

Sourcing/sub-contracting

Many companies take advantage of cheaper costs by sourcing products or components from China. While China presents a unique set of benefits when sourcing there are also many challenges! Presented below are some of the most important issues concerning IP risks when sourcing from China. For an SME it is not an option to spend vast resources on protecting the company's assets – solutions need to be affordable and practical. But it is NOT recommendable to start sourcing from China without having made initial efforts to minimise IP risks and secure your business. IPR has often turned out to be a show-stopper if not considered for SMEs in China.

The IPR issues that should be considered by SMEs depend on which phase you are in:

Before Sourcing in China

Prior to any engagement in China your company needs to consider what know-how is valuable for your business and how it is to be best protected in China. First steps are to 1) identify what IPR and know-how is embedded in the component or product to be sourced, and 2) ensure that correct IP protection is in place in China.

Helpdesk expert Karin Beukel, an IPR specialist from the IPR Company specialising in doing IPR checks in China emphasises:

"Often we see that SMEs haven't considered how to protect their know-how and IP rights in the components or products to be sourced in China. This usually turns out to be the most crucial weakness when the SME wants to control their sourcing partner in China. To give an example, a company started sourcing a product in China from a sub-contractor without having registered their trademark in China. The sub-contractor registered the SME's trademark behind their back. After a while the SME decided to move the production to another Chinese company as the sub-contractor could not deliver the expected quality. However, as the sub-contractor was the legal owner of the SMEs trademark they had to pay €1Million to get the ownership of the trademark back (before they could move the production). Knowing that the trademark could

have been obtained for less than €1000 if registered by the SME in the first place it seems like an unnecessary risk for an SME to take."

Identifying the company's IP rights can be a difficult task for an SME to perform, if the SME has no knowledge of IPR. To read more, see 'Finding Your Way Around IPR in China'. Also, remember that it is always possible to get an external IPR advisor to check whether the IP rights identified really are of core value to your business. Having an overview prior to sourcing in China ensures that IPR risks can be evaluated.

IP risks when looking for a supplier

When looking to identify your supplier, you should consider how you want the relationship to work and what controls you need to put in place to secure your rights. These issues need to be spelt out in a written agreement which can form the basis of a contract between the parties. It is not advisable to start sourcing in China without a signed contract. However, it is important to keep in mind, that a contract could be viewed as a "guideline for cooperation" in China, whereas in Europe a signed contract is viewed as legally binding. Contracts should not be rushed through, but should instead be a process where the contract can work more as a relationship manual.

As an SME you should ensure that the potential supplier really is who they say they are. This can be done in a number of ways, but initially check whether the company is legally registered, and whether it is trading under the registered name.

Helpdesk team leader Simon Cheetham from ERINYES INTERNATIONAL, a firm with expertise in performing background checks, emphasises: Often we find that we can save SMEs a great deal of trouble and expenditure by doing a simple background check prior to negotiations with a potential supplier. In this way we can ensure that the legal entity that the SME is to enter into a sourcing contract with is also the company that can be held responsible for any wrong doing. It pays to know who you are dealing with.

In the contract it is advised to clearly state which Intellectual Property Rights are owned in respect of the items to be supplied and to clearly state that any know-how, discovery, invention (whether patentable or not), design, drawing, computer program, photograph, plan or record

relating to the development of prototypes and the subsequent final version of products or any future developments of products which are made, created, developed or acquired by the supplier (together with all Intellectual Property Rights and any future rights in respect of any such matter) will belong to the SME absolutely. Please see the 'Research and Development' section to read more.

A particular problem can also arise over ownership of tooling developed by a supplier to manufacture products on behalf of an SME. Where the supplier has paid for the tooling and the sourcing agreement is terminated, you may not be able to recover the tooling or transfer it to an alternative supplier (although this does not necessarily mean the supplier can continue to use the tooling). Where the SME owns the tooling then you will have the right to recover it. In order to avoid the risk of losing any Intellectual Property Rights any SME should be aware that they are the only entity that can authorise any production on its behalf. A supplier should not sub-contract production of components to other companies, if this happens you lose control over your product, and the related know-how.

It would be helpful to ask the supplier to promptly notify you of any actual or suspected infringement of any of your Intellectual Property Rights, which comes to their notice, and that the supplier will do all such things as may be reasonably required to assist you in taking or resisting any proceedings in relation to any such infringement or claim. Please see 'Dealing with Counterfeiting' to read more.

During Sourcing in China

IP risks while sourcing in China

It is a mistake to think that once a sourcing contract has been signed, everything is settled. This is not the case. As in most business relationships a hands-on approach will be best. Issues to be considered include:

- To ensure that IP and know-how will not leak – always monitor your supplier. It is good practice to include unannounced visits. Helpdesk expert Karin Beukel from The IPR Company explains how they audit sourcing partners for clients.

"Through an IPR Security Audit(TM), we determine to what extent the IPR area and the IPR

processes within the involved client's organisation are secure. By doing so we can secure data for further optimisation of the client's IPR security platform, and eventually develop a list of potential IPR risks for the company in question."

- Factories which know they must adhere to controls, procedures and standards will do so if they are subject to checks; those factories which are not subject to checks will rapidly deviate from procedures and standards.

- Establish how the supplier deals with your products, factsheets, know-how etc. Consider physical access to the production-site and how this access is secured. In general, if you have access to a competitors' production at your supplier's factory, they will also have access to your production.

- A common issue in China is production overruns, this means that a supplier manufactures more than the agreed quantity, and sells overruns on the black market. A clear policy should be set out on handling overruns, as well as seconds and rejects. Failure to exercise control over these issues is one of the most common causes of infringements. This should also be monitored in the IPR security Audits as well as in the contract.

After Sourcing in China

IP risks when terminating a supplier relationship

If the right precautions have been taken from the start, it is not a problem to cease production with a supplier. However common issues include:

- Difficulties recovering tooling, either because ownership of the tooling has not been clearly established or because physically locating or recognising the tooling is difficult without some clear means of identification.

- Another common issue is that the supplier has acquired the know-how to manufacture even after production is moved elsewhere and keeps manufacturing the products. It is advisable to recover all tools, and any remaining components or completed items to ensure that the sourcing partner cannot continue manufacturing the products.