

# ClientAlert

## Global Antitrust/Competition

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### Do Your Suppliers Use Unauthorized IP?

#### A Critical, Emerging Global Business Risk

Do you know whether the suppliers in your supply chains use unauthorized intellectual property (IP)? Are you in a position to answer this question definitively? Even if you own, or have the legal rights to use, all IP that you need to produce your own products or to deliver your services, you still could face serious legal and business consequences if any supplier in your supply chain uses “unauthorized IP” (patents, copyrights, utility models, software, trade secrets, etc. that have not been authorized by the lawful owner and for which royalties have not been paid in accordance with relevant laws) at any point in its processes.

##### Who does this affect?

According to the Organization for Economic Cooperation and Development (OECD), Asia is fast emerging as the world’s largest producer of unauthorized products. Global companies with supply chain links in certain Asian countries are particularly at risk, especially if they sell in the United States.

##### How severe are the consequences?

If your company’s global supply chain includes any type of unauthorized IP, then: (1) regulatory authorities could require you to pay fines, comply with injunctive measures and even stop importing your products into key markets; (2) private individuals and groups could file law suits against you seeking damages and/or injunctive relief; and (3) damaging press reports and boycotts could cause significant reputational harm.

This note identifies the risks associated with potential unauthorized IP use and how you can mitigate this risk by taking a few preventative steps. Contact us for more information or if you would like to receive training and assistance specific to your company and industry (see below for details).

##### Unauthorized IP in Global Supply Chains

Unauthorized IP in your supply chain can take unexpected forms. For example, one of your suppliers may use unauthorized software to produce the components that it supplies to your company, or it may digitally infringe a copyright by using unauthorized software to design, produce and/or sell its own goods or services. In these cases, the unauthorized IP becomes part of your supply chain—even if you were not aware of the unauthorized use.



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Many global companies have extensive supply chains, and many of them procure components and/or assemble products in certain Asian countries to reduce their overall costs. However, Asia is rapidly emerging as the world's largest producer of counterfeit and pirated products.

And the scope of IP-infringing products around the world is broad and expanding. According to the OECD, the products that are designed, produced, marketed and/or sold using unauthorized IP these days include: machinery and electrical equipment; products made with metals, minerals, chemicals, plastic, rubber, wood, pulp, paper, textiles, stone, plaster, cement, ceramic and glass materials; transportation equipment; optical and photo equipment; precision instruments; Internet content (such as music, movies and software); and many others.

### **Serious Risks for a Global Business**

If any supplier in your supply chain, particularly one linked to Asia, is found to use unauthorized IP, then regulators, customers, competitors and others may perceive that your company is "benefitting" from that use—and try to have your company held responsible.

In the United States, the Federal Trade Commission (FTC) has the authority to seek injunctive relief and civil penalties. The FTC has not taken significant enforcement action to date, but it is under pressure to address unauthorized IP use and is considering enforcement options. In addition, if a product violates Section 337 of the US Tariff Act of 1930, even inadvertently (by using unauthorized IP in the design, production, marketing or sales processes or integrating unauthorized IP into any component of the product), then the International Trade Commission (ITC) can issue an "exclusion order" directing US Customs and Border Protection to block the product from importation into the United States—thus cutting off your access to all US markets.

US state attorneys general can sue for financial penalties and injunctive relief. Some US states (e.g., Louisiana and Washington State) have adopted laws penalizing companies that incorporate unauthorized IP into their products or even merely use it in their business operations (such as distribution, sales and marketing, inventory, logistics and accounting). Other US states rely on "unfair and deceptive acts and practices" laws to pursue companies for the unauthorized use of IP. Significant court cases are currently pending in California against a Chinese and an Indian garment manufacturer. If found guilty, they may be subject to a fine of up to US\$2,500 per item. Massachusetts has already pursued an action and several other states are reportedly in the process of doing so.

Private parties may pursue actions and risks could arise in other jurisdictions. Press reports that portray your company as using unfair business practices to gain an advantage over your competitors can lead to significant business consequences, such as boycotts by consumer groups and unions and other reputational harm.

### **What You Can Do**

The costs of protective step you can take in advance are relatively low compared to the potential risks. And they primarily require a refocus of your company's existing compliance policies:

- 1. Know your supply chain**—You can adapt your current supply chain management techniques to include unauthorized IP risks. Most global companies already understand supply chain risks such as environmental, labor, health and safety concerns, and they monitor their supply chains for risks caused by disasters, forced labor, child labor, and components that pose consumer health or safety problems, among others. Many leading international companies monitor their supply chains for the four UN Global Compact areas (human rights, labor, environment and anti-corruption) and require all their suppliers and sub-contractors to allow access to all offices and work locations, interview suppliers and sub-contracted personnel, and make and retain copies of any records concerning compliance with contract requirements and local law. Unauthorized use of IP risks can be incorporated into this process.
- 2. Protect yourself contractually**—Your contracts with suppliers should include representations, warranties and covenants stating that the products or components supplied will not contain unauthorized IP as well as assessing damages or penalties if these provisions are breached. This places the burden of risk on your suppliers and allows you to end the relationship if there are any violations. Your contracts with first-tier suppliers can require the supplier to insert similar clauses into contracts with its own suppliers and so forth down the line. Your contracts might provide for indemnification if your company is sued. You very likely already conduct significant due diligence on IP, FCPA and other risks when conducting M&A and other deal-related diligence. Your diligence should include a considered assessment of the supply chain as well as of the company you are negotiating with. This can raise sensitive deal issues related to confidentiality and disclosures that may limit just how much diligence you can do. So, it is important to include representations, warranties, covenants to protect your company. The deal protections you will want may vary depending on the perceived risk and extent of diligence that has been conducted.
- 3. Cross-border compliance training**—Many global companies have implemented written policies, training and monitoring processes to help reduce the risks of failing to comply with the laws and regulations (anti-money laundering, anti-bribery, antitrust, etc.) of the many countries in which they do business. This is because the cost of compliance training and awareness-building is cheaper than fixing damaged reputations and paying large penalties. The risk of unauthorized IP in your supply chains should be included in properly designed and implemented corporate compliance programs. These programs can help educate employees, customers and suppliers, and they may help defend your company from accusations that it knew about unauthorized IP use.

- 4. Publicize your policy and work with industry groups**—Publicly announce your policy in regulatory filings and publications and on your websites. This tells present and future suppliers, customers, regulators and potential plaintiffs that your company will use best reasonable efforts to manage the supply chain properly. In addition, your industry association might adopt policy statements and codes of conduct pledging that all members take affirmative steps to ensure compliance in their supply chains with respect to all applicable laws pertaining to the use of unauthorized IP. This would pressure all suppliers to your industry to bring their practices into legal compliance. Some international companies are experimenting with cross-industry collaboration to address supply chain risks (for example, some Asian factories supply components to foreign buyers in diverse industries). Having several companies in various fields maintain the same standards would provide an incentive for suppliers to comply and avoid multiple audits and conflicting requirements. Note, though, that you must use care when discussing standards with competitors and similarly situated customers whether it is within a trade association setting or other context, as authorities and private plaintiffs in many jurisdictions can be expected to scrutinize such cooperation for conduct that crosses into an area regulated by the antitrust laws.
- 5. Help create new standards, rules and best practices**—Currently, there are no internationally recognized industry standards or best practices in monitoring the supply chain for unauthorized IP. If you act now to propose standards, rules and best practices, you can significantly influence the competitive landscape in your favor.

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