

Legitimate Source Defense in Patent Infringement Cases

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Article 70 of the PRC Patent Law (the “Patent Law”) provides for a defense (the “Legitimate Channel Defense”) that a business operator (“Purchaser”) which purchases infringing products for its own use or for resale during its business operation will not be liable for compensating the patent owner if it procures the products from legitimate channels and does not know that the products were manufactured without an authorization by the patent owner. The Legitimate Channel Defense protects good faith Purchasers (the “bona fide Purchasers”) from being claimed for damages for using or selling patent infringing products, thus safeguards transactional safeties.

1. Overview of Legitimate Source Defense

Legitimate Source Defense is not a defense against infringement. According to Article 11 of the PRC Patent Law, unless falling within the scope of “fair use,” implementation of patents without authorizations by patent owners, including manufacturing, offering for sales, selling and importing products, is patent infringement. Purchase of infringing products for use or resale during normal course of business is, by no means, a fair use even if the Purchaser has no knowledge about the infringement. Consequently, a bona fide Purchaser which uses or sells infringing products without knowing the relevant products are infringing still commits an infringement.

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Nevertheless, the Legitimate Channel Defense protects bona fide Purchasers from being claimed for damages. In other words, when infringement is established, patent owners can apply for injunction to order bona fide Purchasers to cease continuing purchasing infringing products for use or resale, but they cannot claim damages from the bona fide Purchasers.

The Patent Law sets out two conditions to a Legitimate Channel Defense: (1) the bona fide Purchaser must procure the infringing products from a legitimate channel; and (2) the bona fide Purchaser must not have knowledge about the infringement. A Purchaser can receive protections by the Legitimate Channel Defense if both conditions are met.

2. Procurement via Legitimate Channels

Procurement from a legitimate channel is the fundamental condition for a Purchaser to enjoy the Legitimate Channel Defense. The Purchaser must provide evidence, such as contracts, invoices, and other transactional documents to identify the party which sells the infringing products to it and to prove that the procurement channel is legitimate.

According to Article 25 of the Interpretation on Several Issues in Trying Patent Infringement Cases II (《最高人民法院关于审理侵犯专利权纠纷案件应用法律若干问题的解释(二)》), the “Patent Interpretation II”) issued by Supreme People’s Court, the procurement via legitimate channel condition is met if a purchase is made (1) through a legitimate market, (2) by a normal sale and purchase contract, and (3) in compliance with customary market practice.

Legitimate market element requires that a Purchaser must procure infringing products under a legitimate transaction. Illegal transactions and procurement via grey markets may not be considered a “legitimate market.” In a few cases, controversies were raised as to whether a purchase of products in violation of the PRC Product Liability Law (the “Product Liability Law”), for example, purchase of products which fail to meet labeling requirements, disqualifies a Purchaser as a bona fide Purchaser. The prevailing opinion is “not necessarily.” As stated in the decision on case 2020 Supreme Court ZhiMinZhong No. 895 ((2020)最高法知民终 895 号), the Product Liability Law has a legislative intent different from that of the Patent Law and therefore, the violation of the Product Liability Law does not illegalize the purchase of the infringing products for the purpose of determining legitimate channels.

A Purchaser must procure infringing products under a normal sale and purchase transaction in order to qualify as a bona fide Purchaser. A commissioned manufacture, although similar to a procurement arrangement, is not a normal sale and purchase transaction which satisfies the legitimate channel condition. In the case 2017 YueMinZhong No. 2900 ((2017)粤民终 2900 号), the court held that if, the products are manufactured according to the designs of the Purchasers or otherwise with Purchaser’s participations, the Purchase will be considered a joint manufacturer and not a bona fide Purchaser.

The element of compliance with market practice is probably the most debated element in determining a legitimate channel. Factors which are often considered include:

(1) whether the relevant transactions are entered in a customary manner between two independent entities; and (2) whether the price for the infringing products is reasonable.

As to the transactional manner, courts review whether they are customary according to the nature of the transactions. Whilst in some cases, for some small low-cost deals, the court held that delivery notes and account books are sufficient to prove a legitimate purchase in a personal business (2020 Supreme Court ZhiMinZhong No. 626 ((2020)最高法知民终 626 号)); in some other cases, the court held that, in a large engineering project, a procurement without a proper contract is unusual and, therefore, the Purchaser fails to prove that it procured the infringing products in a customary way.

The pricing element is also considered in determining whether procurement for infringing products is in line with market practice. The testing criterion is not whether a Purchaser gains a significant profit margin but whether the purchase price is unreasonably low. In the decision on case 2020 Supreme Court ZhiMinZhong No. 758 ((2020)最高法知民终 758 号), the court held that any business operator desires to seek profits and, therefore, that merely acquisition of significant profit from a resale does not conclude that the products resold are infringing. In the decision on case 2020 YueMinZhong No. 2363 ((2020)粤民终 2363 号), the court held that the price at which the Purchaser purchases the infringing products was prominently below normal market price, which ought to alert the Purchaser of possible infringement, and, therefore, the Purchase failed to establish the Legitimate Channel Defense.

3. Lack of Knowledge

A Purchaser is considered a bona fide Purchaser only if it does not have knowledge about the infringement. According to Article 25 of the Patent Interpretation II, “lack of knowledge” includes lack of actual knowledge and lack of constructive knowledge. The lack of actual knowledge means that a bona fide Purchaser does not knowingly procure infringing products; the lack of constructive knowledge requires that a bona fide infringer exercises due care in procurement.

“Lack of knowledge” is a subjective element, which can only be proved or rebutted by evidence about the circumstance, behaviors, and other objective elements. “Lack of knowledge” is also a negative element which means, according to decisions in prior cases, that the burden of proof is shifted to the patent owner to rebut the presumption that a Purchaser which procures infringing products via legitimate channels is innocent about the infringement. In practice, notices of infringement and notices of suits are often evidence raised by patent owners to demonstrate “actual knowledge” or “constructive knowledge.”

Firstly, a Purchaser does not have a proactive obligation to perform freedom to operate analysis. As stated in decision 2003WanMin-3-Zhong No.15 ((2003)皖民三终字第 15 号), the level of due care applicable to resellers is lower than that applicable to manufacturers.

Comparing to manufacturers which have an absolute obligation to ensure non-infringement, Purchasers only have the obligation to exercise due care at the level that it has no reason to believe the products it purchases are infringing.

Secondly, a notice of infringement may put a Purchaser on alert but may not be sufficient to establish a “constructive knowledge.” As stated in the decision on the case 2020 Supreme Court ZhiMinZhong

No.1718 (2020) 最高法知民终 1718 号), a notice of infringement is not a necessary condition for establishing a constructive knowledge about infringement, nor is it a sufficient condition. Nevertheless, a notice of infringement will be considered one of the circumvention evidence to form the context within which the Purchaser's subjective element can be assessed.

Several issues may be considered in determining whether a notice of infringement can form a base to presume "constructive knowledge," including the specificity of the notice, the timespan between the notice and claim against the Purchaser, and the sophistication level of the Purchaser. In the case 2003WanMin-3-Zhong No.15, the court determined that the notice of infringement failed to prove the Purchaser's actual knowledge because (i) the notice only cited the publication number of the patent which the patent owner claimed to be infringed, without a complete list of patent claims, a technical comparison, or asserted infringers; and (ii) the patent owner initiated the patent infringement suit in only fifteen days from the notice, leaving no sufficient time for the Purchaser to react to its notice. In another case (2019) Supreme Court ZhiMinZhong No.686 ((2019)最高法知民终 686 号), the court held that the notice of suit is sufficient to alter Wal-Mart (i.e., the Purchaser of the infringement). In this case, the notice was made in great detail to include a specific technical comparison between the claimed technical features and those of the infringing products; the Purchaser took no actions within more than six monthss after the notice was received, and Wal-Mart is a multinational company having strong legal capacity. The court believed that, taking into the sophistication level of Wal-Mart, it ought to know the high likelihood of infringement by reading the notice demonstrating the infringement and the fact that Wal-Mart took no actions during the half-year period after the notice presumed Mal-Mart's knowledge of infringement.

Thirdly, when an infringement case is lodged and notified to the Purchaser, usually the Purchaser is considered to have the knowledge about the infringement and has the obligation to assess the infringement risks. On the case 2017 Jing73MinChu No. 1156 ((2017)京 73 民初 1156 号), the defendant proved that it had no knowledge about infringement when purchasing the infringing products but the court held that it must cease purchasing and reselling infringing products after being notified of the infringement suit. The court further held that the defendant's continuity in purchasing and reselling the infringing products exposed it to civil liabilities.

4. Conclusions

From a Purchaser's point of view, to establish the Legitimate Channel Defense to avoid being claimed for damages in patent infringement cases, it would be advisable:

- to perform preliminary due diligence into the seller in important procurement and to record the due diligence process and conclusions;
- to enter into transactions in a due process according to the company governance, procurement procedure, and market practice; and

- to retain purchase contracts and VAT invoices, naming specifically the names, types, and quantity of the products.

From a patent owner's point of view, in order to cease infringement promptly, it would be recommended:

- to specify in the notice of infringement (i) the patent which is infringed; (ii) the comparison between the technical features claimed by the patent and those of the products which are asserted to be infringing; and (iii) the names of the suspicious infringer; and
- to request for the disclosure of infringing manufacturers rather than claiming for damages from bona fide Purchasers.

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