

Keeping Your Formulas Secret

Prevention Can Help Protect Intellectual Property in China

Ideas In Jeopardy – For chemical companies doing business in China, few concerns are as ubiquitous as the risk of the theft or loss of intellectual property. Of all the forms of IP that are most difficult to protect in that country, trade secrets may be at the top of the list.

According to both China's Anti-Unfair Competition Law and its criminal law, a trade secret is a specific type of confidential information that gives an economic advantage to a given company, at least for so long as that information is kept confidential. It is necessary when seeking to enforce rights to trade secrets to show the steps that have been taken to preserve the confidentiality of the material. There is no statutory limit on the duration of a trade secret — as long as it is kept secret and can be shown to have value, it can be claimed as a trade secret.

General Strategies for Trade Secret Protection

Prevention is better than cure, and in the first instance there are several simple ways in which chemical companies can prepare themselves to minimize the risk of loss of trade secrets. Regardless of what you may think to be the most likely source for a leak, it is worth establishing certain practical guidelines for your operations in the Chinese market. Such guidelines would include the following:

- Where possible, keep trade secrets offshore. Over the years, many companies have taken advantage of China's manufacturing capabilities and infrastructure but have retained offshore a final component or ingredient or process that gives their product its unique edge.
- If a trade secret must be brought to China, consider breaking it down and allocating it in discrete steps at separate locations so people at any one site will not have full knowledge of the trade secret.
- Where the trade secret is in writing, consider copyrighting the information to afford greater opportunity for protection, and where not in writing, consider reducing portions of it to writing for the purpose of copyrighting.
- Conspicuously mark any written materials that contain trade secrets as "Confidential."
- Limit access to all classified information on a need-to-know basis, and maintain lists of those individuals with access. Using software or swipe cards, monitor who accesses such classified material.



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- Use locks (mechanical or electronic) to deny access to any person who lacks authorized access to trade secrets, and update passwords and codes at least every three months and to track data flows and file transfers.
- Educate/train employees about their responsibilities regarding trade secrets and the sanctions (both internally and under Chinese law) for breach.
- During exit interviews with departing employees, remind them of their continuing contractual duties not to use or disclose any trade secrets.
- Establish a hotline for employees to report risks of theft of trade secrets by colleagues or outside contacts.
- Take prompt action to stop trade secret theft immediately after identifying a problem: for example, you may take control of the employee's laptop, perhaps file the case with the public security bureau, and apply for preliminary injunctive relief if applicable.
- Consider participating in organizations focused on such IP protection in China (e.g., Quality Brands Protection Committee, European or American Chamber of Commerce).

Considering potential sources of leaks can help develop more specific trade secret protection. In China, these typically consist of partners, suppliers and customers, and own employees. The global financial crisis triggered a resurgence of interest in joint ventures; as China becomes not merely the place to manufacture for sale elsewhere, but the target market, where having a local partner may offer the allure of a broader national footprint and existing distribution network. But partners and their employees often present risks. Similarly, companies that supply or purchase from your company may have the opportunity to misappropriate your trade secrets if they have access to technical specifications and tolerances. Lastly, given the high turnover of employees in China, you should anticipate that at some point one or more of your employees will take trade secrets when leaving your employment.

This was alleged in the case of U.S. phenolic resins producer SI Group, which first sued Chinese company Sino Legend in 2007. SI



Group claimed that Sino Legend had hired its Shanghai plant production manager and taken trade secrets to use in its production of "virtually identical" tackifier resins for tires. The lack of effective redress in China led SI Group to file a complaint with the U.S. International Trade Commission in 2012.

Protecting Trade Secrets from Partners

The risks presented by disclosures to your company's partners in China (whether Chinese or foreign) can be managed first by conducting some due diligence regarding your potential partner's IP compliance history. The sources of such information in China are quite limited, but we find that many companies fail even to run the Chinese equivalent of a Google search to determine if the company has ever been noted for theft of IP or similar problems.

As a next step, most companies know the importance of entering into a nondisclosure agreement (NDA) before sharing confidential information; however, typically such obligations are binding only on the company, not its employees. Given the high rate of employee turnover in China, we recommend including in such NDA an obligation on your potential partner to impose consistent nondisclosure obligations on specified or key personnel that will continue for a reasonable period even after any expiration/termination of the employment relationship, to maintain a list showing the names and national ID card numbers of all such personnel, and to indemnify you for any breach of the foregoing.

It is worth including one or more of the following in the contracts with your partner:

- Delineating the parties' respective rights and obligations with regard to any IP, including trade secrets.
- Including an acknowledgement by your partner of your ownership of the trade secrets and a warranty that such trade secrets will be used by the partner only for specified purposes, and consider including an acknowledgement by your partner of what it does not know as of the date of the contract, to establish a baseline — then if the partner has such knowledge in the future, it will need to explain how it obtained such information if not from you.
- Inserting a covenant that the partner will not claim ownership or attempt to register in any jurisdiction any trade secret.
- Creating the right to conduct technology audits and imposing on the partner the duty to cooperate.
- Impose a duty to comply with your own trade secret protection policies, as amended from time to time.
- State your company's right to terminate the contract for trade secret theft, with the explicit right in addition to claim damages.
- Specify the rights of the parties, if any, to the other's trade secrets upon termination and prohibitions/restrictions on use of trade secrets thereafter.

Protecting Trade Secrets from Suppliers and Customers

As with partners, the first step in protecting your trade secrets from

your suppliers is to conduct whatever background check you can to assess the risk of theft. Where possible, apportion production of components among multiple suppliers so that none has full knowledge of your secrets. Consider including in your nondisclosure agreements an obligation to impose confidentiality obligations on the supplier's key personnel also.

In your contracts with suppliers, you might wish to include one or more of the following:

- An acknowledgement of your ownership of the trade secrets and a warranty that such trade secrets will be used by the supplier only to produce goods pursuant to your instruction. As suggested above for partners, you might want to include an acknowledgement of what the supplier does not have knowledge of as of the date of the contract.
- A covenant that the supplier will not claim ownership or attempt to register in any jurisdiction any trade secret.
- The right to conduct technology audits and the duty of the supplier to cooperate.
- A duty by the supplier to comply with your own trade secret protection policies, as amended from time to time.
- Your right to terminate for trade secret theft.
- Prohibitions on any use of your company's trade secrets after expiration/termination of the contract with the supplier.

Recognize also that your own customers may gain access to and then misuse your proprietary information.

It is not uncommon in any market to purchase the products of a competitor for the purpose of learning trade secrets, but such a problem is pervasive in China. Accordingly, you may want to modify some of the above for use in contracts even with your own customers.

Protecting Trade Secrets from Employees

Perhaps the greatest sources of trade secret theft in China are one's own employees. To minimize this risk, we suggest you consider the following:

- Impose confidentiality and non-competition obligations on all "ordinary employees" in their standard employment contracts, which are mandatory under Chinese law.
- Require senior or middle-level management personnel and other employees who have access to trade secrets to sign a separate and stricter confidentiality and noncompetition contract. This separate contract may permit enforcement without going through the labor arbitration that will be required for most employment disputes.
- Specify in employment contracts and the company manual that theft of trade secrets constitutes grounds for termination.
- In exit interviews at the end of any employment relationships, remind the employees of their obligations regarding trade secrets.

Conclusion

Any company doing business in China should anticipate that at some point its trade secrets will be misused or misappropriated. The chemical industry is by its very nature highly complex, with its IP most often a combination of various intertwined manufacturing processes and products. While the situation in China is changing for the better, with increased awareness of and sensitivity to IP issues in Chinese courts, the best course of action for companies in the chemicals sector must remain that of prevention of breaches as far as possible.

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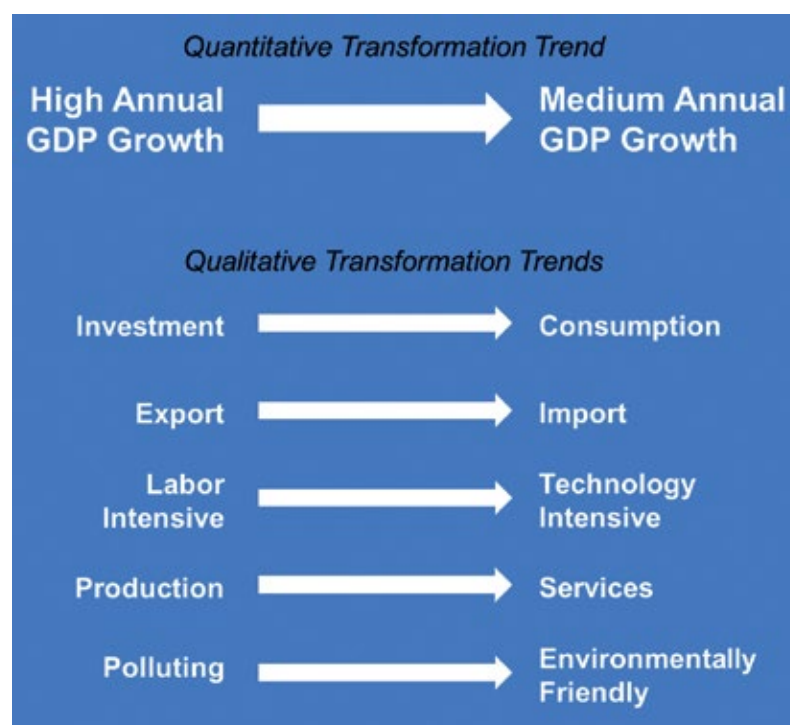
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Change In China



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Reduced exports are likely to negatively affect segments with export-oriented end customers such as textile chemicals, textile dyes and leather chemicals. On the other hand, chemical multinational companies with a strong China presence may benefit by increasing their imports of high-end specialty chemicals and materials.

The transformation toward technology and innovation is already quite visible in the many R&D centers that have been established particularly in the Shanghai area in the past 10 years. It is likely to continue, with smaller and second-tier foreign companies as well as bigger domestic companies also increasing their R&D work in China.

The shift from production of physical products to services is one

that will have a marginally negative effect on most chemical segments, as the chemical industry by definition focuses on physical products.

Finally, growing awareness of environmental issues will benefit a few chemical segments such as water treatment chemicals while at the same time negatively affecting others (such as leather chemicals, pigments and dyes), similarly to the segment shift experienced in Europe and the U.S. a few decades ago.

Effect on Key Chemical Segments

For this categorization, each segment was examined for each of the five transformation factors. For each segment/factor combination, the effect was either judged to be positive (i.e., the transformation factor will favor the growth of the chemical segment), neutral (the transfor-

mation factor will not have a major influence on the growth of the chemical segment) or negative (the transformation factor will negatively affect the growth of the segment). All evaluations were then weighted and aggregated, resulting in four groups of chemical segments:

- Some chemical segments experience strong additional growth as a result of the transformation of the Chinese economy.
- Some chemical segments experience minor additional growth.
- Some chemical segments experience a minor reduction of growth.
- Some chemical segments experience a major reduction of growth.

In summary, the transformation of the Chinese economy will have a substantial effect on the chemical industry. However, the effect depends much more on the specific chemical

segment than on the general properties of the chemical industry.

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