

IP Considerations When Establishing and Managing a Supply Chain in China

Selecting a business partner in China can be a dicey proposition at the best of times. It is even more so now as Chinese companies face exposure to global economic turbulence. Rights holders must be vigilant to ensure their “trusted partner” does not become their main competition.

By Daniel R Plane

Over the last several years, stories of tainted, toxic or defective products manufactured in China turning up in Western markets have become more than commonplace. Worryingly for consumers, a number of these products have borne the trademarks of some of the largest companies in the world. Those brands, fostered and promoted by their owners to act as an instant badge of quality, reliability and safety for consumers, have taken a significant battering in the wake of these repeated scandals. The Chinese government has responded to these problems by beefing up regulations and enforcement efforts relating to product safety and quality. Those actions, primarily taken after the damage has been done, are really just short term remedies for a much larger, and more difficult to cure, condition.

All this is to say nothing of the impact of rampant piracy and counterfeiting on foreign and domestic brands by Chinese manufacturers. To a large degree, consistent anti-counterfeiting actions over the last several years by PRC authorities have driven much of the manufacture of fakes underground. Nevertheless, larger, apparently more reputable and established enterprises are by no means beneath manufacturing of counterfeit or infringing products. This includes as well entities authorised or once-authorised to act as suppliers for major brand owners. Tales of late night, unreported production runs, unauthorised manufacture of branded goods at sister factories, copying of moulds, and misuse of trademark authorisations or licenses are legion in China. This problem is likely to only become more severe during the current economic downturn. With orders for export consumer goods plummeting, Chinese factories will be sorely tempted to shift their manufacturing capacity to the illicit production of low cost and even lower quality counterfeits or infringing products.

To effectively protect its reputation and brand from this double threat of harmful, unsafe products and outright theft of intellectual property protection, brand owners need to educate themselves regarding the potential pitfalls of operating in the China market. Once armed with this knowledge, they next need to take proactive steps to avoid those pitfalls. This article is intended to act as a basic field guide for business people and legal counsels as they navigate the uncertain waters of China sourcing and supply for their brands.

Ensuring Full China Intellectual Property Portfolio and Protocols Are In Place

The first step to IP rights protection in China is to ensure that the full range of rights is adequately protected and that protocols

are in place to minimise the risk that suppliers may become your competitors. For example, as China is a “first-to-file” jurisdiction, failure to register a trademark before authorising a Chinese entity to manufacture products bearing that mark could permit it to file its own application for the mark, regardless of how long the mark has been in use by the rights holder. This would permit it to halt manufacture in China by the rights holder of any goods bearing the mark.

Brand owners should also consider, however, taking additional proactive steps to anticipate common issues that can arise with suppliers, and the suppliers of those suppliers, as outlined below.

Defensive Trademark Registrations

That brand owners should have a full complement of relevant trademarks covering relevant goods should go without saying. Additionally, however, it is also wise to consider registrations not just for products on which your trademarks appear, but also registrations covering accessories and parts that will eventually be attached to counterfeits of your products – and will also bear your trademarks. Accordingly, new filings for defensive trademark registrations in classes covering major individual components – such as zippers, tags, straps, buttons and buckles – can be considered in order to ensure your ability to halt individual manufacturers of those accessories from pirating your brand. Authorities may well refuse to take action against such manufacturers of these accessories in the absence of a valid registration specifically covering those goods.



Note that some form of “use,” even limited, will need to be made of these registrations in China on a regular basis to insulate them from non-use cancellation, to which any trademark is vulnerable after three consecutive years of non-use.

Chinese-language Trademarks

Brand owners with long-range plans in China must consider designing and registering Chinese-language versions of their marks, which will be vital if the brand is to truly take off among Chinese consumers. Failure to choose an appropriate Chinese trademark – and to choose it early – can provide an opportunity to counterfeiters, copycats or even your suppliers to take control of your brand’s image in China. Note that the design of a Chinese-language trademark is really more art than science, and should be undertaken with the close consultation of native Chinese speakers, preferably with both literary and marketing experience.

Design Patent Registrations

Trademarks only protect those products or items bearing copies or imitations of those trademarks. In the case of packaging – unique shapes of products or unique color combinations that do not bear your trademark but are nonetheless dead-giveaways that your company is the manufacturer of the product – additional protection in the form of Chinese design patent registrations is strongly recommended. A proactive approach to filing applications for designs, shapes, patterns, and the like – at minimum, for those which a brand owner feels will be particularly successful – is key. Consider also priority filings for new designs already filed for in other countries as there is a six-month window for such filings from the date of filing of the foreign application. Design patents in China are somewhat vulnerable to invalidation, as applications for them are not substantively reviewed by the PRC Patent Office. Nevertheless, failure to register a design may well leave a brand owner with no legal recourse whatsoever to halt a copycat product.

Invention and Utility-Model Patents

If your product encompasses patented technology, you will want to ensure you have filed for or obtained patent rights for the technology in China, either via foreign-filed Patent Cooperation Treaty (PCT) applications designating China, priority applications or local applications filed directly in China. Authorisations or licenses to utilise such technology in the manufacture of products, be they for export or sale in China, should be carefully drafted to ensure they fully comply with Chinese regulations and provide brand owners maximum protection in the event of misuse of the technology at issue by suppliers.

Copyrights

Consideration should also be given to obtaining copyright registrations for products that contain more artistic or creative elements, such as the pattern of fabrics, or the design of individual constituent elements. Chinese courts have shown a real willingness to extend copyright protection to consumer products that in many Western countries might not qualify for broader protection. For example, Lego, the Danish manufacturer of plastic building blocks, was able to halt the manufacture of similar building blocks by a Chinese toy manufacturer relying wholly on copyrights in the initial design drawings of the individual blocks.

Note well that administrative enforcement of such copyrights would almost certainly be deemed too complex or too likely to invite a lawsuit against administrative enforcement authorities by the accused infringer for those authorities to take action on the

rights holder’s behalf. This likely forces copyright holders to rely instead on lawsuits in order to enforce these rights. Accordingly, evidence of copyright ownership – as well as evidence of infringement – in a form admissible in Chinese courts must be obtained. For example, foreign-sourced materials to support such copyright claims if the complainant has not sought to obtain a Chinese copyright registration certificate, be it a foreign copyright registration certificate, initial sketches or design drawings, will need to be (1) translated; (2) legalised by a Chinese embassy or consulate; and (3) notarised. This is a time-consuming process, but an invaluable one if you have to enforce your copyright via a civil suit in China. Evidence of the infringer’s activity will also need to be notarised, usually via purchase or investigation in the presence of a Chinese notary.

Trade Secrets

Trade secrets and any other confidential information necessary for the manufacture, sale and distribution of your products should be carefully catalogued well in advance of disclosure to any third party, particularly potential suppliers. Further, any disclosure of such information should be carefully monitored and only undertaken under strict controls. Of paramount importance is the execution of solid confidentiality and non-disclosure agreements in advance of disclosure.

In order to ensure the enforceability of trade secret rights in China if those rights are eventually violated or stolen, it is vital that the materials be handled by you and the Chinese third party with a due level of security and care, and that such efforts to maintain their confidentiality be clearly made and monitored during the course of the relationship.

Consideration should also be given, to the extent possible at the start and at the end of any manufacturing relationship, to a non-compete agreement. Depending on the scale of the manufacturer’s business and its existing client base and future plans for expansion, you might not be as able to press it very hard to restrict its work with or for your competitors. But you will definitely want to prevent it from utilising any of your information, technology or other materials to improperly assist them during or after the end of your relationship.

If any work is being done by the factory for any of your competitors (a not-uncommon occurrence in the case of larger, more sophisticated entities utilising cutting-edge technology and techniques), controls must also be in place that wholly segregate your products from intermingling with those of your competitors, and prevent any “cross-pollination” of your IP, trade secrets or other confidential information to competitors, who will likely also have their own representatives regularly on site at the factory to monitor the Chinese manufacturer’s work. Work spaces should be separate from each other and computers, fax machines and e-mail accounts utilised to transmit and store information related to design and production should be secure and well insulated against sharing of data.

Chinese Database Searches

At minimum, and in addition to searching relevant databases and conducting relevant clearance searches to ensure the path to registration for your primary IP rights is smooth, broader searches of relevant Chinese IP databases, such as trademark searches in non-relevant classes, should be conducted to do the following: (1) give you a clear picture of potential obstacles to filings for your IP rights – including potential Chinese-language versions of your marks; (2) identify pirate marks and designs against which pre-emptive action might be beneficial; and (3) identify, for further investigation and action, potential manufacturers of counterfeits

of your products or of otherwise infringing products, which may include more reputable manufacturers – or even your own potential partners – as well. For the same reasons, a basic program to regularly monitor for infringing preliminarily-approved trademarks or just-published design patents by reviewing the PRC Trademark and Patent Gazettes should be established (particularly in light of potential changes to the PRC Trademark Law in recent proposed amendments that will place the onus much more heavily on trademark owners to identify and oppose pirate and infringing marks).

Chinese Domain Names

At minimum, domain name rights in the .cn and com.cn versions of your primary marks should be considered for China, as well as Chinese-character versions of your marks. It is also a good idea to identify pirate filings for identical or similar versions of the various other available domains in China and Asia and consider possible efforts to reclaim those domain names, such as complaints under the Uniform Domain-Name Dispute-Resolution Policy.

Customs Recordals

Optimally, all of a company's IP rights should be recorded with the PRC General Administration for Customs (Customs), energising Customs to actively monitor for exports of products bearing its trademarks, utilising its designs etcetera, including products coming from your authorised factory. Identifying your supply chain partners and suppliers as "authorised entities" undoubtedly speeds exports of your products from China but could also potentially facilitate unauthorised shipments of product by those same partners. Companies can also "blacklist" entities with a history of ripping off their brands, including trading companies that facilitate export of counterfeit products. Note that once a relationship with a supplier has ended, immediate steps must be taken to have that supplier's name moved from the "authorised" list to the "unauthorised" list.

If after recordal of IP Rights, Customs identifies shipments of products from entities not appearing on the "authorised" list, movement of those products will be halted and the brand owner or its designated representative will be contacted and asked to examine the products to determine their authenticity. If products are counterfeit or unauthorised, the brand owner has three days from notification in which to request they be formally seized by Customs. Generally, a security bond will also need to be posted, calculated on the stated value of the seized goods, generally, a few hundred to several thousand dollars. The bulk of this bond is returned upon destruction of the goods, less a small amount for storage and destruction costs.

Note well that simply filing Customs Recordals with Customs is really just the minimal step an IP owner should undertake. To maximise the odds that fakes of a given product will be seized, regular training of relevant front-line Customs officials is key to ensure they are familiar with the protected IP and have a basic understanding themselves of how to identify a fake product from a genuine one. This training can be conducted by any trusted partner or representative, though it will need to be done in Chinese (including presentation materials) to ensure the information is effectively communicated to Customs officials, who are unlikely to be fluent in English.

Licenses and Authorisation Letters

Depending on the nature of the intended relationship with a Chinese supplier, particularly the scope of activities that the supplier will undertake, rights holders will need to decide whether to

execute a full-blown trademark and/or patent license, or to instead issue a mere authorisation to manufacture goods utilising the IP in question.

In a strict manufacturing context, where the Chinese supplier is not authorised to sell, advertise or otherwise market products bearing a brand owner's trademark – and is instead only acting as a behind-the-scenes source of supply for branded goods – a detailed authorisation document should be executed. This authorisation should not only enable the Chinese manufacturer to demonstrate to inquiring authorities that its manufacturing activities are undertaken with the right holder's consent; it should also define the limits of its right to make use of the trademarks, thus providing additional assurance to the brand owner.

Ideally, this authorisation will be as limited as possible, both in scope and duration, specifically identifying the precise use to which it may put the IP, and explicitly excluding any other uses. For example, authorisations should strictly prohibit subcontracting of work to other factories unless vitally necessary, and then only upon separate written permission, obtained from the brand owner in advance, after it has had a chance to consider the need for subcontracting any work, as well as the trustworthiness of the proposed subcontractor. Open-ended authorisations, or authorisations which permit the manufacturer to negotiate sourcing of components on a brand owner's behalf, should also be avoided. These limits should assist in preventing unauthorised third parties from manufacturing fakes with a company's apparent permission or Chinese manufacturing partners continuing to churn out near-genuine products after the relationship ends.

In that same vein, any authorisation or license should provide flexibility for the rights holder to terminate the agreement before its set expiration date in the event of any impermissible behaviour or other grounds which mandate ending the relationship. It is strongly suggested as well that IP owners consider including liquidated damages clauses. These clauses act as an advance agreement between the rights holder and the manufacturer on the amount of harm that will be done to the rights owner in the event certain circumstances, such as an infringement of IP rights, theft of trade secrets or other harmful acts arise. Such clauses should to the extent possible reflect a reasoned, good faith estimate of the potential damage to ensure they are not subject to ready attack by a supplier attempting to squirm out from under them.

It is also important to recognise a common abuse of such authorisation letters – continued use by Chinese manufacturers after their expiration, either by the former partner, or by unauthorised parties to whom the former partner has passed the letter. It is not uncommon for raids against counterfeiters to be slowed down or even halted outright by photocopies of a brand owner's own earlier authorisation letter. If this occurs, enforcement officials may be sympathetic to a counterfeiter's claim of lack of ill intent or mistake. Demanding return of the originals and any copies of any authorisation letters (though photocopies are easy to make) and diligent monitoring of the counterfeit markets throughout the relationship for the presence of particularly high quality goods, or goods which are claimed by sellers to be "genuine" or "manufactured by an authorised factory" are keys to identifying this issue early.

Note that under relevant Chinese law, both trademark licenses and patent licenses, which are beyond the scope of this article, must meet certain minimum standards under relevant laws and are required to be registered with the authorities. Mere authorisations to manufacturers to make limited use of your trademarks or other IP rights in the course of manufacture are generally not required to be registered with authorities.

Vetting Potential Partners for Trustworthiness and Respect of Intellectual Property Rights

There are a variety of different means available to preliminarily identify potential manufacturing partners. Trade associations, trade shows, references from competitors and partners, internet websites and B2B portals, such as Alibaba, Global Sources, and Made-in-China, all provide easy access to manufacturers from a broad range of manufacturers in a wide variety of industries. And of course, the manufacturers themselves have trained sales forces, fluent in English, French, German and other languages, who are also well-versed in the terminology and technology of their given industries.

Regardless of how these potential suppliers are initially identified, however, and how promising the lead looks upon first blush, locating these entities is only half the job in ensuring the selection of an appropriate partner. Indeed, it is not understating things to say that by acting precipitously in selecting a manufacturer, brand owners are putting their consumers' safety, their company's reputation, and their brand's integrity at real risk. As previously mentioned, there have been many stories of supposedly "trusted" partners in China running late-night lines to churn out unauthorised – and undeclared – quantities of a brand owners' products. Moulds for genuine products, meant to be held tightly under lock and key, readily disappear from the factory for an evening, and are utilised to create a near-perfect set to be used by a factory just down the road.

Given this, and assuming a reasonable number of likely potential partners from which to choose have been identified, it is key to ensure those partners are vetted as much as possible in advance before they are given access to a company's intellectual property and can truthfully advertise themselves as a brand owner's "trusted partner" (which they often will do, even if told explicitly not to).

A detailed list of questions on a range of topics, including policies in place to ensure the protection of intellectual property, should be prepared and presented to potential suppliers, and should be translated into Chinese to ensure they are able to be fully understood by the Chinese party. An understanding of the factories systems and capabilities in place to protect IP and their weak points is also key. These elements should be closely inspected during any tours of factories and any concerns in this regard dealt with before the relationship formally begins.

In addition to regular visits by sourcing personnel to ensure that sufficient controls are in place to protect intellectual property rights to be utilised by the Chinese supplier, it is strongly recommended that rights holders conduct additional investigations to confirm the following:

- Before partnering with the supplier, that the factory respects the intellectual property of others, has not pirated others marks, is not itself the subject of any lawsuits or administrative actions for IP violations, and is creditworthy.
- During the course of the relationship, that the supplier's IP protection system is functioning, that the supplier is not exceeding the scope of the limited authorisation or susceptible to requests to do so; and
- After any relationship has ended, that the supplier has fully halted manufacture of products containing the IP and is not breaching any non-compete or non-disclosure provisions to which it is subject.

An undercover investigator, posing as a potential customer, is the most effective means of conducting these checks. For example, companies often readily agree to manufacture products bearing famous marks of other companies, even when the "customer" openly admits they do not possess authorisation from the rights holder. Any company willing to engage in such conduct should automatically be eliminated from consideration. Similarly, an undercover investigative approach seeking offers to manufacture unauthorised products, that is, products exceeding the scope and terms of the authorisation, can also identify partners willing to actively breach a company's IP rights to maximise their profits. Finally, approaches to a factory after the supply relationship has ended to determine whether the company is still actively manufacturing now-unauthorised products can also be conducted. At all times, rights owners should also consider conducting regular surveys of locations where fakes of their products are likely to be sold, including wholesale markets and trade fairs to identify high-quality counterfeits that could well be genuine – but unauthorised – goods sold out the supplier's backdoor. Waiting until such goods show up in overseas markets usually means it is too late to easily track them back to their source.

Conclusion

Selecting a business partner in China can be a dicey proposition at the best of times. It is even more so now as Chinese companies face exposure to global economic turbulence with a mixture of anxiety and opportunism. Accordingly, proactive and prudent steps must be taken early in order to ensure all relevant rights are secure before venturing into the manufacturing market or establishing any supplier relationship in China. If a rights holder's trademarks, patents, designs are not at least applied for (even if not yet registered) and if checks are not put in place in order to provide early warning or freedom of action in response to IP breaches, there is a real risk that a "trusted" partner could quickly become your main competition.



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