

## CHANGING CHINESE MANUFACTURING TACTICS RAISE CONTRACTUAL CONCERNS WITH FOREIGN BUYERS

APRIL 2018

Changing tactics in the Chinese manufacturing industry could create numerous legal problems for foreign buyers. To protect themselves in this new environment, companies will likely need to revamp their current and future purchase contracts.

### PREVIOUS PRACTICES

Until recently, the process of purchasing goods manufactured in China was relatively simple; the desired products were often referred to as “fungible base products.” This is because neither the purchaser nor the manufacturer had any claim to ownership over the design of the product. Put simply, the manufacturing specifications were standard and would be the same anywhere in the world.

When dealing with such standard products, purchasing parties could ensure quality by requiring the manufacturing to be consistent with industry standards or the buyer’s specifications.

### MANUFACTURING CHANGES

As Chinese manufacturers have become more sophisticated, they have transitioned to using proprietary methods to manufacture original goods and products. This shift to Chinese manufacturers owning their own designs and setting the standards for products creates a host of issues, such as determining specifications, safety and quality standards, intellectual property rights, and marketplace competition.

### CONSIDERATIONS FOR PURCHASING PARTIES

- **Product specifications.** Specification issues can result from the absence of industry standards in proprietary designs and methods. Contracting parties should consider how the specifications will be determined and what standards will be applied to evaluate whether the purchased goods meet or fail to meet these specifications. To ensure uniformity, buyers should require the manufacturer to warrant that the products will be manufactured in accordance with the manufacturer’s stated specifications. This can be accomplished by adding clauses in the sale of goods contract. These clauses should be drafted so that an objective viewer can readily determine what specifications were promised and whether the goods comply.
- **Safety and Quality.** If the manufacturer is using a new or proprietary method for producing a good, the manufacturer controls the manufacturing process. Thus, the buyer may not have a way to assess the safety and quality of the finished good. In this case, the contract should require the manufacturer to warrant that the purchased product meets or exceeds the safety and quality and other regulatory standards established by the law of the country or countries in which a resulting good or assembly will be sold or used.
- **IP Rights.** If a buyer does not perform due diligence to ensure the accuracy of the Chinese manufacturer’s claimed ownership of the design or claim that such design or process does not infringe another’s IP rights, the buyer risks that the design or process is the intellectual property of a third party. In that case, a buyer could face an infringement lawsuit that lands the buyer in the defendant’s chair. To ascertain possible liability, contracting parties should, at minimum, perform basic due diligence. The buyer can further protect its interests by requiring the manufacturer to warrant that its product does not infringe on the intellectual property rights of any third party. The buyer should backstop the warranty with an indemnification clause that protects the buyer from any infringement claims made by third parties as a result of the purchase or use of the goods.

- **Competition and Exclusivity.** Marketplace competition issues arise when the manufacturer owns the design and/or process, thus giving it the right to sell the product to any buyer. This increases the likelihood that the contracted product can be sold to the buyer **and** the buyer's competitors. To address the risk, the buyer should negotiate for an exclusive right of purchase. Exclusivity needs to be guaranteed by specific agreement; otherwise, the Chinese manufacturer may sell to third parties regardless of an oral agreement to the contrary. In exchange for such an exclusivity arrangement, Chinese manufacturers typically require the buyer to commit to purchase a certain number of units at a certain price for a certain time period. Although the commitment is often hard to accept, it may be necessary to protect exclusive market rights.

As Chinese manufacturers become more sophisticated in their manufacturing processes, buyers must adapt their purchasing processes, as well. Revising and re-revising pre-existing and future contracts with Chinese manufacturers is the first step in protecting companies' interests in this changing environment.

#### ADDITIONAL INFORMATION<sup>1</sup>

For additional information, please contact:

- **MICHAEL ADELSHEIM** | 415.617.2246 | [michael.adelsheim@tuckerellis.com](mailto:michael.adelsheim@tuckerellis.com)
- **TOD NORTHMAN** | 216.696.5469 | [tod.northman@tuckerellis.com](mailto:tod.northman@tuckerellis.com)

This Client Alert has been prepared by Tucker Ellis LLP for the use of our clients. Although prepared by professionals, it should not be used as a substitute for legal counseling in specific situations. Readers should not act upon the information contained herein without professional guidance.

©2018 Tucker Ellis LLP. All rights reserved.

---

<sup>1</sup> The authors wish to thank **Kelsey Ewing**, a law student at The University of Akron School of Law, for her help in composing this Client Alert.