1. Introduction: OEM in China

The term Original Equipment Manufacturer (“OEM”) designates a company that only makes a part of a product, or a subsystem, to be used in another company’s end product. By extension, OEM (Original Equipment Manufacturing) also designates the agreement whereby one company commissions another to manufacture products according to certain specifications and to affix a trade mark on such products; the said products are delivered to the commissioner who sells them in the market under his own name. The letters “OEM” therefore designate both the manufacturer and the act of commissioning the manufacture of a finished product to a third party.

OEM agreements can be used within a single country but are more common in transnational agreements, wherein the commissioner and the OEM factory are located in different countries. When China adopted its open-door policy in the 1980s, foreign industries moved to China to take advantage of reduced manufacturing costs by either investing via joint ventures or Wholly Foreign-Owned Enterprises (WOFE) or by the simpler method of contracting Chinese OEM factories to manufacture and export their products. China’s OEM sector developed rapidly from its roots in the apparel industry to a sector comprising automotive parts, cosmetics, and ICT equipment.

As the world’s leading manufacturer[1], China attracts manufacturing contracts from global customers in almost every industry by capitalising on Chinese OEM’s core strengths—low (though rising) labour costs, experienced manufacturers, and skilled workers. Although it is difficult to collect reliable statistical figures on how many European companies have used or are using OEM in China, the China IPR SME Helpdesk’s experience and enquiries received from SMEs in recent years indicate that OEM is still a popular format for European companies, small- and medium-sized enterprises (SMEs) in particular, in particular for those adept at design and invention but lacking the means to launch a full-scale investment in China and wishing to capitalise on the growing quality and efficiency of the Chinese industrial network, in particular in the southern and coastal provinces of the country.
Guide to IPR Protection in China for the OEM Industry

Precautions need to be taken in the drafting of the OEM contract to ensure the quality and timing of the production and delivery. Supplemental provisions which protect the intellectual property rights (IPR) related to the goods are also a crucial element of a successful China OEM strategy. This guide will focus on practical considerations and operations for the intent to protect European SMEs’ IP rights in doing OEM businesses in China.

2. Frequent IP issues in China’s OEM industry

Products to be manufactured by OEM in China are usually covered by one or several types of IP rights, e.g. trade marks, copyright, designs, or technical know-how. Therefore, when authorising a third party to manufacture products, the IP owner should carefully examine the status and level of protection of its IP rights in the country of production.

2.1. Trade marks: trade marks are protected on a country-by-country basis. China follows a first-to-file system that grants trade marks to the first individual or company to register it. Thus, a foreign trade mark is not automatically protected in China, and vice versa. Before considering OEM production in China and certainly before beginning the OEM process, SMEs should file all trade marks in with Chinese authorities either directly in China or through international processes. (For further information, please see the Helpdesk’s Guide to Trade Mark Protection in China). Once the trade mark is registered, SMEs can authorise the OEM factory in safety, but if the trade mark is not registered before the process begins then SMEs open themselves to IP piracy.

With a valid trade mark registration, you can:

- Grant a license to the OEM factory. Whether the license is “exclusive” (even you cannot use the trade mark in China for as long as the contract lasts), “sole” (only the licensee and yourself can use it) or “normal” (i.e., non-exclusive) depends on the negotiations and your trust in the factory. Generally, a non-exclusive license is slightly safer in that it allows more freedom for terminating a contract and switching to a different factory. On the other hand, the OEM will have more power and more incentive to act against possible counterfeiters if it has an exclusive license.
- Record the license contract with the China Trade Mark Office. It is in the interest of the OEM factory, in case the trade mark is assigned; that the assignee cannot ignore the contract. Recording the assignment contract, in practice, is more in the interest of the OEM factory or the assignee, as the assignee enjoys the right to use the trade mark from the publication date of the approval of the assignment.
- Record the trade mark with the General Administration of Customs (GAC – China Customs) and benefit from the Custom’s ex officio protection system, whereby officers survey the inbound and outbound flow of merchandise and warn you of any suspicious shipments. After the warning has been issued, you have three days to confirm whether it is an infringement and ask for detention of the goods.
- Take enforcement measures against trade mark infringement. Only registered trade marks enjoy the exclusive right to prevent others from using, manufacturing, selling, storing, etc. products bearing identical or similar marks on identical or similar products without authorisation. The trade mark owner can either file an administrative complaint with the local Administration of Industry and Commerce (AIC) or file a lawsuit before the People’s Court. In general, administrative actions are time- and cost-effective, in particular if you have a straightforward case. For complicated scenarios, or if you are seeking damages, using the courts is a better method.

Read our guide on Enforcement of Intellectual Property Rights in China for more information, and consult a qualified IP lawyer to assess the benefits and risks of each type of enforcement action.

In order to remain valid, a trade mark must be used. If not used for more than three consecutive years, the mark can be revoked. The OEM need only affix the trade mark to protect the mark from being revoked for non-use. In order to emphasize the function of trade mark, the revised Trademark Law stipulates that the use of trade marks consists in “affixing trademark on goods, packages or containers etc. ... to distinguish the origin of the commodities”.

Failing to file a trade mark before embarking on OEM is courting disaster. The trade mark may be registered by another person or company (either registered independently or registered deliberately to gain control of your mark) who can then sue you, stop your products at the border, or claim compensation for infringing their mark that has already been granted in Mainland China. For exports, the case law is not established in China: some courts consider exporting the goods to not expose the trade mark in China and, therefore, to not count as infringement. Others take the opposite view and consider that affixing the trade mark in China without authorisation is an act of infringement.

Trade mark searches conducted at the Trade Mark Office prior to filing often discover that the trade mark, or a similar trade mark, has been already filed or registered, constituting an obstacle to the registration of your own trade mark. When this happens, you can:
• File for an opposition or invalidation on the basis of your own prior use in China (if this is the case) and of the reputation that you may have acquired as a result. Alternatively, oppositions may be filed on the basis of any other prior right, e.g. copyright. However, the mere use of a trade mark in China by OEM does not generate a reputation for such trade mark, and will be of no use to the opposition or invalidation.

• Attempt to prove that the registration was done in bad faith. Chinese trade mark law does not clearly define “in bad faith;” however, it does establish “good faith,” stating that trade mark owners or trade mark agencies must file trade mark registrations in good faith. It further stipulates that if the trade mark agency, the business partner or representative, or another person or entity knows of the existence of a trade mark through contractual or transactional relations, then it must have the permission of the trade mark owner to apply for that mark in China.

• You can negotiate with the trade mark owner in China and buy back your trade mark. This route is practicable but may result in extreme price gouging. To avoid a situation where your company is asked a considerably high price for the purchase of the trade mark, SMEs should not approach the trade mark owner directly, but should rather negotiate via a lawyer or agent.

• Abandoning the trade mark in China and re-branding the product is always an option, but can be costly and can throw away years of consumer trust and goodwill. If you take this route, make sure to run a trade mark search for the new mark and register it in China in both the original language and Chinese before using it.

2.2 Design patents: Products manufactured by an OEM factory are usually made in accordance with specific drawings, blueprints etc. provided by the foreign company. For the same reason as mentioned above, it is advisable to file in advance for the registration of what China calls design patents in order to protect these industrial designs. Be aware that Chinese law requires that design patents be “novel;” the design must not have been disclosed anywhere in the world before the filing of the application. If an SME applies for a registration for a design which is not novel, the design will still be granted, as a design patent is not subject to examination by the State Intellectual Property Office (SIPO). However, the patent will be subject to invalidation.

The registration of a design is a pre-condition for enforcing your rights in an event of an infringement. The European concept of unregistered design, which protects the owner for three years even if there is no registration and which allows a legal action against third parties who reproduce a design, does not exist in China.

For further information on designs and relevant protection methods, please refer to the Helpdesk’s Design Patent Guide.

2.3 Copyright: Chinese law protects copyright without any need for registration. Some products produced via OEM may qualify for copyright protection; however, in China, standards for receiving copyright protection are quite high.

Although copyright is automatically granted, registration is possible and highly recommended to facilitate the submission of evidence of ownership of the copyright in case of a dispute or enforcement action. Copyright should be registered as early as possible as the courts tend to disregard registrations if they have been made after proceedings have begun. Registration of a copyright is a simple and low-cost procedure with the Copyright Protection Centre of China.

Proving ownership of the copyright is crucial and will require preservation of original copies of all documents establishing the creation of the work (e.g. sketches, drafts, various prior iterations of the work) as well as the contractual documents showing the chain of ownership over the rights.

For further information on copyright, please consult the Helpdesk’s Guide to Copyright in China.
3. Including IP in your OEM contract

OEM contracts, like all contracts, need to be properly drafted by legal professionals in order to avoid interpretation issues or omission of important points. IP-related clauses should definitely be included and carefully defined in the contract to protect your interests. To ensure these issues are addressed, before signing an OEM contract, some basic questions should be raised and should be discussed between the commissioner and the OEM factory to clarify, for example:

- Who owns the prototype produced by the OEM factory based on the design provided by the commissioner
- Who is responsible for final products infringing a third party's IP (e.g. trade mark, design etc.)
- Handling of certain contingencies, for example if the factory does not destroy returned or flawed products and instead circulates them in market.

You should require the candidate OEM factory to sign a Non-Disclose Agreement (NDA) to maintain the secrecy of your business plans, your IP information disclosed in conversations or emails chains, etc. However, NDAs are not fool-proof and may fail to prevent information leaks or trade mark squatting. Registering IP before entering negotiations, let alone entering China, will be key to avoid these issues in terms of trade mark and design protection. It's recommended to ensure the appropriate protection of trade secrets and know-how via contractual and other means.

In order to mitigate IP risks in OEM contracts, the following points should be considered carefully:

- Definition of the commissioned product

The definition of the product to be commissioned is a key element of the contract. It is absolutely necessary to define in meticulous detail the products that are to be produced by the OEM factory, including qualities and quantities. Designs or drawings, and in some cases moulds and toolings, should be checked or provided, and validated by the commissioner to confirm that products follow the specifications required. As added protection, you can consider adding annexes describing the technical specificities and functions required for the product.

If the product commissioned is not properly defined and described in the contract, it will be very difficult to prove the non-compliance of the product and thus to terminate the contract or claim compensation.

- Overproduction and defective products

In case of over-production, the contract should state that production shall be stopped and excess goods or defective goods shall be destroyed at the expense of the OEM factory unless the commissioner gives prior consent to purchase or stock them.

- IP use and confidentiality

To prevent unauthorised use, contracts should determine to what extent the OEM factory is authorised to use the IP rights of the commissioner. This should include the use of designs, patents, trade marks and know-how. A monetary penalty for violation of the IP restrictions mentioned in the contract is often the best way to mitigate risks and can prevent the circulation of counterfeit or unauthorised products which ruin your brand reputation and credibility.

- IP flaw guarantees

As Chinese factories’ engagement with foreign firms grows, awareness of the importance of IP protection among these factories develops in turn. Protecting themselves from joint liabilities for potential IP infringement caused due to issues with the IP rights provided by a contracting SME is a very valid concern for these OEM factories. OEM are likely to ask for documents proving your ownership of relevant IP in both China and the goods’ destination country and might ask to include clauses regarding liabilities and compensation responsibilities when IP infringement occurs in the OEM contract.

- IP enforcement

In China, the licensee is considered an “interested party” and, as such, allowed to take action against infringers. Your agreement may specify that the OEM factory has a duty or right to survey the market and to take whatever actions are necessary. However, in an OEM relationship where all the products are exported, OEM factories are often not sufficiently proactive and may not monitor the domestic market for infringement.
• Termination of the contract

Termination of the contract is a key consideration. The contract must provide post-termination obligations, particularly in relation to inventory liability, continuity of supply, and records retention.

For example, tooling disputes are among the most common sources of contention in manufacturing agreements. Manufacturers commonly refuse to return tooling unless compelled to by, for example, a significant lump sum penalty for such a refusal.

• Arbitration vs. domestic courts

To resolve disputes between the commissioner and OEM factories, the parties have the choice between local courts or arbitration. To ensure that neutrality will be fully respected, SMEs are advised to choose arbitration. Arbitration centres used could be either abroad or in China.

China now has arbitration centres capable of guaranteeing a fair arbitration trial, such as the China International Economic and Trade Arbitration Commission (http://www.cietac.org/index.cms) or the Shanghai International Arbitration Commission (http://www.shiac.org/English/).

The parties involved may also agree on an arbitration centre located outside of China without legal issues as China is a member of the New York Convention and arbitration awards granted by foreign arbitration centres are enforceable in China. For example, the World Intellectual Property Organisation (WIPO) operates an Arbitration and Mediation Center for IP disputes (http://www.wipo.int/amc/en/center/background.html).

• Language of the contract

The Chinese-language version of your NNN agreement should be adopted as the official version of the agreement and the version which will be used to resolve any disputes. Though it may seem counterintuitive, this stipulation can greatly augment IP protection. As long as the version is prepared by trustworthy legal counsel with adequate Chinese skills, it can be relied on to accurately reflect the SME’s wishes. An English translation of the contract should be provided to the SME to ensure that the contract is acceptable. The greatest value of writing contracts in Chinese is that doing so creates tighter obligations on the Chinese manufacturer. With a Chinese-language contract, the manufacturer cannot argue that wording was unclear or deceptive. Furthermore, with a Chinese-language contract, Chinese courts will not have a chance to use their own translators (and their concomitant, widely varying grasp of English) to misrepresent the contract.
To reduce production costs, a European footwear company selected a Chinese OEM factory to produce components for them. The OEM contract was originally drafted in English, but at the Chinese side’s insistence they signed both the English and the Chinese contract in rush. Per the contract, the product should be in compliance with certain technical specifications provided by the European company and should bear the European company’s brand, which has been registered in Europe for years but not yet in China.

Less than one month after the delivery of products that should be installed in the final client’s facilities, the European company started to receive complaints from its clients about defective products. The European company decided to seek compensation from the OEM factory based on the product guarantee provided in the contract. In the English version of the contract, the guarantee was granted worldwide, but in the Chinese version, the guarantee was only granted for use in China. This difference shocked the European company, which had never considered that the two versions of the contract might differ. The firm tried to stick to the English version of the contract to support their claim. Unfortunately, the language clause of the contract was very clear, stating that in case of discrepancies between the two versions, the Chinese version should prevail. Thus, the guarantee did not cover the sale of products outside the Chinese territory and the European company had to bear a loss of millions of euros.

Afterwards, when the company tried to find a new OEM factory to commission the same product, they found that their trade mark had been registered in China by the first OEM factory. After consultation with professionals, the European firm filed for cancellation of the Chinese registration on grounds of bad-faith (as the Chinese OEM definitely knew the existence of the concerned trade mark by signing the OEM contract). In this case, the invalidation procedure was successful, but it took the company several months to start production, which required significant resources and which ended with a trade mark registration anyways.

**IP lessons learnt**

- File a trade mark (and other applicable IPR) registration in China as early as possible, even if all the OEM products will be transferred to outside China.

- Do due diligence with your potential partners to help mitigate further liability risks.

- Make sure translations of the OEM contract and other important documents are prepared or reviewed by professionals and identical to the English version.
Take-away messages

• Before even considering having products manufactured by OEM in China, conduct a full search about the protection of intellectual property rights attached to the products.

• File trade marks early (e.g. before entering into negotiations or attending fairs) and in both your language and Chinese. File designs and/or patents before entering negotiations with factories.

• Watch out for counterfeiters – the fact that you may not (yet) sell your products in China does not protect you from infringing activities.

Related Links

China IPR SME Helpdesk guides

Design patent guide

Guide to Patent Protection in China

Guide to Trade Mark Protection in China

Guide to Copyrights in China
http://www.china-iprhelpdesk.eu/sites/all/docs/publications/EN_Copyright_guide_Aug_2010.pdf

Enforcement of Intellectual Property Rights in China

Guide to Using Contracts to Protect your Intellectual Property Rights in China

Guide to Using Customs to Protect Your IPR in China
http://www.china-iprhelpdesk.eu/sites/all/docs/publications/Customs.pdf

External References

中国制造2025 (zhongguo zhizao 2025): Made in China 2025:
http://www.chinadaily.com.cn/opinion/2015-03/10/content_19764324.htm
The China IPR SME Helpdesk provides free, confidential, business-focused advice relating to China IPR to European Small and Medium Enterprises (SMEs).

**Helpdesk Enquiry Service:** Submit further questions to the Helpdesk via phone, email (question@china-iprhelpdesk.eu) or in person and receive free and confidential first-line advice within three working days from a China IP expert.

**Training:** The Helpdesk arranges training on China IPR protection and enforcement across Europe and China, including Hong Kong, Macao and Taiwan, tailored to the needs of SMEs.

**Materials:** Helpdesk business-focused guides and training materials on China IPR issues are all downloadable from the online portal.

**Online Services:** Our multi-lingual online portal (www.china-iprhelpdesk.eu) provides easy access to Helpdesk guides, case studies, E-learning modules, event information and webinars.

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