. Is this true? If so, what is being done to reduce this variability?

PJ: A lot of the variability is the result of problems introducing evidence that meets Chinese standards. Remember that there is no discovery in China (or in any other civil law jurisdiction). Each party is responsible for collecting its own evidence. This process usually presents very serious problems for patents and trade secrets. One of the first questions that I usually ask a client proposing a transaction in China involving a process patent or a trade secret is how we can collect the evidence to prove infringement. I find that it varies a lot with the specific technology.

The other issue is that evidence is best when it is verified by a third party, especially at the time that the event occurred. So if a

trade secret owner wants to prove that the trade secret was transferred to the infringer several years ago – thereby proving ‘access’, a key requirement – then the best evidence would be records, such as a video of the disclosure made by a notary. But many parties inside and outside of China do not see the value in collecting such evidence in advance of potential disputes.

Recently, SIPO released the fourth set of amendments to the patent law. Most of the changes are intended to improve the ability of patent holders to enforce their rights. If adopted, it will allow greater administrative enforcement, allow the administrative agencies to award damages, improve the ability of the courts to require the defendant to produce specified documents and other evidence, and allow the courts to award triple damages.

FD: It has been difficult for the courts in China to determine IP value. The Patent Law states that damages shall be determined based on, in the following order:

- The actual loss suffered by the patent holder.
- The gains from infringement.
- A reasonable amount based on royalties from other agreements concerning the patent in question.
- The judge’s discretion.

The best chance for the patent holder in calculating damages is when the infringer’s products compete directly with its own. In this kind of situation, the patent holder can provide evidence of actual loss from its own financial record and projections.

However, in many cases the infringer’s products do not compete directly with the patent holder’s, which means that the damages cannot be calculated by the first method. In order to apply the second method, one must obtain sales data, financial records and other information from the infringer. Unfortunately, as there is no formal discovery process, it is difficult to establish even some of the most basic facts, such as the infringer’s profits. Thus, one is left either with the third method, which opens up the question of what is ‘reasonable’; or the fourth method, which leaves it up to the judge to decide an amount that ranges from Rmb10,000 to Rmb1 million and may have little to do with the actual damages. Another difficulty in Chinese patent litigation is that the use of damages expert testimony has not been established, which further reduces the amount of information available to the courts to assess damages.

On the bright side, it is expected that



Ji Yicheng, professor at the College of Economics in Xiamen University

“In the past, IP valuation did not attract much attention, but now the situation is different and it attracts extraordinary attention from students”

changes will occur soon. The Patent Law is under revision right now, and Article 61 in the revised draft includes a specific provision on discovery. With the ability to take discovery, there will be more financial information from the infringer provided to the patent holder and more room for the role of a damages expert. All of this makes it possible for better determination of IP value by the Chinese courts.

In addition, the Supreme People's Court of China has been trying to provide more guidance to parties in refining the analyses performed in damage calculations. The Supreme People's Court issued "The Interpretations on Several Issues Concerning Application of Law in Hearing Patent Infringement Cases" – more commonly referred to as "the Interpretations" – at the end of 2009. This document aims to provide the parties with more guidance on various aspects of patent infringement disputes, including patent valuation (ie, quantification of damages). Article 16 of the Interpretations is dedicated to the question of how to calculate the gains

from infringement. It states clearly that the "gains from infringement should be limited solely to those originated from the infringed patent", and that "gains originated from other rights should be reasonably deducted".

A direct interpretation of this provision is that the damages should not be based on profits generated by the non-infringing components of the infringer's products. An extended and more sophisticated interpretation of this provision is that the profits that could have been earned by applying a non-infringing alternative should also be deducted from the profits actually gained on the infringing product, to reflect the infringer's right in employing other non-infringing technology. Already I have seen parties utilising the first interpretation in actual cases, but not the second one, which is admittedly harder to prove and requires more supporting evidence and better arguments.

GF: Variability in IP value, as determined by the courts, is not only an issue in China. During the lawsuit process, the value judgement and variability of

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treatment of intellectual property are influenced by many factors; the judge's discretion is only one of these. China's Property Law, Guarantee Law and Civil Procedure Law have clear regulations guiding the way that courts treat IP value. Under this premise, the courts treat IP value in a legal way, and the variability of IP value is determined more by market factors.

JY: Again, there is some misinterpretation in this area. Generally, IP value which is not entrusted for professional valuation is decided by a judge according to related laws. In such situations, there is no standard for comparison and so it is not easy to assess whether there is variance. But one thing is for sure: the value of an IP element, such as a patent, differs widely when considered outside of a lawsuit. For example, currently, a patent-infringed party receives no more than a maximum award of Rmb1 million from the court if the actual losses are uncertain. In reality, judges must make rulings based on a variety of factors, given that IP cases can involve civil cases, criminal cases, infringements, asset disposal situations and compensation situations.

In the context of civil cases involving intellectual property, if the objective of the parties is to reconcile with one another, the value of the intellectual property is determined based on the bilateral will of the parties. And if the court values the intellectual property by deciding the value itself based on the testimony of the parties, again there is no variability, since there is only the one result. Only if the IP valuation is not entrusted for professional evaluation and the judge does not have the necessary competence to do so effectively is there a risk of variability; but this situation is not the norm. The best way to minimise this risk is for the court to entrust a CPV with the task of valuing the IP in question before trial.

LW: There are four methods for the court to determine the IP value:

- Loss caused by the IP infringement provided by the plaintiff.
- Illegal profits gained by the defendant

through the infringement.

- The judge's subjective assessment according to his experience.
- An evaluation report provided by a valuation institution, acting as an independent third party.

The best choice is to entrust the IP valuation to an IP valuation company, acting as an independent third party, when there is a lack of data. More and more people are making this choice in China.

My understanding is that there is also quite a bit of variability in the quality of IP valuations performed by central-government-licensed IP valuation companies. If so, what is being done to reduce this variability?

GF: Here, 'central-government-licensed IP valuation companies' should be defined as the IP valuation companies which are established according to China's laws. China successively issued the following policy documents: "Notice of Several Problems about the Ministry of Finance"; "SIPO Strengthens IP Asset Valuation Management"; "Asset Valuation Criteria"; "Asset Valuation Criteria-Intangible Assets"; "Guidance Suggestions on Patent Asset Valuation"; "Methods of Approval and Supervision Management of Asset Valuation Institutions"; "Guidance Suggestions on Copyright Asset Valuation"; and "Guidance Suggestions on Trademark Right Asset Valuation". These documents (and others) establish standards for IP valuation management and establish criteria for IP valuation while gradually working to complete systems related to IP valuation.

JY: I agree. The quality of IP valuation by asset valuation companies that have obtained administrative licensed valuation qualification from the Ministry of Finance and the CSRC varies. Currently, there are over 70 such companies, which have branches (subsidiaries and wholly owned subsidiaries) and head offices that number

“ The best choice is to entrust the IP valuation to an IP valuation company, acting as an independent third party, when there is a lack of data. More and more people are making this choice in China ”



Liu Wutang, general manager of Liancheng Assets Appraisal Company Ltd
 “IP valuation is important both in the formation stage of joint ventures and in the dissolution or termination stage”

over 200. These institutions and the accuracy of their asset valuations vary widely, based on the distribution of their valuation professionals, their practical experience, their business quality supervision, the extent to which they adhere to business standards and the different requirements of their customers. However, compared to the quality of local valuation institutions, which engage in IP valuation without actual ability, the service quality level of the central-government-licensed companies is higher.

LW: In my experience, all the qualified asset appraisal companies can engage in IP valuation. Indeed, there is quite a bit of variability in the quality of IP valuations. A lot of work has been done to reduce this variability. At the management level, IP-specific valuation standards and guidelines have been released that have regulated and normalised the process, and spot checks of appraisal reports are made periodically to find and solve problems. State agencies and relevant managerial departments organise periodic training of appraisers to maintain and improve their ability. Liancheng participates in annual seminars on national appraisal standards. The appraisers in Liancheng take part in training every year. This training and continual research are indispensable parts of our routine work.

I was recently involved in a situation in which a central-government-licensed IP valuation company came up with a rather large negative value (tens of millions of dollars) for the intellectual property that my company (Rockwell Collins) intended to license into a Chinese company. Our intellectual property was to be the basis of the company’s future products. How is this possible, do you think?

PJ: I don’t know.

FD: There are only two ways that I can think of. First, if the intellectual property came with potential liability from a lawsuit or fines from the government that would have to be paid in the future, and this liability exceeded the benefits from the intellectual property, then the Chinese company licensee would take the intellectual property only if it were ‘paid’ (through a negative value) an amount that would cover these future costs. But then why not just use some other intellectual property? Second, if the licensee’s use of the intellectual property would prove the value of the technology and this would then lead to the intellectual property being licensed by many other

licensees in China (which would all pay Rockwell Collins money), it is conceivable that Rockwell Collins would be willing to pay the Chinese company to license and use the technology (ie, to ‘prove the concept’) – thus, a negative valuation. However, neither of these seems very plausible.

GF: Firstly, if by a ‘central-government-licensed IP valuation company’ you mean a valuation company that is established by the central government or has a central government background, such a valuation company does not exist in China, according to Chinese law. Secondly, intellectual property is valued as an asset, and the proper vantage points and methods for its assessment are different from the normal technical appraisal. As was mentioned before, the basis for valuing intellectual property in China continues to be the valuation methods used to value tangible assets – that is, the cost method, the income method and the market method. The valuation companies regard one specific IP element or item as an asset, and it is not strange if the companies make a negative judgement of its value. Furthermore, as a singular asset, the variability of value does not depend on the valuation result. And when companies obtain good profit by using this intellectual property to manufacture products in the future, its valuation value will change.

JY: Well, I have to say sorry, because I can only analyse and judge the event after seeing all of the relevant information and knowing the situation. Otherwise, I cannot make a conclusion or offer helpful suggestions to you.

LW: This case is a serious appraisal accident. In my opinion, the appraisal company may have utilised erroneous ideas and methods. It is impossible to reconstruct how someone came to such an unthinkable conclusion.

What are the scenarios in which most of the IP valuations are being done in China?

PJ: Joint ventures. In sensitive industrial areas, the government restricts foreign participation to joint ventures with Chinese companies.

FD: A lot of IP valuations are done in non-litigation settings such as licensing, M&As and the formation of joint ventures. Some valuations are done in litigation settings, such as quantifying economic damages in IP infringement disputes – although, as I mentioned earlier, the role of economic experts in IP cases is still in the conceptual stage in China. In the antitrust setting, for mergers involving high-tech

companies that trigger antitrust review, evaluating the IP assets of the merging parties has been one of the most important steps of the review. For example, in the Google/Motorola merger, the Chinese antitrust agency was concerned that the ownership of many patents – some of which were essential – would enable the merged party to abuse its market position in smartphone device technology and impose unreasonable conditions against licensees.

As for the determination of IP misuse, the official regulation in this area – the “Guide on anti-Monopoly Law Enforcement in the Field of Intellectual Property Rights” – is still in the stage of final revision. There have been no actual cases yet, but some will likely emerge soon after the official regulation is promulgated.

GF: Intellectual property is a kind of intangible asset, and the basic procedure for asset valuation in China is as follows:

- Make clear to the customer the basic steps to be taken in doing a valuation.
- Sign the engagement letter.
- Compile the valuation plans.
- Investigate the assets.
- Collect the valuation data.
- Develop the valuation estimate.
- Compile and submit the valuation report.
- Place the valuation report and working papers on file.

JY: It is a very professional question. I can put it in a simple way: firstly, the valuation company and the client need to put an agreement in place, and an IP classification (patent, trademark, copyright, commercial secret or a combination of these) needs to be performed. Then an investigation needs to be done to discover whether similar intellectual property already exists; and then a determination needs to be made concerning the specific context of the IP valuation (eg, whether there is a lawsuit). Then a financial forecast needs to be developed, assumptions need to be defined and assessed, the value needs to be calculated and tested, and a preliminary report needs to be issued for review. Finally, after the client (which could be a court) provides feedback on the assumptions and approach, a conclusion is reached and a final version of the report is issued.

Currently, IP valuation companies specifically look to certain guidance documents – “Guidance Suggestions on Patent Asset Valuation”, “Guidance Suggestions on Copyright Asset Valuation” and “Guidance Suggestions on Trademark Asset Valuation” – for basic standards

(basic business principles and basic professional ethics principles), procedural standards (business agreement standards, procedure standards, report standards and working paper standards), and intangible assets valuation standards.

These IP valuation standards and guidance suggestions were initially drafted and issued by bodies in China’s public and private sectors, and so far, no other country has independently issued IP valuation standards and guidance suggestions. Furthermore, IP valuation in China should also comply with related laws and regulations, which mainly include Chinese patent law, trademark law and copyright law, international IP laws and conventions.

IW: Most of the IP valuations being done in China involve four levels or contexts: legal requirement, state-owned asset management, IP valuation in economic activities and judicial decision.

The process of IP valuation generally proceeds in the following way. First, the appraisal company accepts the commission and signs a valuation agreement with the client or customer. Materials for evaluation are handed over to the appraisal company and the two parties engage in a discussion. Next, appraisers draw up a plan for valuation. They analyse, plan and estimate the whole project and present this to the client. After discovering and identifying the appropriate data, and developing and applying the best IP valuation methodology, the appraisers make a summary of that data, the methodology and the valuation results. After examining and verifying the data, the assumptions and the selected method carefully, the appraisal report is written and signed by the CPVs and the legal representative of the appraisal institute. The appraisal company then submits the report to the client. Finally, the appraisal institute checks the quality of the report and keeps the report on file.

To what extent is IP valuation regarded as a respected academic subject in China? Are there university courses on IP valuation? If so, in what sorts of schools or departments does one typically find such courses and the research that would back them up? Are business schools taking this subject up? Or are departments of economics doing research in the area?

FD: To my knowledge, most of the IP-related programmes in China are set up in law schools and focus on the legal aspects of the subject. Very few have IP valuation as a separate course, but rather cover this as one

What do you foresee for the IP valuation specialty area in China? Is demand for IP valuation work growing or shrinking? For those interested in the field, does China offer an interesting and challenging future?

Paul Jones: As the value of the renminbi rises and courts implement the government's desire to improve the enforcement of IP rights, I think that the use of IP valuations in the courts will increase. The existing equity joint venture law is based on concepts of technology transfer that are slowly being replaced as China continues to open up and modernise. Joint ventures involving intellectual property are increasingly being replaced by licensing transactions.

Fei Deng: One major specialty area of IP valuation where I see a huge hole is in the use of damages experts in litigation. Demand is growing as the legal structure matures and companies become more sophisticated. However, economic analysis of IP rights is especially challenging in China because of the lack of both reliable data and an established pool of damages experts in this area.

Guo Feng: Along with the rapid development of the knowledge economy, the proportion of IP value accounting for enterprises' intrinsic value in China will gradually increase. I believe that along with the acceleration of economic globalisation, China will maintain close economic relationships with developed countries and IP transactions and protection of

intellectual property will increase, as will the demand for IP valuation.

Furthermore, China's IP strategic plan describes the importance of "promoting enterprises to be entities which assign and use IP and leading enterprises to realise the marketable value of IP by adopting license, pledge, and assignment and other ways". And the field that is responsible for understanding the marketable value of intellectual property is the IP finance field. It therefore has a special responsibility to integrate the special value attributes of intellectual property with mainstream financial thinking and analysis by using current financial instruments and products. Recently (in the past few years), under the guidance of the relevant government departments, financial institutions and various mid-tier service organisations have made helpful advances and established IP trust accounting, IP securitisation, IP insurance and other innovative financial vehicles for managing IP value. In doing this work, the participants realised that all financial products and vehicles related to intellectual property are based on IP valuation. For this reason, we can expect that IP valuation will attract more attention and make great progress in the coming years.

Ji Yicheng: I have high expectations for the future of China's professional IP valuation field. Since China entered the knowledge economy era, the role and effect of intangible assets – including intellectual property – have become increasingly obvious and account for a larger proportion

of society's assets. The state, private and public enterprises, public institutions and individuals will thus see urgent demand for intangible asset valuation. And for those interested in this industry, China will afford bright prospects, full of challenges and opportunities. Personally, I am willing to engage in and promote opportunities for professionals in this field and to establish close cooperative relationships with them.

The Third Assets Valuation New Development International Forum will possibly be held at Xiamen University next year. By then, we will have arranged an article solicitation and meeting agenda related to IP valuation, and we will welcome IP valuation professionals to join us in this international forum.

Liu Wutang: The need for IP valuation is growing rapidly. The Chinese economy is transforming into a high-technology, new-technology economy, and this in turn is making people pay more attention to intellectual property. Compared to technology-based intellectual property, cultural IP asset valuation is more complex and faces more challenges in the future. At present, the development of China's cultural industry is getting a lot of attention, and cultural IP asset valuation is at the core of the development (and financing) of this industry. Related government departments are organising theoretical research on cultural asset IP valuation; Liancheng has been invited to participate in research being conducted by China Appraisal Society and China Cultural Assets Administration Office.

of the many topics taught in a course. In economics departments, there is usually a course on asset appraisal that might cover IP valuation as a small section.

GF: Content related to IP valuation is generally covered in law school courses and rarely appears as an independent course. University economics departments might have similar courses, but this is not common.

JY: In the past, IP valuation did not attract much attention, but now the situation is different and it attracts extraordinary attention from students. Since 2010, 68 universities and colleges have set up and recruited postgraduate majors in asset valuation, and intangible asset valuation is a compulsory course. Among the nearly 20 undergraduate universities that recruited asset valuation majors, intangible asset valuation is seen as an important course. There are nearly 50 junior colleges with asset-valuation majors, and schools with enough teachers have also

launched intangible asset valuation courses.

There are dozens of research institutions that engage in intangible asset valuation study, and several annual national and international conferences that feature valuation and management of intangible assets. For example, the 10th National Intangible Assets Theory and Practice Seminar took place at Tianjin University of Finance and Economics in October; this event is held biennially. The second Assets Valuation New Development International Forum was held in November; this is an annual event. This year's theme focused on the potential tapping of enterprises' intangible assets. There is also the annual China Valuation Forum, sponsored by the China Appraisal Society, which was held in November at Xiamen and focused on brand value and brand value evaluation.

Currently, I lecture on intangible assets and IP value evaluation to undergraduates, postgraduates and doctors at Xiamen

University. In China, some business colleges also offer a course of study on IP economics, including some study on the space distribution of knowledge resources and on the value measurement of intangible assets, which are all closely related to IP valuation.

LW: I am a visiting professor at Central University of Finance and Economics and Renmin University of China. My personal understanding of the situation is that in China, most schools of finance and economics do not offer IP valuation courses, especially at undergraduate level. IP valuation is taught on intangible asset valuation courses and is also offered on graduate courses. At present, departments of economics do not undertake much research on IP valuation, while departments of finance do more research in the area.

More questions than answers

IP valuation (for both technology assets, cultural assets and other kinds of intangible asset) in China is maturing. How long will it take to see excellence in IP valuation analysis across the broad array of valuation companies in place today? That is anyone's guess.

What about discovery in IP litigation? Is it around the corner? Or will it be many years before discovery is an essential element of IP disputes in China? Will it provide the meaningful financial data that plaintiffs seek? What about the role of the IP valuation expert – the damages expert – in legal disputes? When will a trained cadre of such people be available? When will Chinese courts regularly depend on analysis and testimony from such experts?

When will IP litigation in China yield financially meaningful and commensurate outcomes?

How many years will it take before China is written up regularly in the *Wall Street Journal* and the *Financial Times* and *IAM* as the place for innovation, the place for IP protection, the place for savvy global corporations to locate a substantial percentage of their R&D resources?

It will take a great deal of change to get there. And no small contributor to that change will likely be training on IP valuation analytics in colleges and universities in China and elsewhere. Rigorous training in this area is sorely needed around the globe, in both developed and developing economies.

Perhaps it will require a new set of global accounting standards that recognises the value of intellectual property in global economics and the financial reporting of companies.

Perhaps it will take a change in the mind of the Chinese people about intellectual

property and the importance of IP rights to them.

Is China the only economically advanced nation that is of more than one mind about IP matters?

No. One sees disdain for the value of IP rights in some shocking places these days. One sees it in companies such as Google, when this suits its interests. One hears it in anti-patent-troll rhetoric. In the run-up to the America Invents Act, one heard it from some in high-technology. Of course, it is alive and well in the open source movement.

One sees it in young people in the West, who have no maturity – no understanding of what role innovation could play in wealth creation in their future or in the future of the young people in other nations. Nations such as China.

How should we imagine the future; the future of IP rights and innovation? How should we – the IP high priests from China and the West – help the world to shape its future? Maybe what we do together in China and how we do it will make a difference. **iam**

Bill Elkington is senior director, intellectual property management, Rockwell Collins Inc, and vice-president of membership and member engagement on the LES USA and Canada board of trustees

About the Licensing Executives Society (USA and Canada), Inc

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Action plan

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IP strategists looking to properly value intellectual property in China – whether in the context of joint venture formation, antitrust concerns related to M&A activity or litigation – should carefully consider:

- Selection of firms to provide advice on China IP law and to provide representation in Chinese courts.
- Selection of practitioners to support necessary financial analysis.
- Selection of a firm licensed to do IP valuation in China.

What are the criteria for selection? Certainly, prior experience will figure prominently. Often, it is useful to get in writing a preliminary analysis of the issues to be addressed and recommendations for the key steps that need to be taken. And of course, you will want to know the cost.