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Licensing Your Brand in China: Guidelines for Brand Owners

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China is widely recognized as a promising licensing market for brand owners due to the rapid growth in its economy. According to China's National Bureau of Statistics, total retail sales of consumer goods in 2013 was approximately \$3.8 trillion USD (23.7 trillion CNY), a 13.1 percent increase over 2012. Licensed goods sales in China increased at the second highest rate of any country in the world in 2014, swelling by 8 percent.¹ Consumer spending has more than doubled since 2009 and, although it has slowed a bit in 2015, is still growing at a robust pace.² China's urban population growth also will continue to help fuel domestic consumption; it is anticipated to grow from 572 million people in 2005 to over one billion by 2030, of which half are estimated to be in the middle class.³ The rapid growth in consumer spending and the trend toward urbanization make China ripe for brand-driven marketing. To take advantage of China's dynamic and relatively untapped market, brand owners should consider protecting their brands in China and devising brand licensing strategies to target the unique Chinese market.

The potential for brand expansion in China has triggered China's development, implementation, and

execution of a system to protect intellectual property (IP) rights. As a member of the Paris Convention⁴ and the World Trade Organization (WTO), China has strengthened its obligations to the international IP community by signing treaties such as the Agreement on Trade-Related Aspects of Intellectual Property (TRIPS Agreement).⁵ In 2013, the National People's Congress passed amendments to China's trademark law, streamlining the application and appeal procedures and including provisions to combat trademark squatting, require good faith in trademark applications, and expand trademark protection to sound marks.⁶ This recognition for IP reform and protection has contributed to significant growth of China's IP system. The 1.88 million trademark filings in China in 2013 accounted for 26.7 percent of those filed in the world, nearly quadrupling the count in the United States.⁷

Despite the growth of its IP system, China still endures harsh criticism for the endemic and culturally accepted counterfeiting activities that occur within its borders, the high-threshold requirements for criminal prosecution for trademark and copyright infringement,⁸ and restrictions on market access for foreign companies. The US Trade Representative, which placed China on its Priority Watch List again in 2014, expressed concern over China's continued inadequate IP infringement enforcement, especially in the online marketplace.⁹

This article discusses ways that brand owners can take preemptive action to address the unique Chinese market conditions, explore what brand owners should consider when launching and licensing a brand in China, suggest steps brand owners should take to avoid common problems faced in China, and describe the state of brand enforcement in China and the ability brand owners have to protect the goodwill and reputation of their brands in China.

Brand Owner Concerns in China

Market conditions in China pose unique problems for companies seeking to enter the country's

marketplace. Disputes between brand owners and their Chinese licensees can be especially challenging due to cultural differences and the distance between China and many regions around the world. When launching and licensing a brand in China, brand owners should proactively identify any red flags before entering a relationship with a Chinese licensee. At minimum, the foreign brand owner should:

- Research the state of the intellectual property rights in their specific industry;
- Research the history of any potential licensee;
- Be cognizant of cultural differences;
- Strategically register the trademark in China;
- Conduct face-to-face contract negotiations and utilize a translator;
- Travel to China before problems arise, and certainly after they arise;
- Periodically return to China to ensure the terms of any license agreement are being fulfilled; and
- Establish a continuous presence in China to show that you are invested in your licensing outcome in China.

Protecting Brands in China

The China Trademark Office (CTMO) awards trademark registrations on a first-to-file basis. Before embarking on any brand extension to China, a company should find out if the brand name is eligible for trademark protection in China. Best practice is to register the mark in both English and Chinese variants. Similar sounding marks, translations, and transliterations (using the Chinese *pinyin* system) also can be filed as a defensive measure.¹⁰ However, care must be used in selecting a Chinese version of an English language mark, because there often are multiple ways to translate English words into Chinese with subtle connotative differences, and transliterations might have unintended negative meanings. In addition, if a license will extend to Hong Kong and Macau, brand owners should understand that although such territories are part of China, both maintain separate autonomous legal systems and separate trademark registries, and therefore registration should be considered in both jurisdictions as well as Mainland China. A further consideration is that there are two forms of the written Chinese language: (1) “simplified” and (2) “traditional.” Simplified characters generally are used in Mainland China, Singapore, and Malaysia, while traditional characters generally are used in Hong Kong, Macau, and Taiwan. Therefore, brand owners should register their marks in the form in which it will be used in

each territory. Given these linguistic complexities, it is advisable to always consult with native Chinese trademark counsel at the initial stages of selecting a Chinese mark and securing trademark protection. Other steps brand owners may take to ensure the proper registration and protection of a mark in China include:

- Monitoring the trademark registry in China for similar mark filings;
- Filing oppositions against similar trademark applications;
- Filing cancellation proceedings against similar registered trademarks;
- Recording trademark registrations with Chinese Customs; and
- Monitoring the Internet for potential unauthorized trademark use and/or sale of infringing domain names and pirated products in China and taking appropriate action when such actions are detected.¹¹

Key Licensing Provisions

Brand owners often encounter problems in China that are associated with counterfeiting, improper use of child labor, and use of low quality materials/shoddy construction. In an effort to prevent these problems, brand owners should focus on thorough and effective license provisions that address quality control, manufacturing, and enforcement. Note that a non-Chinese registrant must abide by the Chinese Trademark Licensing Contract Recordal Procedures (TLCRP). The TLCRP requires that a license be recorded with the CTMO before payments can be made to the licensor.

Quality Control

Brand owners generally contract with Chinese manufacturers, retailers, and distributors to launch their brands in China because the cost of labor and materials is low, and these local entities generally know the Chinese marketplace better than foreign brand owners. Yet it is advisable that brand owners routinely monitor and control the quality of all products sold under their brand. In China, this is especially important because in recent years there have been several cases requiring the recall of Chinese manufactured products because they posed health and safety hazards.¹² In addition, Chinese vendors sometimes substitute cheaper materials, subcontract to third parties without the licensor’s knowledge, or sell unauthorized quantities “out the back door.” Often these subcontractors subsequently are untraceable or not legally liable for use of poor

quality materials.¹³ As a result, brand owners should incorporate strict quality control provisions when licensing the manufacturing and sale of branded goods in China. Below is a list of suggested terms for a quality control license provision:

- Require acknowledgement of licensor's existing quality control standards and a covenant to maintain those standards in the future.
- Retain approval rights prior to, during, and after manufacturing, sale and use, as well as for channels of distribution, quality control checks, advertising, and marketing of licensed products.
- Require approval of pre-production samples and post-production samples.
- Specify the grade and quality of materials to be used.
- Specify when licensee should submit all samples, to whom they should be submitted, and by when approval will be given.
- Reserve the right to periodically inspect, audit, and monitor locations, products, supplies, sources, methods, and/or practices.
- Reserve the right to require the licensee to recall any/all products if they do not meet requirements in the license agreement.
- Reserve the option to terminate the agreement in the event of material breach of quality standards.
- Explicitly agree to a calculation for liquidated damages in the event of a quality standards breach.
- Reserve the right to monitor the licensee's sales activity and distribution, including Internet activity.

Manufacturing

Because foreign companies have come to expect low prices when manufacturing goods in China, Chinese factory owners are caught between maximizing revenue and enduring the margin squeeze of increasing costs.¹⁴ As a result, Chinese factories sometimes recruit underage laborers and fail to maintain proper safety and working conditions in their factories. Such practices, if they become publicly reported, can cause significant reputational harm to your brand. To avoid these practices, brand owners should clearly define the expected "standards of manufacturing" and require that the licensee abide by these standards. Brand owners should emphasize: (1) the brand owner's commitment to producing high quality goods, and (2) a licensee and/or third party manufacturer's responsibility to observe all international, national, and local laws and regulations. Specifically, the license agreement should include provisions that:

- Reserve the right to disapprove of any/all products not complying with the "standards of manufacturing," even if previously approved;
- Reserve the right to review employee complaints;
- Require that products meet or exceed the industry's highest quality standards and specifications for products similar to the licensed products that are sold in the same distribution channels;
- Require licensee to report inventory and sales quantities on a monthly, quarterly, and annual basis;
- Require that all manufacturing be in accordance with any and all applicable laws, rules, and regulations, including but not limited to product safety laws, human rights laws, child labor laws, and health and safety laws;
- Reserve the right to inspect the factory at which the products are being made at any given point in the production and distribution process; and
- Require that remedial action be taken for any breach of the foregoing provisions, and if none is taken, that the license may be terminated.

Term

A Chinese trademark registration is only valid for a period of 10 years. For recordal purposes, the term of a license agreement may not exceed the term of the trademark registrations against which it is to be recorded. Many license agreements, however, contemplate a term either significantly longer than 10 years or beyond the end of the registration period.

One way to handle this issue is to have a master license agreement that includes the full term, with a short-form confirmatory agreement executed and recorded at the time of initial licensing and at the renewal of each relevant registration. To protect the licensor in the event of non-renewal of the registration or cancellation, a license agreement should provide that:

- Licensor will undertake commercially reasonable efforts to maintain registration of the licensed marks;
- Licensor's failure to obtain renewal or extended protection, or inability to maintain protection for any licensed mark for a reason outside of licensor's control shall not be a breach; and
- Licensee will have no recourse against licensor for such a failure.

Another option is to structure the deal in multiple, automatic renewal terms. For example, the first term would expire at the end of the current registration period and, as long as the trademark registration is

renewed, the agreement would automatically renew for a period of 10 years, a process that could be repeated for the entirety of the desired term of the contract.

Payment

The complicated regulatory environment in China can mean that there is a delay between the date a license agreement is signed and the date the agreement is recorded in the CTMO. During that delay, some licensee payments may become due, and a licensee may be hesitant to pay without the appropriate license recordals. The Chinese government has made it increasingly difficult for non-Chinese brand owners to receive royalty and other license payments prior to the recordal of the license in the CTMO. One way to ensure continued timely payment is to arrange for the licensee payments to be held in escrow by a China bank until the new license agreement is officially recorded with the CTMO. The arrangement should include provisions for:

- The creation of a bank account under the exclusive control of the licensee and a licensor-trusted third party entity in China (*e.g.*, a local China law firm);
- Payments from licensee deposited in the bank account during the time between the effective date of the agreement and the recordal at the CTMO shall be released to the licensor upon said recordal; and
- The immediate termination of the agreement upon failure of licensee to pay the appropriate amounts to the China bank account in a timely fashion.

There should also be a provision ensuring the timely payment by licensee of the relevant royalty taxes required in China, as delay could slow the payment of the royalty to licensor.

Enforcement

China's inadequate enforcement of trademark and other IP rights is a key concern in deciding whether to expand in China through a licensee. To manage these concerns, brand owners must craft strong enforcement provisions that will facilitate resolution of disputes in a reasonable and fair manner. Choice of law provisions in the licensing agreement are important to overcoming uncertainty when seeking relief for a breach of a license. There are limitations in Chinese law regarding the brand owner's ability to enforce choice of law provisions against violators in China. For example, public policy laws, such as the

Chinese anti-monopoly law, often supersede choice of law provisions.¹⁵ Indeed, even if the parties agree to have all disputes adjudicated under US law in US courts, there is no guarantee that the Chinese courts will enforce any orders or judgments rendered by a US court against a Chinese national.

Accordingly, brand owners in China should consider including arbitration provisions in a license with a Chinese entity doing business in China. The New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention),¹⁶ which China recognizes and has signed, has made enforcing arbitral awards more likely in China than an order issued by a US court. The New York Convention requires contracting countries to enforce arbitration awards entered in other territories and mandates recognition of written arbitration agreements. The arbitration provision in a license should specify the following:

- That the parties consent to applying the brand owners local law or some other neutral state or country law to govern all disputes in order to avoid the uncertainty of China law;
- That arbitration is the mandated form of dispute resolution;
- The location for resolution, *e.g.*, the brand owner's place of business, or some other neutral location such as New York, Los Angeles, Hong Kong, or Singapore;
- The specific arbitration body to be used, *e.g.*, American Arbitration Association (AAA) or the International Chamber of Commerce (ICC);
- The specific rules under the arbitration body chosen, *e.g.*, under the AAA, the International Arbitration and Mediation Rules;
- A time limit for the completion of arbitration proceedings, *e.g.*, six months; and
- The type of relief the arbitrators shall have the power to award, *e.g.*, damages, injunctive relief, preliminary relief, temporary restraining orders, reasonable attorney fees, etc.

Arbitration clauses in licensing agreements often are a central issue in negotiating licensing terms. Therefore, it is important to choose a neutral arbitration institution and also to be aware of Chinese law addressing arbitration.¹⁷

Conclusion

There is no magic formula for launching and licensing a brand in China. There have been

significant improvements in China's willingness and ability to protect IP rights, but the implementation and execution of its laws are not without flaws and pitfalls. With that in mind, brand owners looking to expand in China must take the

time to investigate prospective business partners in China, understand the Chinese culture, and draft enforceable license agreements that address potential problems with Chinese licensees before they arise.

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4. Paris Convention for the Protection of Intellectual Property, Mar. 20, 1883, 21 U.S.T. 1583, 828 U.N.T.S. 305 [hereinafter Paris Convention], available at <http://www.wipo.int/treaties/en/ip/paris/>. The treaty has been amended several times (most recently in 1979).
5. Agreement on Trade-Related Aspects of Intellectual Property Rights, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, Legal Instruments—Results of the Uruguay Round, Part II, Section 5, Apr. 15, 1994, 1869 U.N.T.S. 299, 33 I.L.M. 1125, 1197 [hereinafter TRIPS Agreement], available at http://www.wto.org/english/docs_e/legal_e/27-trips.pdf.
6. United States Trade Organization Special 301 Report (2014), available at <https://ustr.gov/sites/default/files/USTR%202014%20Special%20301%20Report%20to%20Congress%20FINAL.pdf>.
7. "Global Intellectual Property Filings Up in 2013, China Drives Patent Application Growth," World Intellectual Property Organization, Dec. 16, 2014, available at http://www.wipo.int/pressroom/en/articles/2014/article_0018.html.
8. Hennessey, *supra* n.3 (citing David Lague, "U.S. Presses Chinese on Piracy," *Int'l Herald Trib.*, Nov. 15, 2006, at 15 ("The estimated loss that a US business faces as a result of the rampant counterfeiting in China was estimated at approximately \$2.3 billion a year in 2006").
9. United States Trade Organization Special 301 Report (2014), *supra* n.6 at 34.
10. See Elizabeth Chien-Hale, "Doing Business in China: Resolving the Challenges in Today's Environment, Institute for Intellectual Property in Asia," *Corporate Law and Practice Course Handbook Series* (2007).
11. See Justin Pierce, "Trademark Enforcement in China," *INTA Annual Meeting* (2010).
12. See Julia A. Phillips, "Does 'Made in China' Translate to 'Watch Out' for Consumers? The U.S. Congressional response to Consumer Product Safety Concerns," *Penn St. Int'l L. Rev.* (2008).
13. Harry Rubin, "Outsourcing to China: Risk Management and Strategies," *The Licensing Journal*, Nov./Dec. 2009, at 8.
14. David Barboza, "Child Labor Rings Reach China's Distant Villages," *NY Times*, May 10, 2009 available at <http://www.nytimes.com/2008/05/10/world/asia/10CHINA.html>.
15. Rubin, *supra* n.13 at 8.
16. Convention on the Recognition and Enforcement of Foreign Arbitral Awards, Jun. 10, 1958, 330 UNTS 38, 21 UST 2517, 7 ILM 1046 [hereinafter New York Convention], available at http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html.
17. See Jian Zhou, "Judicial Intervention in International Arbitration: A Comparative Study of the Scope of the New York Convention in U.S. and Chinese Courts," 17 *Pac. Rim L. Pol'y J.* 41, 46 (2006) (Article 260 of China's 1991 Civil Procedure Law provides criteria, that if present, allow Chinese Courts to invalidate foreign arbitration awards).

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