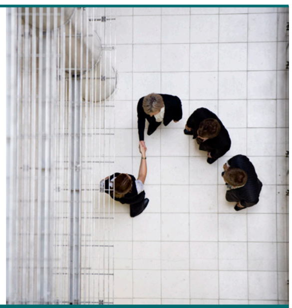
June 2011

Briefing



Intellectual Property For The Automotive Sector: What You Need To Know

The automotive sector is global and highly competitive.

Some 18.3m (or more than 22.5%) of the 77.6m[1] cars and commercial vehicles manufactured worldwide in 2010 were made in China. Japan and Germany still account for another 20% but another 13 countries each made more than a million vehicles last year.

The market is also highly concentrated, with just 9 vehicle manufacturing groups accounting for more than half of worldwide production[2].

All this makes life tough for tier 1 suppliers. For many of them their effective market consists of only a handful of customers. They are often forced to accept very slender margins to win the big contracts and get a presence on the mass market platforms.

It is against this background that intellectual property rights acquire particular significance for tier 1 suppliers. Tier 1 suppliers can use intellectual property rights in the following ways:

- To defend market share and margin – but this requires considerable care and skill (see below).
- To support and defend differential pricing in different markets.
- To stop counterfeiting.
- To enhance shareholder value and for tax reasons.

DEFENDING MARKETS AND MARGIN SHARE

Whether you make engines, control systems for them, locking or air conditioning systems or sub-assemblies, as a tier 1 manufacturer you will have to constantly innovate to ensure that your product meets current market requirements and industry trends.

The best way to defend such substantial investments in product development is by obtaining the right IP protection. Traditionally many manufacturers have relied heavily on the following types of IP:

- **Patents**

  These are 20 year statutory monopolies which protect new and non-obvious inventions from being commercially exploited by competitors. Patentable inventions can include new products as well as new processes.

- **Rights in designs**

  Design rights can protect both the three dimensional shape and configuration of industrially produced items such as a cylinder head or an exhaust manifold as well as the appearance of an item such as a facia on a dashboard. Rights in designs can either be registered or unregistered and can last for up to 25 years.

> "Such discussions are delicate but often times a large patent portfolio will encourage the buyer to go with the patented supplier, even if they are not the preferred or cheapest option."

1 OICA provisional figures for 2010.

2 Toyota, GM, Volkswagen, Ford, Hyundai Kai, PSA, Honda, Nissan and Fiat.

“Europe is a fortress as far as trademarks are concerned.”

- **Copyright**

  In the UK copyright no longer protects the three dimensional design of industrially produced items - they are protected in the UK by unregistered design right - but it does protect the software which is increasingly ubiquitous in modern vehicles, controlling such things as engine management, security and braking systems.

- **Trade Marks**

  Trade marks protect a tier 1 manufacturer’s branded products from counterfeiters and others who seek to use the attractive force of a brand to their advantage in an unfair way.

Tier 1 manufacturers have always relied heavily on patenting. The classic strategy involves filing a “thicket” of patents, each with numerous claims protecting such things as a new clutch actuator or a brake hydraulics monitoring system. The theory goes that although it might be possible to knock out one patent, the prospects of knocking out numerous patents, each with large numbers of claims, becomes vanishingly small.

Deploying Patents In Practice

A key issue for tier 1 manufacturers is how to deploy their patents in practice. They cannot sue their main customers – they may win a battle but they will certainly lose the war. Accordingly, what most tier 1 manufacturers do, is to make it clear to vehicle manufacturers that while they themselves will not be sued for choosing and using a competitor’s product, which infringes their patents, they would nonetheless feel obliged to go after their competitors, whose products infringe their patents. The implicit threat is to continuity of supply.

Such discussions are delicate but often times a large patent portfolio will encourage the buyer to go with the patented supplier, even if they are not the preferred or cheapest option. This is by no means always the case however. Some of the large manufacturing groups for instance will not even allow a supplier to tender without some acceptance of what amounts to compulsory licensing: if we chose your component and you are unable or unwilling to supply, we fall out or don’t like your pricing then we can get it made elsewhere.

The fortunes of tier 1 suppliers turn on the outcomes of these types of discussions and tendering processes.

The OEM market is of course only part of the story and patents also have a particularly important role to play in the aftermarket. Often, this is where the real money is to be made and if at least some margin support can be obtained and market share defended, then the patent portfolios will have earned their keep. In practice what matters is patenting the right features in the right way and then picking one’s targets for enforcement carefully and going after them in a thought out and systematic way.

SUPPORTING AND DEFENDING DIFFERENTIAL PRICING

Intellectual property rights are national rights and can give their owners very considerable power to control the market for their products in different countries and regions. This can be important, in practice, given the global nature of the market. Components and systems command different prices in different countries for a whole host of reasons to do with the structure of the market, exchange rates, local subsidies and tax conditions etc.

A fundamental problem for tier 1 suppliers and their distributors is therefore to achieve best price and avoid facing intrabrand competition from parallel imports and grey goods.

This is where trademarks come into their own. The sale of a branded product outside Europe, even if it is identical to the product sold in Europe under the same mark, does not carry with it a licence to import and sell that product into the market in the EEA. Europe is a fortress as far as trademarks are concerned. This allows a tier 1 manufacturer to defend higher priced markets in Europe from cheaper imported grey goods coming into the EEA from outside.

To take maximum advantage of these provisions there are a number things the tier 1 manufacturer should do and importantly these include making it clear, whenever selling a product outside the EEA, that it is not for resale within the EEA. The use of product tracing technology and trade mark law has become a powerful combination against the free movement of goods, but an eye does have to be kept on applicable anti-trust law.

The position in relation to international exhaustion of patents and other IP rights in Europe is less clear cut but useful protection can still likely be obtained.

Trademarks can also be used to defend the margin structure in selective distribution networks.

COUNTERFEITING

Obtaining reliable figures for the amount of counterfeit or pirated automotive products that are produced worldwide appears to be near impossible but in some markets counterfeit/pirated products are thought to account for up to 20% of the market. The sale of counterfeit products obviously loses the legitimate supplier the profit that he would have made on the lost sale, but it can also impact on reputation as the quality of counterfeit products is so variable.

In the UK when problems with counterfeiting or pirated goods do occur, it is possible to file a notice with HM Customs & Excise (who police the UK's external borders). HM Customs & Excise are then obliged to detain goods they suspect of being counterfeit, which fall within the ambit of the notice sent to them. Goods will be held for up to 10 days and thereafter for longer periods if civil infringement proceedings are started. Otherwise the counterfeit goods will be released unto the market.

It is also possible to file equivalent notices on a pan-European basis.

If the goods enter circulation within the UK then the trade mark, patent or registered design owner has three options:

1 He can complain to Trading Standards (a local enforcement authority) to see if they will seize the goods.

2 He can start a private civil enforcement action in respect of the infringement of his trade mark, copyright, unregistered design or patent – but such proceedings can be expensive in practice.

3 He can start a private criminal prosecution against the importer or person dealing with the goods if the goods infringe his trademark or copyright. The advantage of starting a private criminal prosecution is that the costs of the private criminal prosecution are recoverable out of Central Funds[3], irrespective of whether or not the rights owner is ultimately successful.

"The advantage of starting a private criminal prosecution is that the costs of the private criminal prosecution are recoverable out of Central Funds, irrespective of whether or not the rights owner is ultimately successful."

SHAREHOLDER VALUE AND TAX ISSUES

Generally, a purchaser of a business will like to see that the target's market share and customer contracts are underpinned by IP rights which preclude, or at least limit or slow, the ability of the target's customers to buy product from competitors.

Also, the ownership of IP rights can be used to transfer revenue within a corporate group so as to minimise tax liabilities – the basic idea being to impose IP licence royalties on taxable income in high tax countries to reduce the taxable profit and then to collect and recognise the royalty income in low tax jurisdictions. The governments of many hard pressed countries have introduced anti avoidance regimes that can be used to unpack such schemes but there are still ways of making such schemes work. The UK government's recent announcement of proposed changes to the taxation of controlled foreign companies does open up new opportunities for corporate groups, which carry out international intragroup licensing, and are subject to the UK tax regime.

3 I.e. the British tax payer foots the bill.

“The UK government’s recent announcement of proposed changes to the taxation of controlled foreign companies does open up new opportunities for corporate groups, which carry out international intragroup licensing...”

Finally, the UK government has recently announced plans for what it calls “Patent Box”, which is a reduced taxation rate for patent licence revenues. Accordingly, if some of the value of a patented product can be treated as patent licence royalties then at least part of the revenue will attract a lower tax rate (it is proposed to be 10%) rather than the standard rate of corporation tax in the UK which for large companies is currently 26%.

Squire, Sanders' Automotive Group would be pleased to field any questions you have in relation to the contents of this briefing note. Please contact:-

Andrew Clay
Squire Sanders & Dempsey (UK) LLP
Rutland House
Birmingham, B15 1 HN
Tel: +44 (0) 121 222 3358
Email: andrew.clay@ssd.com

5254/05/11