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Pamela J. Gordon

Short-Term Profits in Exchange for IP Risk

Electronics manufacturers lured by China should be cautious to preserve IP.

Electronics company executives are pressuring their operations management to move manufacturing and related services to China. Seeking a quick recovery in profits—on the heels of revenue decline that started in 2001—executives saw few alternatives but to reduce costs as quickly as possible by outsourcing manufacturing to China. But considering the weak protections for intellectual property (IP) in China, along with the competitive importance of innovation and brand names in the electronics industry, these quick moves to China might mean short-term boosts for profits at the cost of brand erosion and market share in the future.

Why would so many executives insist on risking valuable patents and copyrights to save—in some cases—a few cents in total cost differential? This question is especially relevant, given that much energy in electronics has been absorbed with staking claims for patents and other IP in the past few decades.

Last quarter, my company engaged economist Clive Jones, manager at Economic Data Resources, to ascertain to what degree IP can be protected when outsourcing manufacturing to China.

“The surge in patenting and IP litigation stemmed from policies implemented in the U.S. in the early 1980s,” said Jones. “The policies, instigated by Intel—among other companies—set up a central appellate court for patent infringement cases, passing the Semiconductor Chip Protection Act (1984). Today, license and royalties for global electronics original equipment manufacturers (OEMs) run perhaps \$40 billion a year.”

The result has been the erection of virtual fortresses of patent protection in U.S. jurisdictions and to a lesser extent in Japan and Europe. Larger OEMs have acquired patent portfolios, and some have followed questionable practices, such as registering blocking or submarine patents that have no immediate direct application.

Jones continued, “Many companies were blindsided in late 2000/2001 when the market plummeted. Companies plunged into outsourcing to China—lured by the appeal of low wage rates.”

The fear of company insolvency led executives to cast their IP to the winds in China, according to Jones. “Few companies are applying for Chinese patents, for example. They do not exercise many of the simplest precautions and quite often decide to make all the chips as well as boards in China, loading all the software there. This is absolutely guaranteed to result in loss of control over IP.”

These companies have a tradeoff. On one hand are immediate profits and boosts to the value of the company stock. On the other side are the costs and threats to the company from future competition from Asian concerns, which you have increased by a virtual IP giveaway.

While no guarantees exist, some companies are implementing traditional legal remedies and a host of new initiatives, such as registering IP in China, guarding against loss of code in programmable logic chips, approving vendor lists, pre-qualifying or screening contract manufacturers, tracking parts and products, and even product redesign.

Chris Broad, marketing manager for North America at SMT Ltd., is a Westerner who has worked in Hong Kong for a decade. He says his company does a good job of IP protection in China.

When asked how to convince international customers to transfer their confidential documents for contract manufacturing in China, Broad said, “Their confidence in us grows by meeting our people, seeing our nondisclosure agreements and knowing that companies including Sony and Emerson send us repeat business.”

Making a full circle from when Intel helped shape U.S. patent policy, Chairman Andy Groves recently gave a presentation that warned that the software and services industry could follow the trend in which the U.S. market share for steel dropped from 50 to 10% and from 90 to 50% for semiconductors. By 2009, the number of software and service employees in India may exceed one million while the number of such U.S. employees declines to one million—half of its 2001 level.

Groves’ advice: “Raise the hurdle for IP litigation; strengthen the patent office.” ■

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