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By Merritt R. Blakeslee

Sourcing Your Products From China...

...Without Losing Your Shirt, Your Intellectual Property or Your Customers—Part I



■ A useful way to approach this issue is to categorize the risks of sourcing from China that differ from the risks of doing business with a U.S. supplier.

There is a saying about sourcing from China: Anything is possible, but everything is difficult. This article, the first in a two-part series, discusses some of the difficulties of sourcing from China and offers a set of strategies for dealing with them.

This series will consider problems confronted by a U.S.-based company supplying the automotive aftermarket in the United States that wishes to source products from China on an ongoing basis, including how to find a suitable Chinese supplier; how to build a productive and durable relationship; how to prevent problems in your relationship with your supplier; and how to protect your intellectual property rights and your customers. (As you will see, the issues raised are applicable to many other countries beyond China.)

What Can Go Wrong: Nightmare Scenarios

Before talking about how to get it right, let's first discuss what can go wrong. Here are three nightmare scenarios that you should keep in mind if you intend to begin sourcing

your products from China.

Nightmare 1: Company A carefully selects a Chinese manufacturer to produce its product, which contains proprietary software or other proprietary technology. Without Company A's authorization, the Chinese manufacturer copies the technology and uses it to manufacture products that compete with those of Company A. As a result, Company A loses its competitive edge and substantial market share to low-priced counterfeits produced using the misappropriated technology.

Nightmare 2: Company B sells high-performance aftermarket wheels, which it sources from a supplier in China. As with most products sold in our industry, these wheels are safety critical. A wheel bearing Company B's name breaks, causing a fatal accident in the United States, and B is sued

for product liability. Company B inspects the defective wheel and suspects that it was not an authorized product but cannot be sure since it does not mark its products in a way that would permit it to identify counterfeits. Ultimately, Company B must defend a product liability suit and do an expensive product recall. It believes, but can never prove, that its supplier was doing "midnight runs"—making unauthorized production runs of its product with relaxed quality controls—and selling the unauthorized products into the United States market. The fatal accident, the lawsuit and the product recall were the result.

Nightmare 3: Company C sources fully finished and packaged products from China. It has its supplier drop-ship these products directly to C's customers in the United States. After a few months, C finds its orders declining. Upon investigation, it discovers that one of its largest customers is buying directly from the Chinese supplier, which is supplying Company C's products under a different brand name.

What Are the Risks of Sourcing Your Products From China?

A useful way to approach this issue is to categorize the risks of sourcing from China that differ from the risks of doing business with a U.S. supplier. Let's divide these into background and specific risk factors.

Background risk factors include:

- Information deficit
- Language
- Distance and logistical risks associated with transnational transactions
- Time and calendar differences
- An absence of U.S. and U.S.-type legal remedies
- Currency exchange risks
- Geopolitical risk

The four specific types of risks that come with sourcing from abroad are:

- Risks associated with your relationship

with your Chinese supplier (quality, delivery, payment, etc.)

- The risk that the integrity of the supply chain for your products will be compromised
- The risk that your company's intellectual property will be misappropriated
- The risk that your customers will be stolen

Managing Risks in the Relationship With Your Chinese Supplier

You already have a relationship with a supplier or suppliers in the United States, whether you manufacture in-house or purchase your products fully or partly finished. In large measure, the issues—quality, delivery and payment—you will face with a Chinese supplier are the same as with a U.S. supplier and the solutions are the same. This article discusses techniques for minimizing and managing the risks specific to doing business with a Chinese supplier.

Finding a Reliable Supplier

The first and most fundamental risk of sourcing from China flows from your lack of information about the Chinese industry where you wish to place your manufacturing. While you should be able to identify reliable suppliers of quality products in the United States, it is unlikely that you will have the same level of expertise concerning your Chinese suppliers. Thus, the first challenge is to find a reliable supplier.

It is recommended that you get professional help with your search to overcome the information deficit. There are many search services—called match-making agencies—that work in China to assist foreign purchasers in locating a suitable manufacturer. However, many of these agencies work for the suppliers, much in the same way that a real estate agent in the United States works for the home seller, not for the buyer.

The challenge is to find an agency that is rigorously independent. Organizations, such as the U.S.-China Business Council, the American Chambers of Commerce in China and the Department of Commerce's Foreign Commercial Service, assist U.S. companies doing business in China, and they are a good starting point for locating a reliable search agency. Once you have selected a prospective supplier or suppliers, you should go through the normal qualification process that you would use with a U.S. supplier.

In addition to the considerations that would govern the selection of a supplier in the United States—capacity, capability, core competence, size, design capability (do they have the ability to adapt your designs to their manufacturing processes) and quality certifications—here are two more considerations that should factor into your selection of a Chinese supplier.

Look for a supplier that has prior experience with exporting—particularly experience with exporting to the West. By selecting such a supplier, you have some assurance that the company understands the supply-chain and logistics issues associated with supplying a foreign purchaser and, more important, that it has some experience in meeting the demands of a Western customer.

Language is also a background risk factor. It is not true in China, as it is in some other parts of the world, that “there is nothing to worry about because everybody speaks English.” Some Chinese manufacturers hire young English-speakers fresh out of university to interact with their U.S. customers. These young people effectively become the project managers in charge of your relationship with the supplier. Frequently, however, they lack technical knowledge and experience; their sole expertise lies in speaking English.

This is a recipe for trouble. You should consider carefully whether you want to begin a relationship with a company where you cannot communicate directly in English (a) with the managers, with whom you will have to work to solve delivery and relationship problems, and (b) with the engineering department, with whom you will have to work to solve technical and quality-related issues. Most people will tell you that it is impractical to try to work through an interpreter. Thus, you may want to make English-language competence on the part of key personnel a requirement in selecting a supplier.

General Techniques for Managing Risk

Most risks in your relationship with your supplier can be minimized by reliance on a combination of the following:

- A well-drawn contract
- Ongoing onsite inspections
- Payment terms that shift the risk of non-performance to the supplier
- Use of multiple suppliers

A significant background risk factor of sourcing from China is the absence of reliable

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■ In large measure, the issues—quality, delivery and payment—you will face with a Chinese supplier are the same as with a U.S. supplier and the solutions are the same.

legal remedies if things go badly. If your supplier lets you down in the United States, your ultimate remedy is the U.S. court system. But with a Chinese supplier, several things are different. Unless the Chinese supplier has a presence in the United States, even if you sue and win in a U.S. court of law, it is probable that you will be unable to collect a judgment—either in the United States, where the defendant has no assets, or in China, where the courts and the authorities will not assist you in enforcing a monetary judgment obtained in the United States.

It is, of course, possible to sue in a Chinese court, but this carries with it a different set of difficulties. You will need reliable Chinese counsel, and the uncertainty as to the outcome that is always a fact in U.S. litigation is even greater in China where the legal system is still developing. Moreover, even if you win, the enforcement mechanisms in China are weak. In short, obtaining a satisfactory litigated solution to problems with your supplier is even more uncertain in China than in the United States, and an important goal of the four techniques mentioned above is avoiding the need to resort to litigation against your supplier.

A Well-Drawn Contract

A carefully thought-out and drafted contract can provide the basis for a long, productive relationship with your supplier. Think through the problems that could arise—including those discussed in this article—and provide solutions to those potential problems in the contract. Think of the contract first and foremost as a blueprint for a harmonious

relationship with your supplier. In addition, however, your contract should be an airtight legal document that can be enforced in a Chinese (or U.S.) court if you have no other alternative but to sue your supplier.

Inspection Service

There are many independent, reliable companies in China that will inspect the goods you are purchasing during the manufacturing process and/or prior to shipment, and it is recommended that you use one. Ideally, the inspection should be done in the factory, and your contract should give your inspector unfettered, around-the-clock access to your supplier's facility. Not only will a competent inspection service identify quality problems before the goods are shipped, but it can also alert you to upcoming delivery problems and possibly detect diversion of your product or misappropriation of your intellectual property.

Payment Mechanisms

Chinese companies often do business on the basis of letters of credit. However, where you pay for your merchandise with a letter of credit at the time you take delivery in China is where you bear the risk of receiving non-compliant goods unless the letter of credit contains an inspection provision. Moreover, letters of credit are expensive. Trouble with quality and other problems that can arise in the relationship with your supplier are managed more effectively if you negotiate payment terms that protect you against quality and delivery problems. Such payment terms can include: (a) a delayed payment term,

where you are not required to make payment until 30 or 60 days after delivery, allowing you time to identify quality problems; (b) a non-payment term, in the event of severe problems with the merchandise; and (c) a reserve in the initial payment specifically to cover potential warranty problems that do not appear within the payment period. Moreover, your supplier has an incentive to agree to such terms in order to build a durable, productive relationship with you.

Use of Multiple Suppliers

Using more than one supplier carries obvious problems: Do you have enough demand? Are you sacrificing buying power by splitting your order? Are you unnecessarily complicating your operations?

On the other hand, supplier redundancy can confer important benefits: It can protect you against quality, delivery and capacity problems. It ensures that you are not hostage to a single supplier. It may actually help you in negotiating price.

Managing the Risk of Receiving Non-Conforming Goods

Quality is the single most important issue in the supplier relationship. We have already discussed using a match-making service to locate a reliable supplier, using an inspection service to catch quality problems at the production stage and using payment terms that give you the recourse of withholding payment where quality problems arise. Another vital element in ensuring quality is the use of production-process documentation that spells out for you and your supplier, at the beginning of the relationship, all the steps that he or she will follow in manufacturing your products. This may be the single most important technique for creating successful production runs.

Finally, your contract should spell out warranty terms and provide a detailed understanding of how quality defects will be handled by your supplier.

Managing the Risk of Delivery and Customs Problems

Delivery problems can be divided into two types: those that are the fault of the supplier and those that are not.

Contract provisions specifying a penalty for late delivery and requiring rush delivery by air at the supplier's expense when the

goods would otherwise be late if delivered by ocean freight, place the risk of late delivery on the supplier; it is wise to include such provisions in your contract with your supplier.

But what about those background risk factors that are outside the control of the supplier? Most goods from China are shipped to the United States by ocean freight. Transportation by ship from China to the United States adds about five weeks on top of the normal manufacturing lead time. In addition to sheer distance, there are the twin risks of weather-related delays and of bottlenecks at the ports of lading and unloading.

To guard against these hazards, you should consider maintaining safety inventories in the United States, with the additional cost that it entails. You should also be prepared to make emergency shipments by air at your own expense when your goods are delayed in transit for reasons that are not the fault of your supplier.

A related but different risk of delay arises from the fact that your Chinese-origin goods are subject to the U.S. Customs laws when they enter the United States. You should hire a competent Customs broker and, when necessary, a good Customs attorney to ensure that your products are not delayed in Customs and to take quick, competent action if they are.

Avoid the temptation to use a Chinese freight forwarder as your U.S. Customs broker, even though that may be less expensive in the short term. This is an invitation to problems with Customs. If possible, use one—and only one—U.S.-based Customs broker and work closely with him or her to ensure that your goods are correctly classified and documented to avoid Customs problems. This will help you to avoid overpaying Customs duties and thereby losing money or underpaying Customs duties, thereby placing yourself at risk that you will be on the receiving end of a Customs enforcement action.

Managing the Problems Associated With Time and Calendar Differences

One very practical problem that you must solve is coordinating a work schedule with your supplier in the face of time differences and very different national holidays. Unlike many western factories, where the holiday schedules are staggered to maintain

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operations, factories in China often close completely during holidays to allow workers to be at home with their families. Moreover, most American holidays do not overlap with Chinese holidays.

Time differences add to the difficulty of communicating and coordinating with your supplier. Where there is a 12-hour time difference between you and your supplier (the difference, for example, between Detroit and Shanghai), there is never a time when the business hours of your company and your supplier's overlap. Moreover, leaving aside the time difference, there is only a three-day overlap in the five-day business week. When it is 7:00 a.m. on Friday morning in the United States, it is 7:00 p.m. in Shanghai and the business week (if it ends on Friday) is already over. By the time the U.S. company opens for business on Monday morning, it is already Monday evening in Shanghai. Thus, you will have to find practical means of maintaining good communications with your supplier and of ensuring that your delivery schedule is not disrupted by Chinese holidays. Your contract with your supplier should lay out how these problems will be addressed.

Managing the Risk of Currency Fluctuation

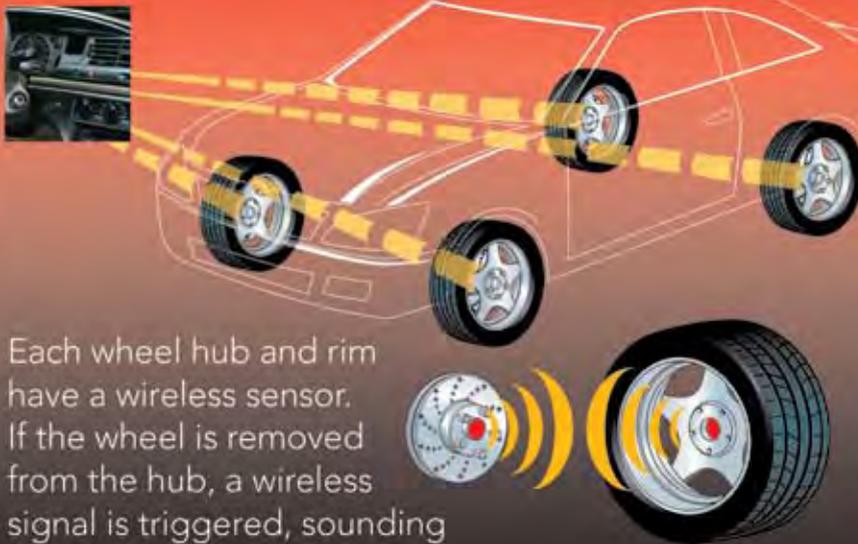
Whenever a U.S. company purchases abroad, currency risk is an issue. In the short term, the risk of currency fluctuation can be shifted to your supplier by doing business in dollars. This means that it is your supplier that will have to absorb these fluctuations if the exchange rate between the dollar and the yuan fluctuates. But this arrangement protects you only as long as the effect of the fluctuations does not become intolerable for your supplier. If it does, your supplier will insist on renegotiating prices.

A contract provision could provide that the price will not change if the input cost rises or falls by a certain percentage. If the cost goes outside the agreed-upon band, then the price will be raised or lowered by an agreed-upon percentage. (You can use the same technique to provide for spikes in the cost of inputs not related to currency fluctuation—for example, changes in the price of copper or steel.)

The currency risk in China is magnified by geopolitical risk. As you know, China is under intense pressure from the international community to revalue its currency upward. From your point of view, this means that

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there is a risk that the yuan will be revalued upward at some time in the future and the products that you have been purchasing at an attractive price will suddenly cost more in dollars, even though the price in yuan remains unchanged. By using more than one supplier, and by ensuring that at least one of your suppliers is not located in China, you minimize the geopolitical risks specific to sourcing from China.

Use of a Non-Compete Provision

Finally, you may also want to obtain assurances that your supplier is not selling to your competitors and to include a provision in your contract that it will not do so in the future.

Part II of this article will appear in a future issue of *SEMA News*.

RESOURCES

- The U.S.-China Business Council:
www.uschina.org
- Embassy of the United States Beijing/China IPR Toolkit—Intellectual Property Rights in China:
<http://beijing.usembassy-china.org.cn/ipr.html>
- U.S. Department of Commerce Office of China Economic Area Intellectual Property Rights In China Webinar Series: http://www.stopfakes.gov/events/china_webinar_series.asp
- The American Chambers of Commerce People's Republic of China:
www.amcham-china.org.cn

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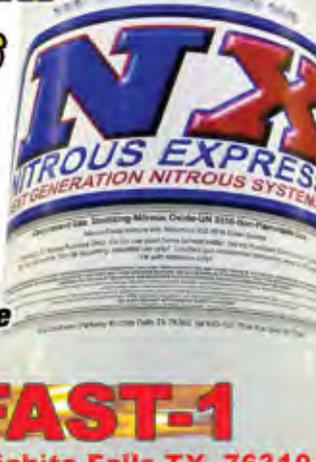
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By Merritt R. Blakeslee

Sourcing Your Products From China...

...Without Losing Your Shirt, Your Intellectual Property or Your Customers, Part II



This is the second in a two-part series on issues to consider when sourcing products from China (and other countries). See Part I in the *SEMA News* December 2007 issue, which outlined the risks specific to sourcing from a Chinese supplier and offered techniques for minimizing and managing them.

Safeguarding Your Intellectual Property Against Misappropriation by Your Supplier or Others

A. Preventing the Theft of Your Intellectual Property

When sourcing from a Chinese supplier, you must take steps to protect your intel-

lectual property: the trademarks with which your products are branded; the copyrighted materials in your product instructions, marketing materials and software; the patents on the technology incorporated into or used to manufacture your products; and any trade secrets covering your manufacturing processes. Here, the best offense is a good defense.

It is important to understand that your intellectual property is at risk whether or not you turn it over to your Chinese supplier. Chinese manufacturers routinely reverse-engineer and copy products that they obtain on the open market. Here are some tips on how to manage the heightened risks to your intellectual property that go with sourcing from a Chinese supplier.

1. Use due diligence in selecting your supplier.

Your search for a reliable supplier (as

■ It goes without saying that you should continually monitor the market for products that violate your intellectual property rights, and that is true whether or not you source in China.

discussed in Part I) should include an intellectual property audit of any prospective supplier to determine what else it is manufacturing, for whom and whether there have been any complaints related to intellectual property and any evidence of unauthorized products being sold in China or the United States. You may wish to run a background check on key personnel.

2. Protect your intellectual property through contractual provisions.

In protecting your intellectual property, prevention is better than enforcement—and prevention begins with well-drawn

contractual documents. Your contract should include a non-disclosure section in which your supplier agrees not to disclose either (a) your company's confidential business information or (b) confidential intellectual property (for example, a trade secret). It should also include language specifying that your supplier does not have a license to use your intellectual property except in connection with products manufactured for and delivered directly to you. In addition, you should work with your supplier to raise his intellectual property awareness. Finally, the use of an inspection agency to monitor the activities of your supplier (as discussed in Part I) is also a safeguard against the theft of your intellectual property. These are prophylactic methods and, like washing your hands to prevent catching a cold, they are necessary but not fool-proof.

3. Hold on to your intellectual property and trade secrets.

If you do not turn your intellectual property over to your Chinese supplier, it makes it more difficult—although not impossible—for your intellectual property to be misappropriated. Some companies source only semi-finished goods from China and add the items critical to intellectual property during final manufacturing in the United States. To protect your patents, you can add the patented component—or perform the patented process—once the product reaches the United States. You can do the same with trade secrets—by using them only in the United States. You can ensure that your trademarks are affixed only in the United States. This may mean that you provide display packaging only in the United States. Final steps to prepare your products for sale—e.g., any proprietary software programming—should be performed in the United States, if possible.

Obviously, this involves significant trade-offs. It may be advantageous or even essential for you to be able to source fully finished and packaged products from the Chinese; that is, after all, why you went to China in the first place. On the other hand, to obtain the greatest possible protection for your intellectual property, you would stay away from China entirely, although, as mentioned, even that does not guarantee that your intellectual property will not be misappropriated. A workable solution lies somewhere between these extremes, and you must decide where to draw that line.



■ With respect to trademarks, you should know that China has a “first-to-file” system that requires no evidence of prior use or ownership, making it legal for an unrelated party to register your trademarks in China.

4. Monitor the market.

It goes without saying that you should continually monitor the market for products that violate your intellectual property rights, and that is true whether or not you source in China. To monitor for intellectual property problems related to your production in China, you should monitor Asian and European trade shows, as well as trade shows in the United States; websites; B2B bulletin boards, such as Alibaba.com; and publications, such as the *China Transportation Equipment Guide*, which is distributed at the SEMA Show and to which you can subscribe.

B. What to do if your intellectual property is stolen.

If your intellectual property is stolen, you have two main choices, and they are not mutually exclusive. One is to take action to bar the importation of infringing merchandise into the United States. The other is to take legal action in China.

Your options for taking action in the United States are: working with the Bureau of Customs and Border Protection and the Bureau of Immigration and Customs Enforcement to prevent importation; filing suit at the International Trade Commission to bar importation; or seeking an injunction against importation in federal district court. All of these remedies are imperfect because

the protection you obtain extends only to the U.S. market. Separate enforcement action is required in other countries where you sell your products.

There are at least three different types of legal action that you can take in China to combat the misappropriation of your intellectual property: requesting enforcement by the local administrative authorities; requesting the Chinese Customs Service to bar the export of the products that infringe your intellectual property; and bringing a civil suit in a Chinese court. It is essential to realize that before you can take any of these three types of action to enforce your intellectual property rights,

Intellectual Property Webinar Available

A discussion of the means of preventing the importation of your misappropriated intellectual property is outside the scope of this article. However, in September 2005, this article's author gave a SEMA webinar entitled, “Why Your Company's Intellectual Property Is a Valuable Asset and What to Do to Protect It From Infringement,” discussing precisely this topic. That webinar can be accessed on the SEMA website at Programs and Services/Education/Webinars (www.sema.org/main/semaorghome.aspx?id=51488).



■ Most U.S. companies that seek enforcement of their intellectual property rights in China file suit in a civil court. China has established specialized intellectual property panels in its civil court system throughout the country.

you must register your intellectual property in China. The Department of Commerce has posted on its website an “IPR Toolkit—Intellectual Property Rights in China” (www.stopfakes.gov) that explains what is involved in registering your intellectual property in China. With respect to trademarks, you should know that China has a “first-to-file” system that requires no evidence of prior use or ownership, making it legal for an unrelated party to register your trademarks in China.

U.S. companies have experienced mixed and often disappointing results in attempting to enforce violations of their intellectual property through the administrative agencies that enforce intellectual property rights in China. On the other hand, Chinese Customs has been effective in preventing the exportation of infringing merchandise, but its effectiveness depends on receiving accurate, timely information from you about the movement of infringing goods—and this is information that you may not possess.

Therefore, most U.S. companies that seek enforcement of their intellectual property rights in China file suit in a civil court. China has established specialized intellectual property panels in its civil court system throughout the country. You could bring a suit for intellectual property infringement—or possibly for breach of contract—and this is the

most effective means of resolving problems but, as noted, it is far from perfect.

Protecting the Integrity of Your Supply Chain—Midnight Runs and How to Avoid Them

A so-called “midnight run” is the unauthorized manufacture of your product by your supplier. The name supposes that the supplier produces your product for you during normal business hours and runs an extra night-time shift to manufacture additional units, which the supplier then sells into the gray market.

This type of unauthorized manufacture of your product does not necessarily involve a violation of your intellectual property rights, although if the manufacturer reproduces your trademarks, copyrighted instructions, software or patented technology, then, in addition to violating your trust—and its contract—the supplier has misappropriated your intellectual property.

Here again, well-drawn contract language and good onsite inspection are the first lines of defense. In addition, two techniques will give you further protection against diversion by your Chinese supplier: withholding or rationing key components that make the product marketable, and ensuring that your products are marked in a way that will permit immediate determination in the field

whether a product with your company’s name on it is authorized or not.

It is a matter of common sense that if you do not entrust your supplier with the responsibility for manufacturing components or products that are salable as is (i.e., without the necessity of further manufacturing), then it is harder for a supplier to sell any unauthorized units of your product that it manufactures without your knowledge. In other words, midnight runs are less of a problem with semi-finished products than with components or fully finished goods. Thus, one defense against midnight runs is to complete the manufacturing process in the United States. This is particularly effective if you withhold a component that is difficult to copy or reproduce.

If your business plan requires full assembly by the supplier, you can still protect yourself by shipping a key component from the United States in carefully regulated quantities. For example, Levi Strauss has the tags for its “401” blue jeans produced in the United States with sophisticated anti-counterfeiting technology, and it carefully ensures that for every tag that it sends to its supplier, it receives a pair of jeans in return. A number of companies in the United States will provide this type of security relatively cheaply.

In addition, it is essential that you ensure that your products are carefully marked—by individual serial number or at least by lot number—so that when you find suspect products in the marketplace, you can immediately determine whether they are products whose manufacture you authorized. The marking should give information on date of production, location of production facility, lot number, etc. Ideally, each unit should bear an individualized mark, and this mark should be readable in the field, i.e., with a handheld scanner. If the wheel manufacturer with the broken wheel and the product liability suit mentioned in Part I had employed this type of marking, he would have been able to show that the broken wheel had been manufactured without his authorization.

Protecting Against the Theft of Your Customers

When your supplier sells your product—or an equivalent product—to entities who have been buying directly from you, the supplier has stolen your customers. Because SEMA members generally supply the automotive aftermarket rather than the OEM

market, theft of customers can be slightly less of a problem because many high-performance aftermarket products are sold on the basis of their brand name and trademarks. Nevertheless, there is a danger of customer theft, particularly where your supplier offers your product with different markings. The rules for protecting against the theft of your customers by your Chinese supplier are common-sense ones:

- Include contract language that prohibits your supplier from selling your product—with or without your markings—to anyone except you.
- Don't have your supplier drop-ship your goods to your customers.
- Don't disclose your customer lists to your supplier.
- Watch for a drop-off in orders from your customers.

RESOURCES

- The U.S.-China Business Council: www.uschina.org
- Embassy of the United States Beijing/China IPR Toolkit—Intellectual Property Rights in China: <http://beijing.usembassy-china.org.cn/ipr.html>
- U.S. Department of Commerce Office of China Economic Area Intellectual Property Rights In China Webinar Series: http://www.stopfakes.gov/events/china_webinar_series.asp
- The American Chambers of Commerce, People's Republic of China: www.amcham-china.org.cn

Merritt R. Blakeslee, a partner in the Washington, D.C. office of deKieffer & Horgan (www.dhllaw.com), has practiced in the field of international law and trade law regulation since 1991. He advises clients on compliance with U.S. and international trade regulations and represents clients before federal agencies and U.S. courts on a wide variety of issues, including the enforcement of U.S. intellectual property rights against imported merchandise, antidumping and countervailing duty proceedings, Customs issues (including proper classification and valuation of imported merchandise) and general commercial transactions. He may be reached at mblakeslee@dhllaw.com.

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