

Property protection

How small firms can learn to recognize and head off product piracy.

BY JAMES CHAN, PH.D.



Most American businesspeople understand that the theft of intellectual property is a big problem—one that costs U.S. firms \$300 billion a year. For decades, I have counseled my small and mid-size clients that this is a problem that should concern them ... but not scare them away from doing business overseas.

Recently, though, we have seen a new kind of threat—one that comes not from upstart foreign manufacturers and distributors but from the companies that have historically been our best customers. Companies that have prospered from selling components to multinational companies based in North America, Europe and Japan are getting squeezed.

What had been a collaborative process has now become more adversarial, as some multinational customers have tried to exploit my clients' valuable design capabilities and production methods, ultimately by contracting with low-cost Asian manufacturers to actually produce the product. Our oldest and best customers, some of the top companies in the world, aren't the kind of pirates we usually worry about; but when they exploit our expertise while not allowing us to make a profit, the threat is just as real.

Not all multinationals do this, naturally, but I have been hearing of more and more examples, so please be forewarned. My clients have had some success in dealing with this situation, at least so far. Companies will need to assess their own situations and develop their own strategies and safeguards. But the first step is to realize that the problem exists.

Export intelligence

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UNDER ORDERS ...

One company that I've been working with since 2005 used to supply specialty engineered parts to a large European-owned multinational. We would sometimes get phone calls from this large customer asking us to design a new part for a new product; we would then spend three to six months working with the customer's engineering and design team. We went over their technical requirements and created a design, which ended up in a technical drawing. Based on this drawing, we would create a sample part.

The client would place an order for a small quantity of samples, which we call a "sample order." The goal was to test if these parts worked perfectly in the final product. These sample orders were in the \$3,000 to \$5,000 range, a small sum that barely covered our costs, but we were willing to make the effort in the hope that our client's new product would become a hit. When that happened—as it often did—the client would place large orders for our engineered components. These production orders typically ranged from a few hundred thousand to several million dollars annually, significant revenue for a firm with fewer than 100 employees.

About three years ago, things changed. Our customer placed a sample order as usual, but many months went by and there was no production order. We waited for months and never got any production order. Our client wrote off the incident, assuming that the new product had not succeeded. A few months later, the same thing happened again. We started to wonder what went wrong.

Recently, after three years without placing any production orders, a Europe-based executive of our multinational customer came to see my client. She revealed that her company had turned over our previous designs and drawings to an Asian contract manufacturer that offered better pricing. This means, essentially, that our customer was using us as its research and development team. The executive coolly admitted that her company was sharing our drawings without our knowledge or permission. They were stealing our intellectual property, and leaving us with the most difficult and unprofitable part of the process. And they boosted their own profits by turning over the work we had done to a low-cost supplier, who received the profitable, big-scale order.

Fortunately for us, the adage “You get what you pay for” often turns out to be true. The executive told us that the components made by the Asian supplier had begun to decline in quality, and the contract manufacturer was missing its production deadlines as well. She came back to my client seeking a new improved design and drawings, along with samples.

In the meantime, through our trusted agent in Asia, we learned that our customer had broken ties with the Asian vendor. That gave us the confidence and courage to stand firm. My client told the multinational customer that we were no longer willing to accept just a sample order; we demanded a five-figure fee to be paid up front plus guaranteed minimum production orders. It took three months of haggling, but the customer finally gave in. We wrestled the business back, at least this time.

CAREFUL CONSULTING

Not all multinational customers are in cahoots with their lower-cost Asian suppliers, but it can be extremely difficult to tell which request for drawings is sincere and which is an exploitation. Nor is it easy to accuse a big firm of stealing our intellectual property, until there is enough proof or the client admits it to be the case.

Coincidentally, there is another similar and even more intriguing situation that we are now facing.

Two years ago, a U.S. multinational customer telephoned us and wanted to meet in person to discuss a new product they planned to develop. The client asked us to design a mechanical device to be incorporated into a precision instrument. The device itself includes our proprietary metal parts as well as plastic components and accessories. This device is far from being a commodity; we know, because we helped invent it. Each device, including the many metal parts, is customized and crafted by skilled technicians to pass rigorous testing procedures.

As usual, for a project like that, we spent months working with our customer’s engineering team, and succeeded in creating the prototype device. We got the sample order and, shortly after, received the production order—not a big one, but sufficient for us to

feel that business was proceeding normally. We did not anticipate any problems.

One day, the client called and said that they wanted to manufacture that device in China to lower costs. They put us in touch with their “China team,” who were aware that we were the original designers.

The Chinese engineers subsequently showed up at our U.S. office. They were blunt, informing us that they would place an initial order for a limited quantity of the device but then would proceed to replicate the product. They told us they would place an order only for our metal parts; they recognized that these parts are very difficult to replicate and are the critical components. We tried to persuade them against this course of action, and told them honestly that both our metal parts as well as the device itself must be customized and crafted one by one by skilled hands. They ignored our arguments.

Not long afterwards, they placed an initial order for our device as well as a separate order for our metal parts and proceeded to reverse-engineer our products.

They didn’t succeed—so they changed their tactics. They would show us a technical drawing for a metal part and ask if the drawing was correct. In other words, instead of telling us what to make, they would ask: “Is this the right way to do it?” This turned out to be only one of dozens of trick questions over a nine-month period. We did not answer any of them. We made it clear that we are a manufacturer and designer, not an engineering consulting firm. The China team then asked their U.S. colleagues to put pressure on us.

We have so far stood firm. We don’t teach our customers how to replace us—our expertise is our livelihood. The best way to stave off this kind of threat to your property and your profits is to recognize the signs, and say no as soon as you do. ☞

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COMPANIES WILL
NEED TO ASSESS
THEIR OWN
SITUATIONS AND
DEVELOP THEIR
OWN STRATEGIES
AND SAFEGUARDS.
BUT THE FIRST
STEP IS TO
REALIZE THAT THE
PROBLEM EXISTS.



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