The Promotion of Cross-Border Exchange of Intellectual Assets

between China, Japan and Switzerland

-The Case of Music and Trade Secrets -

FINAL REPORT (Excerpt)

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Introduction

Promotion of cross-border exchange of intellectual assets is a global issue. Its outcome, if realized, would be beneficial to all stakeholders. Various causes, such as legal barriers, cultural or linguistic differences, geographical remoteness, divergent levels of economic or technological development stages, and historical contexts, may cause difficulties and may affect the smooth cross-border exchange of intellectual assets. With respect to legal barriers, they shall not only relate to intellectual property law but also to other legal areas such as civil procedures and private international law. In addition, perceived deficiencies of protection in the country to which intellectual assets shall be transferred (host country) may prevent the exchange of intellectual property assets because entities will generally not be willing to transfer its valuable intellectual property assets to another country without the opportunity to protect and exploit such assets.

This project focuses on the legal barriers, both actual and perceived generally, which are directly or indirectly related to intellectual property law and their implications in view of the economics. Geographical scope of the research is limited to China, Japan, and Switzerland. Switzerland and Japan, which are both developed countries, represent traditional civil law and the latter with significant civil law influence after the World War II. China is becoming a key global player in the market for intellectual assets both as a user or importer of intellectual assets created in other countries and as an exporter of such assets.

In view of the extremely high variety and number of intellectual assets which exist and could thus potentially be analyzed, the project focuses on two types of intellectual assets, i.e. music content and trade secrets. These two types share the common trait of being non-registered intellectual property assets. Copyright can be registered right in some jurisdictions (such as Japan), but its registration is not a condition of protection under an established international norm, starting from the Berne Convention to the recent WIPO Internet treaties, of the non-formality principle. Trade secrets by their nature are protected independently from any registration or recordation requirement. Thus, cross-border exchange of trade secrets or copyright may be more difficult than that of registered intellectual property rights, such as patent and trademark, in the sense that rights owners are not obvious for possible transferees or licensees around the world.

This report, with all five chapters containing contributions written by partners to the project, is followed by an Executive Summary. In each chapter, the partners identify and present their viewpoints on the barriers to the cross-border flow of intellectual assets, focusing on musical content and trade secrets, and mainly between China, Japan and Switzerland. The discovered facts, methodology, and basic concepts and framework, however, can have universal implications that can be applied to other bilateral or multilateral cross-border flows of intellectual property. References to relevant scientific sources (academic articles, regulatory materials and case law) are found in each contribution.

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Executive Summary

July 2008
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The Executive Summary explains the general framework of the research project and its implications both for future scientific research activities and for society as a whole. The author at his own responsibility comments on the validity of viewpoints and perspectives found in contributions or submitted from partners who do not necessarily share a uniform viewpoint on all issues but rather have diversified perceptions and expertise. Thus, readers are encouraged to refer to each chapter for details about each partner's perspectives. Nevertheless, the partners do agree that the legal system relating to the cross-border protection of intellectual property is still immature, and this may block the smooth flow of intellectual assets across borders. However, legal obstacles are not the only elements because, as identified in the course of the research project, non-legal hurdles are also relevant. It is expected that future research will reveal various aspects of these problems and find solutions.

I. The Research Plan

(1) Purposes

The goal of the project is to identify and solve the legal and economic issues which may hinder or obstruct the cross-border exchange of intellectual assets resulting from the applicable regulations in the relevant States. The ultimate goal of the project is encourage cross-border communication and transfer of intellectual *cultural* and *business* assets.

Musical content is probably exchanged with far less economic impact than trade secrets (though the number of exchanged music files is continuously expanding via the Internet). Nevertheless, Professor de Werra points out that "the cross border exchanges of music raises cultural and personal aspects which must be taken into account". Access to creative works is a basic right recognized under the International Covenant on Economic, Social and Cultural Rights. In addition, an effective protection of trade secrets can promote the international transfer of business information and can produce economic growth in developing countries. Thus, the project may contribute to address a broad issue relating to basic rights and development issues.

(2) Organization of the research activities

This proposed project aims to identify interdisciplinary issues between law and economics, which may prevent or hinder the cross-border exchange of intellectual assets between the States. This project was organized as follows.

First, data were gathered based on the following sources. The business contract practices and subject matter of contracts in the music industry was surveyed through written responses to the questionnaire or oral responses to interviews. Some information was provided to the project team directly from individual companies or through the representative business association.

- Written responses to the questionnaires by and interviews with music industry associations and business entities involved or affected by the

cross-border exchange of trade secrets, it being noted that in view of the sensitivity of such data and information, the partners had limited access to or were not allowed to disclose some of data regarding trade secrets. Even in such cases they obtained and used informal information from various sources on these issues.

- Meetings with business associations, international organizations, and law firms as well as educational study meetings.

Second, suggestions submitted by legal and economics experts during a conference in Tokyo and a workshop in Geneva enriched and deepened the analyses on the above findings and analysis. Personal discussions held during the meetings and network obtained through the participants' activities enabled further insights into the issues.

Finally, participating lawyers and economists organized the obtained data into academic analyses. The following chapters are the outcome of their works, analyzing the legal status in the respective legal systems, mainly in China, Japan and Switzerland, of the international contract practices of copyright and of trade secrets and the potential problems which could arise in the context of cross-border exchange of the targeted intellectual assets. Comments of economists provided by UNCTAD are found in report of the Geneva Workshop, and other perspectives of economists, namely Dr. Odaki and those of United Nations Industrial Development Organization (UNIDO), are integrated in this Report.

(3) Novelty of the methodology

The project integrates new elements of the interdisciplinary perspectives. Economists and business experts have essentially focused so far on the patent system and corporate R&D strategy, but have not intensively worked on issues relating to non-registered intellectual property assets such as trade secrets. R&D expenditure has been the measure of the input into innovative activity, and the quantity of patent applications has been the measure of the output level[1]. There are several limitations to such an analysis.

First, innovative outcomes that were not the object of patent applications are ignored. Whereas Western companies tend to opt for trade secrets protection, Japanese companies tend to select the patent application strategy. Therefore, the above empirical analyses underestimate the innovative activities of Western companies. Differences in corporate strategy may prevent comparative empirical analysis of otherwise equal conditions.

Second, the impact of the intellectual property protection level differs between industries. The transfer of technology is relatively easy in the medical and foods industries, whereas it is difficult in the case of the electronics and automobile industries. In addition, cross-licenses are regularly found in most manufacturing industries but are not so common in the pharmaceutical or chemical industries.

Finally, other non-IP factors, such as the competition policy and education level, should not be ignored. Fragmentation analyses for each value-chain and geographical market are also helpful. India in the 1960s failed to create its own technology due to excessive IP protection. Once patentability was narrowed in the chemicals and pharmaceutical industries, technological capacity developed. On the

[1] For example, Lee G. Branstetter, Raymond Fisman and C. Fritz Foley, *Do stronger intellectual property rights increase international technology transfer? Empirical evidence from U.S. firm-level panel data*, Policy Research Working Paper (The World Bank) No. WPS 3305, 2004.

other hand, according to Professor Neil Foster, China failed to import the most advanced technology in the world due to insufficient IP protection. It is difficult to present a comprehensive list of barrier areas, but the research activities of this project and the partners' own research show that the judicial system, import/export control of technology, private international law, taxation, and regulations on corporate structure are all elements which can hinder the cross-border flow of intellectual assets.

II. The Obtained Results and Analyses

Barriers relating, either directly or indirectly, to intellectual property law that hinder the smooth flow of intellectual assets across borders can be classified as follows[2]. The first two types of barriers are applicable to non-traditional intellectual property family of subdivided copyrights and trade secrets.

(i) Existing legal instruments without consensus on the effectiveness
(ii) Issues that require future legal devices that do not exist today
(iii) Unsophisticated business practices for licensing of intellectual property or confidential agreements

Nevertheless, there seems to be no economic analysis focusing on the economic implication of the protection of subdivided copyrights and trade secrets. Numerical or empirical data are scarce for these types of intellectual property goods. This project use, as a substitute, general perspectives obtained from analyzing data surveyed on intellectual property in general, mostly surveyed for patent.

(1) Legal Barriers Relating to Intellectual Property Law

(i) Existing legal instruments without consensus on the effectiveness

- Copyright issues

Protection of musical works is ensured in all the three countries. However, there are still divergences in the effectiveness of protection and in the management of the rights which may affect the cross-border flow of these intellectual assets.

Switzerland and Japan have non-state administered collective societies, Swiss Society for the Rights of Authors of Musical Works (*la Société suisse pour les droits des auteurs d'œuvres musicales*, SUISA) and Japanese Society for Rights of Authors, Composers and Publishers (JASRAC). China also has collective societies: Music Copyright Society of China (MCSC) administers music copyrights and China Audio-Video Collective Administration (CAVCA) does the rights of audio-video works authors. Foreign collective societies are not qualified to file a judicial action in China. Collective societies in China seem to be yet widely recognized even in Chinese urban society[3]. Nevertheless, their social recognition is improving. Ms. He has introduced into the records of this project a consensus in China, thanks to a National Copyright Administration of China (NCAC) official notice, that copyrighted music works can no

[2] Professor de Werra classifies legal barriers to the cross-border exchange of trade secrets into: hurdles resulting from substantive law, regulatory constraints, and private international law.

[3] *China's karaoke bar royalty scheme reaches impasse*, People' s Daily Online, November 29, 2006. Ms. He reports that, in practice, the charging process was hardly taken due to the reluctance of karaoke bar managers to pay royalties.

longer be used in karaoke bars without paying royalties. An enhanced functioning of Chinese societies will offer one solution to the piracy problem in China.

Insufficient protection of copyright in China is commonly perceived in Japan and Switzerland, while Chinese experts assume that China has done significant progress. Chinese experts are prepared to present already enacted laws, regulations, guidelines, judicial cases, as well as number of judicial cases. Ms. He explains the details of development within the Chinese legal system.

Copyright protection issues in China became a politically hot issue, after the United States filed a complaint "China – Measures Affecting the Protection and Enforcement of Intellectual Property Rights" (DS362). The WTO panel was composed in December 2007 based on the United States' request, while China repeatedly requests to withdraw the complaint. Thus, when requesting data from the Chinese Embassy in Tokyo, we were suggested to make all inquiries relating to intellectual property directly to Beijing. The necessity to make the direct contact to the central government or its related academic institution has become apparent in order to understand Chinese perspectives.

Professor de Werra explains the political and legal discussion presently taking place in Europe relating to the on-line distribution of musical works, focusing on hurdles to a multinational licensing scheme between collective societies which shows that limits can potentially justify the local collective management of copyrights in order to preserve cultural diversity and thus may justify to refrain from adopting an excessively liberalized approach to the cross-border management of musical works in the online environment.

As a result of this, even though the protection of musical works is widely harmonized at the substantive level (because of the existence of international instruments) discrepancies still exist in the assessment of the effectiveness of such mechanism.

- Trade secrets issues

Insufficient trade secrets protection in Japan was raised by Switzerland as well as the United States, while this perception was not commonly sustained by Japanese lawyers. Leakage of trade secrets during civil proceedings might be avoided with recently introduced legal protection mechanisms under Japanese law: Protective orders, in-camera proceedings and closed proceedings.

Nevertheless, use of these devices, mostly imported from the United States, is not automatic but rather left to judges' discretion. As Professor Ueno describes, judges seem to be reluctant to authorize closed proceedings, which constitute an exception to the general principle of the publicity of court proceedings. In addition, trade secrets, if put into criminal procedures, will be disclosed due to the Constitutional requirement in Japan. Therefore, the right holder of trade secrets might be in a weak bargaining position vis-à-vis the infringer, fearing that enforcement might result in the forced leakage of trade secrets.

Turning to China, the consensus is that leakage of trade secrets in China is problematic, due to the frequent job mobility of employees. Trade secrets protection under Anti-Unfair Competition Law of China is said to be insufficient due to its strict condition of practical utility for protection as well as scope of the limited scope of rights holder. Nevertheless, Chinese law may be more favorable than Japanese system in terms of trade secrets protection, because judicial process, including even criminal proceedings, may not be disclosed to the public eyes, when so decided. Instead,

protection of trade secrets is generally left to managerial skills that should be handled privately by each corporation. Corporate strategy or managerial administration is the key for the trade secrets protection in China. In addition, Ms. He points out that governmental officials' duty of confidentiality is being questioned by many scholars.

In Switzerland trade secrets are protected during the court proceedings but their protection is still not unlimited in particular in the context of labor disputes for which the legitimate interests of an employee to change job (and thus to potentially continue to use trade secrets in the new professional environment) must be balanced with those of the ex-employer.

- Efficiency of enforcement and of dispute resolution systems

Claims raised by developed countries are not only Chinese laws or regulations, but also actual enforcement system including the judicial system. Particularly, some experts claimed that neutrality and independence of judges were insufficient. Since judges are not tenured, they are obliged to avoid sacrificing local interests. On the other hand, another expert points out that judicial judges are more reliable in China than in other developing countries despite the vulnerability to local interests[4]. It is also pointed out that Japanese companies are less sophisticated in dealing with local situations than European or US companies. A case might support such an observation[5]. In addition, Japanese companies generally have a weaker compliance system than European or US counterparts. In sum, the problem rooted in the judicial system is not clear-cut and more work, based on empirical analysis, needs to be done.

Intellectual Property High Court of Japan was established in 2005, aiming at speedy trial proceedings in intellectual property cases. Average trial period is gradually decreasing, i.e. to 8.5 months in 2006 from 9.8 months in 2005. Nevertheless, the number of settled cases is only approximately one hundred annually. Effectiveness of the judicial process cannot be concluded at this time.

As Professor Yokomizo suggests, alternative dispute resolution (ADR) plays an important role in the resolution of international disputes over musical content and trade secrets, when international jurisdiction and applicable law rules are unpredictable. China, Japan and Switzerland are all party to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention, 1958) so that ADR could be an appropriate dispute resolution system. Because the qualifications required for arbitrators are constantly discussed and scrutinized even in or between developed countries, a comparative analysis of the ADR system focusing on cross-border IP disputes would be meaningful.

(ii) Issues that require future legal devices that do not exist today

Professor Yokomizo points out that clear rules for defining the applicable law under private international law are important, in particular relating to Internet music downloads. Even today, each country has its own conflict-of-laws rules. It can be safely affirmed that private international law issues, i.e. jurisdiction, applicable law, enforcement of foreign judgments, relating to intellectual property are still in an infant

[4] Elliot Papageorgiou's presentation at workshop: *China IP Beyond WTO & TRIPS – Practical Strategies for Effective Enforcement of IP in China* (University of Berne, 28 May 2008).

[5] "A Japanese-owned company in northeast China had its equipment destroyed by order of a local court and was forced to suspend operations after it failed to pay a bribe demanded by a judge […]", *China judge forced Japanese-owned company to close*, Daily Yomiuri Online, 10 April 2008.

stage. The Hague Convention on Choice of Court Agreements (2005) cannot solve all issues resulting from international transactions because of its still limited scope and member countries. In particular, issues relating to trade secrets or contractually subdivided rights were not recognized during the legislative process of the Agreement. It is not self-evident whether the Agreement is applicable to these types of intellectual property.

Even at national level, predictability of legal consequences is far from being achieved. Jurisdiction of, as well as recognition and enforcement of, foreign judgments of trade secrets cases were ultimately decided on a case-by-case basis, rather than predetermined statutory rules, in the above States. The law governing the issue of misappropriation of trade secrets is generally the law of the market where the trade secrets are misappropriated. However, such a market could be found in multiple jurisdictions, particularly in the globalized era. Priority of the two approaches for applicable law of subdivided copyrights, i.e. contract or IP law, has not been determined.

Intellectual property law and private international law are the two main subject matters of this project concerning legal barriers to the cross-border flow of intellectual assets. However, as Professor de Werra points out, regulations relating to corporate structure, and technology import and export controls, are hurdles to the cross-border transfer of trade secrets. Judicial systems were also heavily discussed at the Tokyo Conference. Finally, there may be other types of legal barriers, such as governmental control over foreign direct investment, especially in developing countries, and tax law might also have an indirect negative impact on the cross-border transfers of intellectual assets but on which this project has not focused (but which would clearly deserve further studies and analyses).

(iii) Unsophisticated business practices for licensing of intellectual property or confidential agreements

Three types of legal barriers relating, either directly or indirectly, to intellectual property law that hinder the smooth flow of intellectual assets across borders were recognized.

The first type of barrier is the current legal instrument, for which there is no consensus yet on its protection effectiveness. The issue of insufficient trade secrets protection was raised even between developed countries. The rights holder of trade secrets might be in a weak bargaining position vis-à-vis the infringer, fearing that enforcement might result in the forced leakage of trade secrets. Such a fear discourages the transfer of intellectual assets to that particular jurisdiction.

Removal of the second type of barrier requires future legal devices that have yet to be realized. In particular, private international law issues, i.e. jurisdiction, applicable law, and the enforcement of foreign judgments, relating to intellectual property, are still in the infant stage. Without clear knowledge of what the legal framework is investors will refrain from the transfer of intellectual assets to a foreign country.

The final type of barrier is unsophisticated business practices for the licensing of intellectual property, or confidential agreements. The corporate strategy for securing trade secrets is more immature in companies with faster employee turnover than in those with a tradition of lifetime employment. A survey of the project revealed that effective measures include elaborated confidential agreements against the leakage of trade secrets and compensation payment for the leakage of trade secrets. Contractual Practice shall also include appropriate drafting of contractual provisions regulating the

issue of dispute resolution methods for the purpose of solving potential disputes (be there a choice of court agreement or an arbitration clause).

As Professor Ueno explains, the subdivision of copyright is widely recognized in Japan, where licensing contracts are often concluded orally. It is true that a transfer of subdivided rights is usually executed in writing in the broadcasting industry. Nevertheless, oral contracts are commonly found in most cases. Lack of the writing contract might be interrelated with evidence rule during the judicial process. This practice prevents the cross-border flow of copyright, since ownership of the right under Japanese law may be denied if litigated.

Japanese collective societies handle a statutory subdivided right but not a contractually subdivided right. Japan abandoned the statutory monopoly of JASRAC, which, nevertheless, still maintains a dominant market share. Collective societies in Japan are not so flexible or updated that all business needs are accommodated. On the other hand, according to Ms. He's report, the subdivided rights of music copyright can be trusted to MCSC.

Corporate strategy for securing trade secrets is immature in case of Japanese companies than Swiss or other Western multinational companies. Job transfers are so common that Chinese and European companies normally take effective measures, such as elaborated confidential agreements, against the leakage of trade secrets. Because Japan has the tradition of lifetime employment, even though eroding gradually, the ratio of Japanese companies that have the confidential agreements or any other devices vis-à-vis their employees is much lower than their counterparts. In addition, compensation payment for the secrecy of trade secrets is not normally taken in case of Japanese firms. The amount of this compensation is usually greater than the penalty. If breached, employees are requested to return the compensation to the former or current employer.

(2) Viewpoints from Economists

Protection of intellectual property, with an incentive, aims at encouraging innovative and creative activities. Owners of intellectual assets rely on the protection granted to them in order to recoup the investments made in the creation of these assets. If the protection is held insufficient in a given jurisdiction, owners of such assets will not allow third parties to use such assets in such jurisdiction. Thus, it could be reasonably induced that the level of protection of intellectual assets, as well as the legal infrastructure for the exploitation of such assets in a given country is one of the key determining factors for foreign rights holders to transfer the asset to such country.

A surveyed evidence in China reveals that managers of foreign enterprises are reluctant to locate R&D facilities in China for fear of misappropriation and patent infringement. Nevertheless, strong IPR protection is not always a condition for attracting foreign direct investments (FDI) from overseas. If it were, then countries with high growth rates without strong IP protection tradition, such as China, would not have attracted the large amounts of FDI. In fact, an economist from UNCTAD pointed out the limitation of the incentive mechanism. On the other hand, a UNIDO report, surveying and conducting empirical data, suggested the following model:

(i) Stronger IP protection may produce greater domestic innovation and increased technology diffusion in developing countries with sufficient capacity to innovate

(ii) Stronger IP protection has little impact on innovation and diffusion in those developing countries without such capacity and may merely cause increased costs.

Due to the lack of available data, that there has been no survey that covered trade secrets. Since economists need numerical or empirical data, R&D expenditure has been a measure of the input into innovative activity, and quantity of the patent applications has been a measure of the output level. There are several limitations on such an analysis, as seen in the above paragraph, *Novelty of the methodology*.

Professor de Werra surveyed UNCTAD's reports (2005 and 2008) and emphasizes the necessity for a multidisciplinary approach to identify the measures which can effectively promote the cross-border flow of intellectual assets.

Dr. Odaki emphasizes that the simplified model of pro- and anti-IP analysis is not productive. Both developing and developed countries have various economic development levels and stakes relating to the transfer of technology. In addition, he points out that both the excessive IP protection of developed countries and the excessive ignorance of IP protection in developing countries are not realistic such developed countries will be unable to find opportunities to invest in foreign markets and such developing countries will be unable to attract FDI. In the real world economic equilibrium is located somewhere between these two extremes, as long as the promotion of R&D-intensive FDI is competitive among host countries.

III. Evaluative Aspects

(1) Summary of the achievements

The obtained results suggest not only the difficulties of the dialogue between different fields of expertise (i.e. lawyers and economists), but also the way how they could be overcome. In particular, the necessity of interdisciplinary approach is a must for identifying and getting over barriers to the cross-border flow of intellectual assets. In our project, interdisciplinary discussion between lawyers and economists began at the Geneva Workshop which offered an opportunity to confirm that the analysis conducted in each field relies on a different approach. While lawyers are not used to relying on empirical data for purposes of their analysis, economists and business experts do rely on such data, but have essentially done so far by reference to the patent system and to corporate R&D (research and development) strategy, and have not intensively worked on issues relating to non-registered intellectual property assets, namely copyright and trade secrets. This focus may be explained by the availability of numerical or empirical data.

The project awakens recognition of the necessity, when it comes to intellectual assets, for closer dialogue between lawyers and economists. In addition, the obtained data in our project implicate the availability of empirical data relating to trade secrets. Trade secrets could be no longer labyrinth to economists.

(2) Implications of the outcome

Constructive ripple effects are envisaged. First, propelling movements towards norm setting. The exploitation and administration of non-registered intellectual property are to be done privately. Excessive public regulation creates inefficiency and reduces international competitiveness. Nevertheless, an infrastructure for protection, and a minimum norm that reduces the transaction costs between parties, are necessary. For example, the effectiveness and effects of confidential agreements could

be determined by a norm. This project will promote universal norm setting addressed both domestically and internationally.

Secondly, improved corporate strategies. Administrators of non-registered intellectual property are not only lawyers and managers but also, or even more importantly, employees who directly engage in research and development activities, production, distribution and sales activities. For example, Personnel Division and security officers play an important role in protecting against the leakage of trade secrets. This project shows that the administration of trade secrets should be conducted jointly with non-experts, and that cross-company or -border exchange of intellectual assets is pivotal at all levels. In so doing the discovery and exploitation of trade secrets are promoted throughout the company.

(3) Possible future developments of the project

The value chain analysis will produce high academic value. Economists from UNIDO and WIPO unanimously pointed out the necessity of analyzing the issue in accordance with the value chain model. The value chain of intellectual property is comprised of creation, operation, distribution, marketing & sales, and consumer services. Each stage has a series of legal issues. Competitive advantages can be examined for each stage and, if necessary, for mutual relations between each stage. UNIDO's existing researches can be used and further developed. If data can be obtained with the network and possible future budgetary resources, joint work between lawyers and economists would provide meaningful outcomes.

In addition, barriers to the cross-border flow of intellectual assets are not static and finding ways to overcome them must not be done in a static way. Quite to the contrary, it is necessary to keep in mind that methodology of the economic analysis and drafting of any regulatory principles should remain flexible and open-minded in view of potential future evolution.

Legal analysis will be developed further. As Professor de Werra points out, it could be that at some point in the future China shall become a major exporter of intellectual assets, so that it may shift its regulatory approach, i.e. from a licensee perspective to a licensor perspective, so that China – as well as other countries – would have an interest in adopting a balanced legal system. New research activities always need to be explored based on a balanced approach between local and global interests. In addition, international integrations are also being sought these days bilaterally and regionally. The implications of these bilateral agreements and negotiations as well as regional integrations will provide meaningful perspectives.

Note: This Report is not 'final'. After concluding this Report, the project team did and individual partners will continue to work on issues of the cross-border exchange of intellectual assets.