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## COUNTERFEITING IN THE PEOPLE'S REPUBLIC OF CHINA

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\* Professor of Law, The Ohio State University College of Law; B.A., 1979 Yale College; J.D., 1982 Yale Law School. During the 1997-99 academic years, I was on leave in the People's Republic of China ("PRC"). I lived in Guangzhou, Guangdong Province, and served as in-house legal counsel for a large multi-national enterprise with significant investments in China. During part of this period, I also served as Secretary for the China Anti-Counterfeiting Coalition, an ad hoc group of multi-national enterprises with serious counterfeiting problems in the PRC. As Secretary, I was involved in researching and writing draft papers for the Coalition on issues related to counterfeiting. Some of the research done in connection with those drafts is used in this Article. In the fall of 1999 after my return to Ohio State, I helped to coordinate and organize an exchange initiative on counterfeiting sponsored by the U.S. Department of State. The first part of the exchange, which I participated in, occurred from November 8-16, 1999 and consisted of a series of meetings between a United States delegation of experts, including two federal judges and a federal prosecutor, and high level PRC officials in Beijing, Shanghai, and Guangzhou. These meetings were useful because they gave some indication of the most current views towards counterfeiting held by senior PRC officials. I was involved also in the drafting of the report of the U.S. Delegation for the U.S. State Department. Some of these views are reflected in this Article.

Many of the views expressed in this Article are based upon first-hand experiences, including contacts with numerous multi-national companies with serious counterfeiting problems in China, United States government officials, PRC law enforcement officials, foreign and local law firms, investigation agencies, and suspected counterfeiters and infringers. I participated in numerous enforcement actions, including filing complaints with local authorities, and was present at raids of factories, warehouses, and other premises used for counterfeiting. On some occasions, I was able to sit in on interrogations of suspected counterfeiters by PRC authorities.

Thanks to Dean Gregory H. Williams for encouraging me to take this leave of absence and be a witness to the vast changes occurring in the People's Republic of China. Thanks also to the following persons for their views on earlier draft papers related to counterfeiting: Malcolm Brookes, Jack Chang, Al Clovis, Xu Min, Nancy Chen, Nick Chen, Frank Guerra, Stan Harsha, Bob Miller, David Peerless, Joe Simone, and Bill Thompson. Thanks also to Craig Bryson for his research assistance on this Article. The views expressed here are my own.

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## INTRODUCTION

The counterfeiting of trademarks, brands, and other forms of intellectual property in the People's Republic of China ("PRC") is now the most serious counterfeiting problem in the history of the world and appears to be still on the rise.<sup>1</sup> Estimates put the losses from counterfeiting suffered by trademark and brand owners doing business in China in the billions or even tens of billions of dollars per year.<sup>2</sup> As almost every consumer in China knows, counterfeit and infringing versions of famous international and local brands are openly on display and available in plentiful supply in virtually every street market in China.<sup>3</sup> A disturbing trend is the recent increase in the export of counterfeit products from China to countries and territories abroad, indicating that China has become the source of a global counterfeiting problem.<sup>4</sup>

The unprecedented severity and magnitude of the counterfeiting problem raises a number of immediate questions. How did a problem of this magnitude arise, and what measures are being undertaken to improve the current situation? The origins of the counterfeiting problem can be traced to three interrelated sources: China's unprecedented economic growth, a political system in transition, and a nascent legal system unable to anticipate and control the many new problems generated by swift social and economic changes.<sup>5</sup> Government and regulatory structures appropriate to a centrally planned economy created problems as China moved to a mixed or transition economy with free market features.<sup>6</sup> In particular, local governments

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1. Counterfeiting is defined *infra* at text accompanying notes 26-33.

2. See *infra* text accompanying notes 39-49. China's official position is that there has been substantial progress made in the protection of all forms of intellectual property, including the protection of trademarks against counterfeiting and infringement. See STATE INTELLECTUAL PROPERTY OFFICE OF THE PEOPLE'S REPUBLIC OF CHINA, 1998 REPORT ON INTELLECTUAL PROPERTY RIGHTS PROTECTION IN CHINA (1998) (copy on file with the author).

3. See *China Consumers Grow More Vigilant About Fakes*, CHINA DAILY, Mar. 16, 1998, available in 1998 WL 7594586 ("Is this authentic? Whether the words are on the lips or not, the suspicion is there for a good many consumers in China."). Estimates are that in large urban areas up to 90% of certain daily-use products found in street markets are counterfeit. See David Murphy, *Fake Goods Sales at Critical Levels in China*, BUS. TIMES, June 21, 1999, at 5. Foreign investors are finding that on average 15-20% of all products sold in China under their trademarks are counterfeits. See Joseph T. Simone, *Countering Counterfeiters*, CHINA BUS. REV., Jan. 1, 1999, at 12, available in 1999 WL 11878204. For some types of products such as clothing, the percentage of counterfeit product is as high as 80-100%. See *id.*

4. See *infra* text accompanying notes 37-38.

5. See *infra* text accompanying notes 92-101. For an overview of China's legal system and the development of the rule of law, see ALBERT H.Y. CHEN, AN INTRODUCTION TO THE LEGAL SYSTEM OF THE PEOPLE'S REPUBLIC OF CHINA (1992).

6. See *infra* text accompanying notes 92-94.

contributed to the rise of the counterfeiting trade by helping to create the distribution channels that serve the vital role of delivering counterfeit goods to retail markets and consumers.<sup>7</sup> Serious conflicts of interests have arisen as local governments often promote and have an economic stake in the very counterfeiting activities that they are now seeking to suppress.<sup>8</sup> In many areas of China, local protectionism has erected serious barriers to effective enforcement against counterfeiting.

Although the counterfeiting problem in China is daunting, China has demonstrated that it can take swift, effective, and ruthless measures to suppress commercial crimes such as smuggling when a political commitment has been made at the highest levels of government.<sup>9</sup> A firm political commitment is necessary because there are real political and social costs associated with any serious crackdown on a problem as massive as counterfeiting.<sup>10</sup> Overcoming local protectionism will require the expenditure

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7. See *infra* text accompanying notes 95-96.

8. See *infra* text accompanying notes 97-99.

9. Premier Zhu Rongji announced a nationwide crackdown on smuggling on July 15, 1998. See *China Launches New Crackdown on Smuggling*, ASIAN PULSE, July 16, 1998, available in 1998 WL 12623359. Leaders in Beijing became concerned because smuggling had not only reached new levels, but many smuggled goods were adding to deflationary pressures precisely in those areas where there was already excess supply produced by domestic industries: steel, petrochemicals, and household goods. Downward price pressures increased headaches for already struggling domestic industries and state enterprises. See Henny Sender, *In Stifling Smugglers, China Makes Waves Across Asia*, ASIAN WALL ST. J., Mar. 5, 1999, available in 1999 WL-WSJA 5429104; Zhu Rongji on *Anti-Smuggling*, XINHUA ENGLISH NEWSWIRE, Aug. 31, 1998, available in 1998 WL 12181771. China was also losing billions of dollars in unpaid tariffs. See *Anti-Smuggling Raids Aid Industry, Fatten Tariffs*, CHINA DAILY, July 15, 1999, available in 1999 WL 17780922 (customs revenues increase by 117% from a year earlier to hit \$9.44 billion as a result of the crackdown on smuggling). Leaders in Beijing also became alarmed at the extent of involvement in smuggling by state owned enterprises, the People's Liberation Army, other military units, the police, and other government officials. See *China Launches New Crackdown on Smuggling*, *supra*; Vivien Pik-Kwan Chan, *Zhu's Warning on Corruption in Guangdong*, S. CHINA MORNING POST, Oct. 24, 1998, available in 1998 WL 22023825 (a ring behind a \$7.2 billion cigarette smuggling scandal was uncovered involving local customs officials, a bank governor, and several economic and trade officials). See also *China Shows Way to Combat Smuggling*, MANILA STANDARD, Oct. 1, 1999, available in 1999 WL 27426566 (discussing role of army, judges, law enforcers, and state officials in smuggling). Issues of government involvement were so serious that China had to set up a special 10,000 member police force with special powers to combat smuggling. See *China Sets Up Anti-Smuggling Police Force*, ASIAN WALL ST. J., Jan. 7, 1999, available in 1999 WL-WSJA 5425471. These efforts against smuggling seem to be reaping good results. See *Anti-Smuggling Raids Aid Industry, Fatten Tariffs*, *supra*.

10. Although China has recently enacted an impressive number of laws to increase the protection of trademark rights, the critical issue remains whether China has the political will to fully enforce these laws. All of the following laws are available in both the original Chinese and English in 5 China Law Reference Service (Asia L. Prac.) 5100 *passim*. See Zhonghua Renmin Gonghe Guo Shangbiao Fa (Xiuzhen) [Trademark Law of the People's Republic of China (Revised)] (adopted at the 24th Session of the Standing Committee of the 5th National People's Congress on August 23, 1982, revised by the 30th Session of the Standing Committee of the 7th National People's Congress on February 22, 1993, and effective July 1, 1993); Zhonghua Renmin Gonghe Guo Shangbiao Fa Shishi Xize [Trademark

of considerable political capital and divert limited resources from China's myriad other pressing problems.

Significant social costs are also involved because the trade in counterfeit goods has now been integrated into many local economies and a serious crackdown will likely result in economic disruption and hardship for some locations.<sup>11</sup> In addition, China's complex bureaucratic structure coupled with professional rivalries among the various parallel government enforcement entities at both the central and local levels may result in political resistance to legal and structural reforms that may have the effect of shifting or curtailing current entrenched distributions of power and resources.<sup>12</sup> The significant political and social costs associated with any serious nationwide crackdown on counterfeiting suggest that China's leaders must be convinced that compelling interests are at stake and that a decisive political will is necessary. As discussed further in Part III of this Article, it is unclear whether such a political commitment is forthcoming.<sup>13</sup>

For the long term, it remains to be seen to what extent counterfeiting harms China's national interest in the development and modernization of its economy. Historically, no nation has been able to achieve a high level of economic and industrial development without strong protection for intellectual property rights.<sup>14</sup> Protection of intellectual property would seem

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Law Implementing Rules] (effective May 15, 1995); Duiwai Maoyi Jinji Heduo Ji Gongshang Xingzheng Guanli Ju Guanyu Duiwai Maoyi Zhong Shangbiao Guangli De Guiding [Administration of Trademarks in Foreign Trade Provisions] (promulgated by the Ministry of Foreign Trade and Economic Co-operation (MOFTEC) and the State Administration for Industry and Commerce (SAIC) on July 12, 1995 and effective August 1, 1995); Zhiming Shangbiao Rending He Guanli Zhanxing Guiding [Recognition and Administration of Well-Known Trademarks Tentative Provisions] (promulgated by SAIC on August 14, 1996 and immediately effective); Zhonghua Renmin Gonghe Guo Zhuduo Quanfa [Copyright Law of the People's Republic of China] (adopted at the 15th Session of the Standing Committee of the 7th National People's Congress on September 7, 1991 and effective June 1, 1991); Jisuanji Ranjian Baohu Tiaoli [Computer Software Protection Regulations] (passed by the State Council on May 24, 1991, promulgated June 4, 1991, and effective October 10, 1991); Zhonghua Renmin Gonghe Guo Zhuanli Fa (Xiuzheng) [Patent Law of the People's Republic of China (Revised)] (amended at the 4th Session of the Standing Committee for the 6th National People's Congress on March 12, 1984, and also amended by decision adopted at the 27th Session of the Standing Committee of the 7th National People's Congress on September 4, 1992); Zhonghua Renmin Gonghe Guo Zhuanli Fa Shishi Xize [Patent Law Implementing Regulations of the People's Republic of China] (adopted by the State Council on December 12, 1992 and promulgated by the Patent Office of the People's Republic of China on December 21, 1992).

11. See *infra* text accompanying notes 140-43.

12. See *infra* text accompanying notes 107-12.

13. See *infra* text accompanying notes 139-64.

14. See Brad Swenson, *Intellectual Property Protection through the Berne Convention: A Matter of Economic Survival for the Post-Soviet New Commonwealth of Independent States*, 24 DENV. J. INT'L L. & POL'Y 77, 101-102 (1995) (economically successful countries "have carefully maintained the protection of intellectual property rights as part of their economic development strategies"). *But cf.* William P. Alford, *How Theory Does—And Does Not—Matter: American Approaches to Intellectual*

particularly important at this point in history because information, technology, and intellectual property of all kinds are becoming an increasingly important part of economic development.<sup>15</sup> In addition, protecting intellectual property rights is also necessary to encourage the foreign investment<sup>16</sup> needed to sustain China's long term growth,<sup>17</sup> and to reassure those foreign investors concerned about mounting losses due to counterfeiting.<sup>18</sup> As we shall see, despite its severity, China's counterfeiting problem has not imperiled the nation's economic growth, at least up to the present.

This Article examines counterfeiting in China, its origins, and problems in enforcement. It also provides some suggestions for alleviating the problem, and concludes with some observations about the future of counterfeiting in China. This examination is timely because of the

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*Property in East Asia*, 13 UCLA PAC. BASIN L.J. 8, 15 (1994) (stress on the importance of intellectual property rights alone cannot fully explain success in economic development).

15. See, e.g., J.H. Reichman, *Universal Minimum Standards of Intellectual Property Protection under the TRIPs Component of the WTO Agreement*, 29 INT'L LAW. 345, 381-82 (1995) ("intangible intellectual creations have become the most valuable source of wealth for twenty-first century economic development").

16. Estimates are that over \$216.6 billion in direct foreign investment has been injected into China in the past 20 years, giving China the capital it needs to become a participant in the international economy. See *China: New Doors Open to Investors*, CHINA DAILY, Jan. 4, 1998, available in 1998 WL 7593342. Additionally, China receives a disproportionate share of foreign direct investment when compared with other developing countries, allowing it to fare better in the international economy than others. See Keith E. Maskus, *The Role of Intellectual Property Rights in Encouraging Foreign Direct Investment and Technology Transfer*, 9 DUKE J. COMP. INT'L L. 109, 115 (1998) (China's share in foreign direct investment to developing countries rose from 15% in 1990 to 52% in 1995). See also Alan Wm. Wolff, *The Asian Question: Integration of East Asia into the World Economy*, 3 UCLA J. INT'L L. & FOREIGN AFF. 43, 45 (1998) (foreign investment has transformed China "from a . . . remote outpost of the world economy . . . to this decade's equivalent for foreign investors to the California Gold Rush a century ago").

17. See Yong Wang, *Why China Went for WTO Institutional Arguments Go Some if Not All of the Way in Explaining China's WTO Change of Heart*, CHINA BUS. REV., Jul. 1, 1999, available in 1999 WL 11878241 (arguing that recent economic reforms in China are motivated by Chinese leaders' belief in the necessity of increasing foreign investment); *China: New Doors Open to Investors*, supra note 16 (new tax incentives for foreign investment announced after such measures were "highly commended" at a Chinese national conference on the importance of foreign investment).

18. See Duncan Hughes, *US Says Relocation of Counterfeiters Remains Problem*, S. CHINA MORNING POST, Oct. 29, 1998, available in 1998 WL 22050336 (according to David Aaron, U.S. Undersecretary of Commerce for International Trade, many companies are increasingly reluctant to invest in China because of piracy and counterfeiting). "Same bed, different dreams" is a common expression in China for the sometimes-differing views of foreign investors and their local joint venture partners. For a reassessment of a long-term approach to foreign direct investment in China by multinational enterprises, see Daniel C.K. Chow, *Reorganization and Conversion of a Joint Venture into a Wholly Foreign-Owned Enterprise in the People's Republic of China*, 73 TUL. L. REV. 619 (1998); Daniel C.K. Chow, *The Limited Partnership Joint Venture Model in the People's Republic of China*, 30 LAW & POL'Y INT'L BUS. 1 (1998). For a discussion of some sobering lessons for foreign investors and a scaling back of expectations, see Lisa Shuchman, *All Eyes on China*, ASIAN WALL ST. J., May 11, 1998, available in 1998 WL-WSJA 3476695.

seriousness of the problem, the increased attention given to counterfeiting, and China's on-going efforts to bring existing laws into conformity with the World Trade Organization's Agreement on the Trade Related Aspects of Intellectual Property as part of the negotiations to bring China into the WTO.<sup>19</sup> Part I of this Article examines the size, scope, and severity of the counterfeiting problem. Part II reviews the enforcement system in China, the current issues that contribute to a lack of effective enforcement, and provides some suggestions for improvement. Part III examines the issues of political will and commitment and discusses future trends.

### I. OVERVIEW OF COUNTERFEITING IN THE PRC

The origins of the counterfeiting problem can be traced in part to China's unprecedented economic development,<sup>20</sup> the rise of consumer wealth and spending power,<sup>21</sup> the development of well-known brands, and a commercial

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19. See *China, US Sign Agreement on China's Entry to WTO*, ASIAN PULSE, Nov. 16, 1999, available in 1999 WL 27968236. The United States' endorsement of China for WTO entry is politically necessary before China undertakes the formal accession process. China's accession to the WTO requires approval of two-thirds of the 135 current WTO members. See David Blumenthal, "Reform" or "Opening"? *Reform of China's State-Owned Enterprises and WTO Accession—The Dilemma of Applying GATT to Marketizing Economies*, 16 UCLA PAC. BASIN L.J. 198, 219-20 (1998).

20. China's economy grew at an average annual rate of 9.8% from 1980 to 1992, see WILLIAM H. OVERHOLT, *THE RISE OF CHINA* 29-30 (1993), and at a rate of 9% more recently. See, e.g., Stanley B. Lubman, *Dispute Resolution in China After Deng Xiaoping: "Mao and Mediation" Revisited*, 11 COLUM. J. ASIAN L. 229, 241 n.32 (1997). China's economic success can be attributed in part to a dramatic increase in the export of manufactured goods, the value of which increased from US\$9.8 billion in 1978 to US\$121 billion in 1994. See Todd K. Ramey, *China: Socialism Embraces Capitalism? An Oxymoron for the Turn of the Century: A Study of the Restructuring of the Securities Markets and Banking Industry in the People's Republic of China in an Effort to Increase Investment Capital*, 20 HOUS. J. INT'L L. 451, 457 (1998). China's rate of economic growth has decreased recently due in part to systemic problems in its economy. See, e.g., *Report Says China's '99 GDP Growth Will Top 7%*, ASIAN WALL ST. J., Oct. 11, 1999, available in 1999 WL-WSJA 20532960 (noting that "'deep-level' flaws in income distribution and industrial-production systems . . . continue to stymie economic growth"); Andy Xie, *China's Debt-Driven Growth Runs Out*, ASIAN WALL ST. J., Nov. 2, 1999, available in 1999 WL-WSJA 20534283 (much of the current growth in the economy is driven by inefficient deficit spending by state-owned enterprises). Despite recent sluggish growth in the industrial sector, other areas of the economy, such as high-tech production, continue to grow at an impressive rate. See *China's High-Tech Zones Show Rapid Development*, ASIA PULSE, Nov. 5, 1999, available in 1999 WL 27966818 (income from industries located in China's designated high technology zones has increased from US\$1.07 billion in 1991 to US\$59.31 billion in 1998).

21. Retail sales in China increased at an average of 17% each year for the past 20 years, from US\$15.3 billion in 1978 to US\$352.7 billion in 1998. See Angela Leary et al., *Hold on to Your Wallets—Bargain Hunting is Back*, ASIAN BUS., Oct. 1, 1999, available in 1999 WL 13425527. This trend will most likely continue as the Chinese government pursues policies to increase consumer spending in order to combat deflationary pressures. See *id.* See also *China's Retail Price Index Drops 3.1%*, CHINA ONLINE, Aug. 16, 1999, available in 1999 WL 20785709 (discussing China's attempt to combat deflation by initiating infrastructure spending programs, offering more opportunities to invest

advertising industry.<sup>22</sup> Additional contributing factors may include unemployment caused by reforms in the state sector<sup>23</sup> and the additional pressures caused by the recent Asian economic crisis.<sup>24</sup> In these respects, the counterfeiting problem in China is not unusual—historically, all economies, including that of the United States, have encountered counterfeiting problems once a certain stage of development is reached.<sup>25</sup> What is unusual in world history is the magnitude of the problem in China. Economic development or setbacks alone cannot account entirely for the rise of a problem that in terms

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in the stock market, and cutting interest rates); *China Mulls Tax on Savings Interest to Spur Consumer Spending*, CHINA BUS. INFO. NETWORK, July 28, 1999, available in 1999 WL 17730208.

22. In 1998, China became the second-largest market for advertising in Asia, with a total annual market value of US\$5.3 billion. See Michael Flagg, *China's Ad Market Rocks to the Surging Beat of Consumer Spending*, ASIAN WALL ST. J., July 9, 1999, available in 1999 WL-WSJA 20527383. Additionally, a recent Nielsen study shows that in the first half of this year advertising has increased by three percent when compared with the first half of 1998. See Paul Wiseman, *Tidal Wave of TV Ads Overwhelms: Some Chinese Viewers Rebel Against Blitz by Suing*, USA TODAY, Oct. 18, 1999, at 7B, available in 1999 WL 6855639 (greatest increase was in magazine advertisements, which showed a 15% rise).

23. For a report on how dismantling a state-owned enterprise making porcelain has led to a rise in counterfeit Ming and Qing dynasty antiques, see Erling Hoh, *Immaculate Deceptions: China's Made-to-Order Antiques Fool Even the Art Connoisseurs*, FAR E. ECON. REV., Mar. 19, 1998, at 37, available in 1998 WL-FEER 6521460.

24. See, e.g., Joseph Kahn & Craig S. Smith, *Unemployment Boosts Tensions in China: In the Cities, Idle Workers Vie with Rural Newcomers*, WALL ST. J., Feb. 6, 1995, at A8 (state enterprise reform is one cause of soaring unemployment); Wang Xiangwei, *Jobless Rate Rises as State Sector Struggles*, S. CHINA MORNING POST, Aug. 3, 1996, at 3, available in 1996 WL 3763470 (jobless rate increased 9.4% over previous year and is still getting worse). For a review of the problems with the ailing state sector and the need for reform, see Daniel C.K. Chow, *An Analysis of the Political Economy of China's Enterprise Conglomerates: A Study of the Reform of the Electric Power Industry in China*, 28 LAW & POL'Y INT'L BUS. 383, 395-401 (1997). For chronic problems with the state sector and why efforts at reform have been largely unsuccessful, see James B. Stepanek, *China's Enduring State Factories: Why Ten Years of Reform Have Left China's Big State Factories Unchanged*, in 2 JOINT ECON. COMM., 102D CONG. 1ST SESS., CHINA'S ECONOMIC DILEMMAS IN THE 1990S: THE PROBLEMS OF REFORMS, MODERNIZATION, AND INTERDEPENDENCE: STUDY PAPERS SUBMITTED TO THE JOINT ECONOMIC COMMITTEE 440 (Joint Comm. Print 1991). In particular, there is no social security system for those left unemployed by state sector reform. See Peng Weixiang, *Building the Last Line of Defense for Social Security*, CHINA L.Q., Sept. 15, 1996, at 54-55 (discussing attempts to implement a Chinese social security system in recent years). It was announced recently that Premier Zhu Rongji, widely regarded as one of China's most ambitious and talented economic reformers, was relieved of his responsibilities for state sector reform, suggesting that the long battle to reform this troubled sector of the economy has encountered yet another complication. See Willy Wo-Lap Lam, *Economic Tsar's Declining Role*, S. CHINA MORNING POST, Sept. 15, 1999, available in 1999 WL 26573411.

25. At a certain stage of development, consumers begin to identify a particular trademark with a certain level of quality. This association confers goodwill on the trademark, and it is this goodwill that motivates consumers to purchase one brand over another. In order to develop goodwill, brand owners must invest in research and development, advertising, marketing, and manufacturing. The brand owner recovers these costs through the sale of its products and the price of the good reflects this investment. The counterfeiter—who has no investment costs—essentially engages in theft by benefiting from the brand's goodwill by the unauthorized use of the trademark.

of size, scope, and severity appears to have no parallels in history. As further discussed below, certain factors specific to China have also contributed to the growth of this problem.

### A. Scope and Size of the Counterfeiting Problem

Counterfeiting refers to the unauthorized act by one party of producing and passing off exact duplicates of authentic products with trademarks owned by another party.<sup>26</sup> Counterfeiting should be distinguished from copyright piracy, a problem which was the subject of international attention and intense trade negotiations between the United States and China in the early 1990s.<sup>27</sup> Copyright piracy refers to copying the content of a fixed medium of expression, such as books, films, musical recordings, and computer software, that are contained in print, audio and videotapes, compact discs, or computer diskettes. In the case of copyright piracy, there is not necessarily any attempt to convince the consumer that the pirated product was produced and distributed by the original copyright owner.<sup>28</sup>

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26. At present there is no specific definition of counterfeiting under Chinese law. There are a number of different legal provisions that refer generally to trademark infringement and broadly encompass counterfeiting. For further discussion of these specific laws, see *infra* text accompanying notes 117-21. A law that specifically defines counterfeiting and that distinguishes counterfeiting from other less serious forms of trademark infringement would help improve enforcement in the PRC. See *infra* text accompanying notes 133-35.

27. Serious copyright piracy in China nearly prompted a Sino-American trade war twice in the early 1990s. In 1992, under the threat of "Special 301" sanctions by the United States, China's Ministry of Foreign Economic Relations and Trade (now known as MOFTEC) and then-United States Trade Representative Mickey Kantor entered into a "Memorandum of Understanding" (the "1992 Memorandum") in which China promised to initiate legislative reform to address copyright piracy. See Robert B. Frost *Intellectual Property Rights Disputes in the 1990s Between the Republic of China and the United States*, 4 TUL. J. INT'L & COMP. L. 119, 129 (1995). For a discussion of the legislation enacted by China pursuant to the 1992 Memorandum, see Joseph T. Simone, *Damning the Counterfeit Tide: New Laws Promise Foreign Trademark Owners Much-Needed Protection*, China Bus. Rev., Nov. 1, 1993, available in 1993 WL 10862142. While China's new laws extended the rights of foreign copyright and trademark owners, another dispute arose in 1995 when the United States accused China of failing to enforce the laws. See Frost, *supra* at 130-33. The United States once again threatened sanctions and this time China threatened to retaliate. See *id.* The dispute was finally resolved when China and the United States formulated another Memorandum of Understanding in 1995 (the "1995 Memorandum"). For the text of the 1995 Memorandum, see Treaty, 4 J. INT'L L. & PRAC. 403 (1995), and for a brief discussion of the implications, see Note, *The 1995 Agreement Regarding Intellectual Property Rights Between China and the United States: Promises for International Law or Continuing Problems with Chinese Piracy?*, 4 TULSA J. COMP. & INT'L L. 169 (1996). Subsequent to the 1995 Memorandum, China initiated a well-publicized nationwide crackdown on copyright pirates. See, Frost, *supra* at 131-33; Duncan Hughes, *Copyright Pirates Face Big Penalties as Laws Get Tough*, S. CHINA MORNING POST, May 27, 1995, available in 1995 WL 7528438.

28. In many cases, the infringer will often openly indicate that the product is a copy and will sell the pirated product at a price that is much lower than the price of the original. Many consumers who purchase such products are attracted by the low price of the product and are aware that the product is

In contrast, the counterfeit products are often indistinguishable from the genuine product and will often bear the registered or unregistered trademark of another party along with the company name, address, and trade dress of the lawful manufacturer or trademark owner.<sup>29</sup> In many cases, even the brand owner cannot distinguish between real and counterfeit products without subjecting the counterfeit product to detailed testing and analysis.<sup>30</sup> Unlike the copyright infringer who offers an identical copy at a low price, the counterfeiter seeks to deceive the consumer into purchasing an inferior product disguised as a famous brand.<sup>31</sup> This type of consumer fraud can damage the good will and reputation of the brand<sup>32</sup> and the inferior product quality of some counterfeit products can create issues of consumer safety, which is not usually involved in the case of pirated copyright products.<sup>33</sup>

Unlike copyright owners, trademark owners have been reluctant until

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an unauthorized copy. These consumers are not concerned that the original copyright owner did not produce the product because current technology allows for exact duplication, resulting in little or no difference in quality between the pirated copy and the genuine original. There is an unfortunate perception in the PRC and other countries that consumers benefit from copyright piracy because it allows many consumers access to products that they would not otherwise be able to obtain if they had to purchase the products at legitimate retail prices set by the copyright owner.

29. China uses a registration system under which registration confers the exclusive right to use the mark in China. See PRC, Trademark Law, Art. 37, available in 5 China Law Reference Service (Asia L. Prac.) 5100/93.07.01, *supra* note 10. Non-registered marks do not generally enjoy an exclusive right to use. See PETER FENG, INTELLECTUAL PROPERTY IN CHINA 250–51 (1997).

30. Counterfeiting should also be distinguished from trade dress and other less serious forms of trademark infringement, *i.e.*, copying the package design or partially copying the trademark of another party. In most cases, illegal and unlicensed underground factories manufacture counterfeits, whereas other types of less serious trademark infringements are committed by lawful and licensed enterprises. Trademark infringement—as opposed to counterfeiting—is also very serious, and some of the issues overlap with the issues discussed in this Article. On the other hand, counterfeiting on any scale is criminal activity and causes more serious harm, whereas trademark infringement is generally a civil matter and causes less serious harm. As a result, the main focus of this Article is on counterfeiting.

31. This is not true for all types of goods. In certain instances, the consumer is aware that the goods purchased are counterfeit. This tends to occur in cases of clothing, shoes, handbags, and other accessories where product quality is either not of major importance to the product, or where there are not significant differences between the quality of the counterfeit and the genuine product and it is the prestige associated with a certain trademark that the consumer wants. For example, Hong Kong is famous for the many varieties of counterfeit clothing, handbags, watches, and other items that are knowingly purchased by many consumers. On the other hand, most consumers are unlikely to knowingly purchase an inferior quality product that is applied to the body, such as shampoo or skin lotion, or that is meant to be ingested. Certain companies draw a distinction between “low involvement” consumer goods that are meant to be worn and “high involvement” consumer goods that are applied to the body or ingested. While some consumers will knowingly purchase a counterfeit “low involvement product,” most consumers are unlikely to knowingly purchase a counterfeit “high involvement” product.

32. For a discussion of the harm that counterfeiting can cause to brand market share, goodwill, and reputation, see the case studies in the Appendix *infra*.

33. Issues of risks to consumer safety are further discussed *infra* at text accompanying notes 50–55.

recently to focus public attention on counterfeiting because brand owners are concerned that counterfeiting harms the public image of their products and might deter consumers from buying the genuine article. This is not an issue in most cases of copyright piracy because there is usually no attempt to deceive the consumer by passing off a pirated copy as an original. Several factors seem to have coalesced to create some serious concern in brand owners and have caused them to take more aggressive action. Although the level of copyright piracy seems to have decreased recently in China due to aggressive campaigning by copyright owners,<sup>34</sup> trademark counterfeiting continues to increase.<sup>35</sup> Brand owners have also recently found counterfeit parallel imports in China<sup>36</sup> as well as an increase in the export of counterfeit products from China<sup>37</sup> to countries and regions in Asia and around the

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34. See Renee Schoof, *US Trade Representative Urges China to Drop More Trade Barriers*, AP ONLINE, Apr. 24, 1998, available in 1998 WL 6655951 (remarks of U.S. Trade Representative Charlene Barshefsky noting that China has closed 64 factories making pirated compact disks). It should be noted that many believe that China's actions against copyright piracy were primarily motivated by a desire to eradicate pornography. See, e.g., *Crackdown on Porn*, XINHUA ENGLISH NEWSWIRE, Feb. 13, 1999, available in 1999 WL 7918363 (discussing harsh measures against vendors of pornography, including an 11-year prison sentence for selling pornography).

35. See Schoof, *supra* note 34 (quoting remarks by Charlene Barshefsky, US Trade Representative); see also *China: Crackdown on Fakes Intensifies*, CHINA DAILY, Mar. 16, 1998, available in 1998 WL 7594529 ("In spite of legislative amplification, the fake-making business seems to still be booming and has even been upgraded."). Complete statistics are unavailable, but the information that does exist confirms this trend. For example, in 1997, Administration of Industry and Commerce officials seized 240 million counterfeit and trademark infringing goods and 4,826 pieces of equipment used directly in the production of these goods. See STATE ADMINISTRATION OF INDUSTRY AND COMMERCE, 1997 ANNUAL REPORT 11 (hereinafter "SAIC 1997 ANNUAL REPORT"). For a discussion of the Administration of Industry and Commerce's scope of authority and responsibilities with respect to counterfeiting, see *infra* text accompanying notes 74-75, 82. In 1998, over 400 million illegal goods and 19,340 pieces of equipment were seized. See STATE ADMINISTRATION OF INDUSTRY AND COMMERCE, 1998 ANNUAL REPORT 15 (hereinafter "SAIC 1998 ANNUAL REPORT"). This represents a 67% increase in the number of illegal products seized and a 300% increase in the amount of equipment seized. Statistics compiled by specific industry groups also indicate that the problem is getting worse. See Simone, *supra* note 3, at 16 (citing ten-fold increase in seizures of counterfeit cigarettes in Shanghai area in 1997-98 as compared with mid-1990s).

36. Counterfeiters in the PRC have recently begun to manufacture counterfeits of parallel imports, *i.e.*, counterfeits that are then passed off as products manufactured by the brand owner or its affiliates abroad that have then been imported into China. For example, counterfeiters will manufacture a product with Taiwan packaging and labeling that differs somewhat from the version of the same brand manufactured on Mainland China. The counterfeiter will then pass off the counterfeit as an imported product from Taiwan. These counterfeit parallel imports create an additional layer of confusion for the consumer who simply assumes that the import must be genuine and, in many instances, for law enforcement authorities who may refuse to seize such products for fear that they are genuine products that have been lawfully imported. Counterfeiters will also export the counterfeit parallel product to Taiwan, other countries in Asia, and other regions.

37. There is a sharp increase in the export of counterfeit products made in the PRC to countries abroad. For example, in 1997, U.S. Customs seized PRC-made goods violating intellectual property rights valued at US\$14,490,069 in 250 seizures. See United States Customs Service, *Seizure Statistics* (visited Oct. 25, 1999) <<http://www.customs.treas.gov/imp-exp2/ipr/stats/china.htm>>. In 1998, the

world,<sup>38</sup> raising brand owners' concerns that counterfeiting in China poses a global threat to their trademarks.

### 1. *Estimating the Size of the China Counterfeiting Problem*

There is no scientific method for determining the exact size of the counterfeiting problem and any efforts to do so can proceed only on the basis of partial and scattered information. Counterfeiters operate outside the reach of the law and public scrutiny; thus a great deal of information about counterfeiting is simply inaccessible and it becomes necessary to proceed based upon extrapolation from existing data. One method is to estimate the total value of counterfeit products available in or originating from China based upon all available sources. This is less complicated and controversial than attempting to determine losses from counterfeiting, *i.e.*, revenues lost to counterfeiting, which are based on certain assumptions concerning the

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total value of infringing PRC goods seized increased almost 100% to US\$28,951,681 while the number of seizures more than doubled to 636 seizures. *See id.* In both years, China was the leading country of origin for value of infringing goods seized by U.S. Customs accounting for 27% of the total in 1997 and jumping to 38% of the total in 1998. *See id.* for 1998 statistics; *see also* United States Customs Service, *Protection of Cultural and Intellectual Property: Seizure Statistics* (visited Oct. 25, 1999) <<http://www.customs.treas.gov/imp-exp2/ipr/stats/china.htm>>; <<http://www.customs.treas.gov/imp-exp2/ipr/stats/yearly.htm>> (for summary of seizures from 1993-99). The statistics above refer to goods violating all intellectual property categories and do not specifically isolate counterfeit goods, but anecdotal evidence indicates that counterfeit goods are the largest portion of the goods seized.

38. Brand owners have begun to find counterfeits and counterfeit parallel imports that can be traced back to China in ever increasing numbers in other parts of Asia, Europe, the United States, and other territories. *See, e.g., Smuggling of Cigarettes From China Rampant*, MANILA STANDARD, Aug. 11, 1999, available in 1999 WL 10389764 (reporting seizures of large quantities of counterfeit cigarettes produced in China and smuggled into the Philippines); *Tobacco Haul*, S. CHINA MORNING POST, July 31, 1999, available in 1999 WL 21935171 (French officials seized 36 million counterfeit cigarettes originating from China and bound for the Canary Islands); Jo Pegg, *Undercover Hunt for Rogue Teletubbies*, S. CHINA MORNING POST, Dec. 3, 1998, available in 1998 WL 22054753 (counterfeit Teletubbies children's toys from China are found across Asia); Magdalen Chow, *Businessman Accused of Mastermind Role in Cigarette Smuggling*, S. CHINA MORNING POST, Sept. 23, 1998, available in 1998 WL 22020234 (smuggled counterfeited cigarettes from China destined for Vietnam); *Gillette's Duracell Unit Warns UK Retailers Over Fake Batteries*, AFX NEWS, Apr. 28, 1998, available in 1998 WL 17625301 (company warning United Kingdom retailers about low quality counterfeit batteries from China). Some of these counterfeit products involve health and safety risks for consumers abroad. *See, e.g., House Commerce Committee Requests FDA Assessment of Each EU Member Country's Pharmaceutical Inspection Program in Preparation for US-EU MRA Hearings*, HEALTH NEWS DAILY, Aug. 7, 1998, available in 1999 WL 9314932 (counterfeit glycerin product originating in China and shipped through Germany contained ethylene glycol and poisoned 89 children in Haiti); *see also* Scot Stevens, *Challenges on China: Product Counterfeiting in China and the Role of Underwriters Laboratories, Inc.*, APPLIANCE, June 1, 1998, available in 1998 WL 10568910 (electrical products from China bearing counterfeit Underwriters Laboratories marks are considered dangerous and can lead to home fires). With the advent of the Internet, Chinese counterfeiters now have a powerful new tool to expand their trade across national boundaries and around the world. *See* David H. Freedman, *Fakers' Paradise*, FORBES MAG., Apr. 5, 1999, at 50.

recovery of market share if counterfeits were no longer in the market.<sup>39</sup> The information discussed below draws upon all available sources—value, losses, and anecdotal information—in order to arrive at an estimate of the size of the problem.

According to industry groups, counterfeiting now accounts for as much as fifteen to twenty percent of total sales, *i.e.*, the additional amount of sales revenue that these companies would have earned if counterfeits did not exist in the market.<sup>40</sup> Individual multi-national companies have reported losses of \$150 million, \$70 million, and \$24 million per year and many other companies report suffering losses on a similar scale.<sup>41</sup> Although industry groups have an incentive to report losses as high as possible and it is unclear whether actual losses are as high as those reported,<sup>42</sup> there can be no doubt that corporate losses are substantial.

A second source of information concerning the size of the problem is based on available government statistics, which provides a partial picture. In 1998, all levels of the Administration of Industry and Commerce seized over 400 million counterfeit and trademark infringing goods in raids.<sup>43</sup> While the statistics do not indicate the aggregate value of these products, an estimate of several million to tens of millions of US dollars is not unreasonable. All levels of the State Technical Supervision Bureau confiscated additional counterfeit products valued at \$20.4 million.<sup>44</sup> In 1998, the United States, Customs Department seized counterfeiting and infringing goods worth \$29 million that were produced in China and were bound for entry into the United States, which made China the leading country of origin of counterfeit goods by value of goods seized, with thirty-eight percent of the total.<sup>45</sup> These figures, already in the tens of millions of dollars, refer only to goods seized

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39. See *infra* note 42.

40. See Simone, *supra* note 3, at 12; Murphy, *supra* note 3, at 5.

41. Estimated annual losses for Procter & Gamble are \$150 million, while Nike and Unilever reported losses of \$70 million and \$24 million, respectively. See Murphy, *supra* note 3, at 5.

42. For example, if losses from counterfeiting account for 15-20% of the total sales of a product, it does not follow that eliminating counterfeiting will allow the brand owner to recoup 100% of its sales lost to counterfeiting. Some counterfeit products are sold at significantly lower prices than the genuine article and some consumers either know or strongly suspect that they are purchasing counterfeits, especially in the case of clothing and shoes. Eliminating counterfeiting may allow the brand owner to recover the bulk of its sales from consumers who pay full or close to full price for a counterfeit good that the consumer believed was genuine. This is some portion of the total number of consumers who buy counterfeit goods, but it is not possible to determine the exact size of this group.

43. See SAIC 1998 Annual Report, *supra* note 35, at 15.

44. See STATE TECHNICAL SUPERVISION BUREAU, 1998 ANNUAL REPORT 13, 17. For a discussion of the Technical Supervision Bureau's scope of authority and responsibilities with respect to counterfeiting, see *infra* note 83 and accompanying text.

45. See United States Customs, *Seizure Statistics*, *supra* note 37.

from counterfeiters in raid actions and certainly represent only a fraction of what is actually produced and sold.

A third source for estimating the magnitude of the counterfeiting problem is based upon anecdotal information, observation, and experience. As almost every consumer in China knows, counterfeit products are in abundant supply just about everywhere. While genuine versions of consumer products are sold in department stores, supermarkets, authorized dealers, and other legitimate sources, a plentiful supply of counterfeit and infringing versions of the same products are being sold in nearby closed or open air wholesale markets, small retail stores, side street kiosks, and by unlicensed street vendors and hawkers. Counterfeiting has emerged as a significant trade in China and supports entire local economies.<sup>46</sup>

Based on these factors and other available information such as the size of the PRC consumer economy (\$352.7 billion),<sup>47</sup> the percentage of total sales reported to be lost from counterfeiting by industry groups (fifteen to twenty percent), the amount of counterfeit goods seized, the total worldwide losses to counterfeiting suffered by US companies (\$200 billion),<sup>48</sup> and China's role as a source of worldwide counterfeit goods<sup>49</sup>—it is possible to estimate that the total value of counterfeit goods available in or originating from the PRC is in the billions, if not tens of billions, of dollars per year.

## 2. *Consumer Issues*

Complaints by Chinese consumers about counterfeit and inferior quality products have risen sharply in recent years.<sup>50</sup> These complaints indicate that many counterfeits are inferior quality products that may cause harm to unwitting consumers. Perhaps the most notorious recent incident involved counterfeit liquor, which led to the deaths of twenty-seven people in 1997.<sup>51</sup>

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46. See *infra* text accompanying notes 66-72.

47. See *supra* note 21.

48. See H.R. REP. NO. 104-556, at 2 (1996), reprinted in 1996 U.S.C.C.A.N. 1074, 1075.

49. See *supra* note 38.

50. Reflecting an increase in inferior quality counterfeit products in the marketplace, complaints by Chinese consumers across all categories to the China Consumer's Association increased by 19% in 1997 to 624,641, and by an additional 6.8% to 667,016 in 1998, representing a total increase of over 25% in two years. See CHINA CONSUMER ASSOC., SUMMARY REPORT: 1997 NATIONAL COMPLAINT STATISTICS 1 (1998); CHINA CONSUMER ASSOCIATION, SUMMARY REPORT: 1998 NATIONAL COMPLAINT STATISTICS 1 (1999). In fact, economic crimes of all kinds are on the rise. A small sample of such crimes includes smuggling, credit card fraud, fraud involving the stock market, export duties, and other taxes. For the first eight months of 1999, 51,000 economic crimes involving \$10 billion were reported to the police. See Mark O'Neill, *Tech-Wise Criminals on Rampage*, S. CHINA MORNING POST, Oct. 14, 1999, available in 1999 WL 26576566.

51. In general, cases involving serious bodily harm and death to consumers have recently

As reflected by consumer complaints, virtually every product category is subject to counterfeiting, including television sets, washing machines, radios, stereos, cameras, motorcycles, pharmaceuticals, baby food, and instant noodles.<sup>52</sup>

Although there are product quality issues for some counterfeit goods, this is not the case for all goods. Some counterfeit products are still of average and serviceable quality, although inferior to the quality of the premium brands they imitate. Counterfeit goods have also increased in both the quality of the packaging and the product itself as counterfeiters have gained experience in their trade. This has led to what appears to a strong appetite for counterfeit products by a significant segment of the less affluent and less educated population.<sup>53</sup> Not only will these consumers intentionally purchase counterfeit shoes and apparel, but they will also knowingly purchase counterfeit daily-use products such as shampoo, soap, and detergent.<sup>54</sup> A common explanation is that less affluent consumers cannot afford to

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increased dramatically. Reported cases of serious injury increased 80% from 672 cases in 1997 to 1214 cases in 1998; cases involving permanent injury increased 100% from 35 in 1997 to 70 in 1998; and cases involving death increased 73% from 19 in 1997 to 33 in 1998. See CHINA CONSUMER ASSOC., 1997 REPORT, at 2; CHINA CONSUMER ASSOC., 1998 REPORT, at 4. Although these figures include both counterfeit and inferior quality products, of the 33 deaths and 1214 serious injuries in 1998, 27 deaths and 1,000 injuries can be traced to counterfeit rice wine in Shanxi Province in North China. See *Shanxi Counterfeit Liquor Case*, GENUINE PRODUCT WKLY., Feb. 3, 1999, at 1. Widespread sales of counterfeit medicines also pose risks to Chinese consumers. See, e.g., Alison Smith, *Counterfeit Stroke Medication Sold over Border in Locally-made Packaging*, S. CHINA MORNING POST, July 6, 1999, available in 1999 WL 19488202 (stroke victims were sold ineffective counterfeit intravenous medication). Although the PRC government has recently intensified its efforts to crack down on counterfeit medicines, the task is a daunting one. A recent study by the State Drug Administration indicates that 13.1% of all drugs tested in a national survey were either counterfeit or fell below minimal pharmaceutical standards. See Richard Tomlinson, *China Cracks Down on Counterfeit Medicines*, BRITISH MED. J., Mar. 6, 1999, available in 1999 WL 10991410.

52. See CHINA CONSUMER ASSOC., 1998 REPORT, at 11; Murphy, *supra* note 3, at 5; *Specials*, J. COMM., May 3, 1999 available in 1999 WL 6376866 (discussing wide variety of counterfeit goods widely available on China's streets). For a sample of the wide variety of products subject to counterfeiting, see TRADEWINDS INDUSTRY WKLY., July 15, 1999, available in 1999 WL 16969345 (counterfeit motorcycles); *Lucent's Chinese Anti-counterfeit Operations Successful*, TELECOMWORLDWIRE, July 15, 1999, available in 1999 WL 7555978 (counterfeit telecommunications copper cable); *Viagra Sales Illegal*, CHINA DAILY, Mar. 30, 1999, available in 1999 WL 5968647 (according to the State Drug Administration, with the exception of certain pills used in clinical studies, all "Weige," the Chinese translation of Viagra, an American drug, sold in China is counterfeit). One of the fastest growing areas of counterfeiting is in the area of agricultural products. In Liaoning Province, use of counterfeit fish feed resulted in the "loss of livelihood for local fish breeders for several years and caused some fish breeders to become homeless." CHINA CONSUMER ASSOC., 1998 REPORT, *supra* note 50, at 4. Counterfeit corn seeds in Inner Mongolia caused an entire town to lose a crop harvest. See *id.* In 1998, complaints about counterfeit agricultural products, such as fertilizer and agricultural chemicals, increased 24.6% over 1997 levels. See *id.*

53. Interview with Chinese Consumer Group at The East China School of Politics and Law, Shanghai, on Nov. 18, 1999.

54. *Id.*

purchase premium goods and that counterfeits of premium goods carry a certain caché and are of the same quality and price as local brands.<sup>55</sup>

### 3. *Local Industry*

Counterfeiting is not limited to foreign trademarks. Local Chinese industries also suffer from counterfeiting on a similar scale.<sup>56</sup> Some local brands that are still in the early stages of building consumer loyalty and goodwill may be more vulnerable than some established foreign brands; counterfeiting reduces revenues and profit margins, resulting in less available capital for reinvestment in advertising, marketing, and product development.<sup>57</sup> Local companies may also lack the resources to withstand an attack on the brand by aggressive counterfeiting, which might prevent a local brand from establishing a firm hold in China's markets.<sup>58</sup>

### B. *The Economics of Counterfeiting in China*

The trade in counterfeit goods in China can be roughly divided into two different groups: manufacturers and distributors. The differing roles played by each group and their relative importance in the trade are further discussed below.

#### 1. *Manufacture of Counterfeit Goods*

Many of the factories that manufacture counterfeit goods are in the southeastern coastal provinces of Guangdong and Fujian. These territories are located close to Hong Kong and Taiwan; Guangdong is the ancestral home of many Hong Kong residents and Fujian is the ancestral home of many Taiwanese. When China first opened its doors to foreign investment in

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55. Some consumers further explained that they may use a counterfeit premium brand soap to wash their hands only and use a counterfeit detergent to wash work clothes, but not bed sheets. In other words, consumers recognize that certain products are counterfeit and will adjust their usage of those products accordingly but will not forgo buying those products. *See id.*

56. *See* Murphy, *supra* note 3, at 5. Some data exists suggesting that counterfeiting of local brands exceeds that of foreign brands by a wide margin. *See* Simone, *supra* note 3, at 12.

57. *See* Simone, *supra* note 3, at 12. One example is the Nanyang Tobacco Company, which saw a decline of 60% in its contribution to the profits of the corporate conglomerate of which it is a part. *See Shanghai Industrial Holdings*, M2 PRESSWIRE, Sept. 3, 1999, available in 1999 WL 24355584. A number of problems, including counterfeiting, contributed to this decline, and the decline is expected to continue next year. *See id.*

58. Chinese counterfeits are not only harming China's own local industry but exports of Chinese counterfeit compact disks to Vietnam are threatening to destroy Vietnam's nascent compact disk industry. *See* Huw Watkin, *Pirates Send CD Industry Spinning*, S. CHINA MORNING POST, Aug. 17, 1999 available in 1999, WL 21936599.

the late 1970s, Taiwan and Hong Kong businesses began to establish manufacturing sites in these provinces.<sup>59</sup> Both provinces are still known for the concentration of legitimate manufacturing sites, but these areas are now also known for their concentration of counterfeit manufacturing,<sup>60</sup> with some of these activities financed by sources in Hong Kong and Taiwan.<sup>61</sup> These factories tend to be scattered, unorganized, and small-scale operations with workers from other provinces laboring under squalid conditions.<sup>62</sup>

## 2. *Distribution of Counterfeit Goods*

While the manufacturers of counterfeit products tend to be scattered and disorganized, there are a number of large distribution centers that are organized and drive the manufacture of counterfeit products.<sup>63</sup> There are at least five major wholesale distribution centers: Hanzhen Street in Wuhan City, Hubei Province; Linyi Market in Linyi, Shandong Province; Nansantiao Market in Shijiazhuang, Hebei Province; China Small Commodities City in Yiwu City, Zhejiang Province; and Wuai Market in Shenyang, Liaoning Province. Together, these centers form a corridor that

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59. For a discussion of the favorable economic policies granted to Guangdong and Fujian Provinces because of their special relationship with Hong Kong and Taiwan at the beginning of China's economic reforms, see ERZA F. VOGEL, *ONE STEP AHEAD IN CHINA: GUANGDONG UNDER REFORM* 80–87 (1989). For a discussion of Taiwan's rise from sleepy agrarian society to economic powerhouse after the Chinese civil war, see Daniel C.K. Chow, *Recognizing the Environmental Costs of the Recognition Problem: The Advantages of Taiwan's Direct Participation in International Environmental Law Treaties*, 14 STAN. ENVTL. L.J. 256, 265–66 (1995). For a discussion of the quick emergence of private business in Xiamen, located in Fujian Province, in the 1980s, and the alliances formed between business and government, see David L. Wank, *Private Business, Bureaucracy, and Political Alliance in a Chinese City*, THE AUSTRALIAN J. CHINESE AFF., Jan. 1995, at 55.

60. Some factories produce both genuine products and counterfeits. See Freedman, *supra* note 38, at 49.

61. For an example of a Hong Kong counterfeit operation that involved a number of Guangdong manufacturers and trading companies, and extended to include a state-owned department store in Shanghai, see *Unilever PLC v. No. 3 Department Store of Shanghai et al.*, in SHANGHAI HIGH COURT INTELLECTUAL PROPERTY DIVISION DECISIONS 369–89 (1998) (copy on file with author). The plaintiff was able to recover a total civil judgment of RMB278,948 or approximately US\$34,000 against 12 defendants, including a state-owned and operated department store, manufacturers, and various printing companies and trading companies. See *id.* at 283–86. This case was unusual because it involved a number of state-owned entities, giving the plaintiff a series of suitable defendants. In many cases, counterfeiters operate in underground factories and through unlicensed distributors with no assets, making a civil lawsuit much more difficult to bring.

62. See Freedman, *supra* note 38.

63. The information in this and the next section on the role of wholesale markets in the counterfeit trade in the PRC is based on several thousand hours of intensive fieldwork, due diligence, and document and evidence gathering over a six month period by a professional investigation agency with help from local lawyers. The author was involved in closely supervising the investigation and research activities conducted by these parties and accompanied these parties on numerous field trips to these markets.

connects China's geographic center in Hubei to the far northeast in Liaoning Province, near the Korean border. Links to the factories in southern China create a manufacturing and distribution chain that covers the entire length of China from the subtropical areas of Guangdong Province to the northern climate of Liaoning Province. This manufacturing and distribution system includes all of China's major urban centers, which are China's most prosperous areas: Shenzhen in the South across the border from Hong Kong, Guangzhou in the South, Shanghai in the central coastal region, and Tianjin and Beijing in the North.

These large wholesale distribution centers drive the manufacture of counterfeit consumer products in South China and not the inverse.<sup>64</sup> The manufacturers of small consumer products in the South are scattered, unorganized, and independent entities that depend on purchase or production orders from large distributors for their livelihood. The counterfeit trade in consumer daily use goods is demand driven, as opposed to supply driven, and these wholesale and distribution centers are the most significant source of that demand because of their size. These organizations can effectively and efficiently deliver counterfeits in massive volumes to retailers throughout the PRC.

#### *a. Role of Wholesale Markets*

The major wholesale distribution centers referred to above sell goods directly to retailers or to other wholesale markets located throughout China. Wholesale markets serve as vital distribution channels for counterfeit and smuggled goods, which cannot enter retail markets through regular distribution channels. Large wholesale markets that traffic in counterfeit and smuggled goods can be found in every province and in almost every large city in China. Located in densely populated areas with convenient transportation access, these markets are often massive in size and may

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64. This discussion focuses on counterfeit consumer and daily-use products where there is not a large capital investment involved in buying equipment to produce these products. In some cases, the capital investment tends to be negligible. For example, for certain types of daily-use products, such as shampoo, counterfeiters will generally buy bottles from certain illegal manufacturers, use recycled authentic bottles, or used genuine bottles that are discarded because they fail to meet the brand owner's quality specifications. The counterfeiters then buy bulk shampoo from wholesale markets. Counterfeiters have been known to work out of their homes in filling counterfeit or otherwise illegal bottles from large vats of bulk shampoo in their living rooms. For products of this type, the distributor, not the producer, is the key player in the counterfeit trade. On the other hand, for other types of products that require a significant capital investment, such as electronic and industrial goods, the manufacturer may play a much more pivotal role in the trade. For these types of goods, the discussion above on the major role of the distributor driving the entire counterfeit trade may not be applicable.

contain more than one thousand outlets, each a wholesaler-distributor, in a large open air or partly enclosed area.<sup>65</sup> These markets are noted for an abundant and free flowing supply of goods with heavy turnover rates. Wholesale outlets offer genuine and counterfeit goods together, with genuine and counterfeit goods openly displayed, or with genuine goods only on display but with counterfeit goods hidden but available for the asking.

There is no known wholesale market that does not carry counterfeit products and it is unlikely that these markets could survive without selling counterfeit goods. Legitimate manufacturers tend to tightly control their distribution channels by going through a regular set of distributors who are selected on the basis of passing a strict set of qualifying requirements and who are locked into profit margins within very narrow ranges. Legitimate distributors earn profits by selling bulk quantities to reputable wholesalers and large retailers who are in turn also locked into narrow profit margins if they sell the product at a competitive price. Vendors in large wholesale markets would generally not be able to qualify as a distributor for many large manufacturers and in addition would have to charge competitive prices if they sourced genuine product throughout the manufacturer's regular distribution system. Charging competitive prices would not allow vendors in large open area wholesale markets to attract consumers from regular distribution and retail outlets that are often located in more convenient locations and provide a more attractive and comfortable shopping environment. Rather, these wholesale markets attract consumers by offering goods that are sold at two-thirds or one-third of the retail price of the product.

Purchasers of products in wholesale markets are vendors or retailers who purchase stock for resale to end-use consumers. In Beijing, hundreds of vendors swarm the Tianyi wholesale market everyday and use small trucks, lorries, and three wheel bicycles to furnish abundant stocks of counterfeit and smuggled good for the street stores, kiosks, and small- and medium-sized retail stores all over Beijing. In a major city such as Beijing there are more than ten such wholesale markets.

*b. Yiwu City*

A sense of the size, organization, and potential reach of the wholesale trade in counterfeit goods can be obtained by a review of Yiwu City, located in Zhejiang Province near Shanghai and Hangzhou, and well known as the

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65. Some markets are much larger, with as many as 30,000 wholesale businesses. Markets approaching this size would be found in the major distribution centers discussed *supra* at text accompanying notes 63-64.

largest and most significant wholesale distribution center for counterfeit goods in the PRC.<sup>66</sup> There are reportedly at least 30,000 wholesale stalls and 3,500 full sized stores in Yiwu selling 100,000 different products. Every day approximately 200,000 visitors visit the wholesale markets in Yiwu and purchase approximately two thousand tons of goods, which are then transported by rail and truck for sale throughout China. The products sold in Yiwu tend to be quite inexpensive and this appears to be driving the rapid growth of the Yiwu wholesale trade. At least ninety percent of the daily-use consumer products, such as shampoo and soap, found in Yiwu are counterfeit or infringing products. In one instance, local enforcement officials raided a small storage room in Yiwu and discovered 10,000 counterfeit bottles of shampoo and discovered that in just the surrounding two blocks there were at least 200 other storage rooms and warehouses; the interior of one storage room, viewed from an open window, contained boxes of shampoo stacked up to a twelve foot ceiling in a very large room of at least thirty by fifty feet.<sup>67</sup>

According to local government officials, Yiwu's total annual gross wholesale sales in 1991 reached US\$100 million. By 1993, total sales had more than quadrupled to US\$450 million and in 1997, the last year for which statistics were available, total sales had reached US\$2.4 billion,<sup>68</sup> representing a twenty-four fold increase over six years or an average annual increase of 342%. Although there appears to be some slowdown in the growth rate recently, it is quite possible that this trade is now close to US\$3 billion per year, rivaling or surpassing the revenues of many multi-national companies. The rise in this trade has created new prosperity in what was once a poor farming area and has earned Yiwu a national reputation as an economic model.<sup>69</sup>

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66. The information contained in this section about Yiwu is based upon several visits that the author made to Yiwu during 1998-99 while the author worked as legal counsel to a multi-national enterprise that experienced large-scale counterfeiting in China. Working with a private investigation agency and local counsel, the author was able to spend a total of several weeks in Yiwu examining some private and unofficial documents and gathering additional information through informal discussions with local government officials, business people, lawyers, suspected counterfeiters, and various acquaintances. In some instances, information was gathered through the use of various false identities, pretexts and other subterfuges. There were issues of personal safety in gathering this information so the account above, while incomplete, is the most thorough account available. The author also had access to numerous investigation and field reports prepared by professional investigation companies and by local counsel.

67. This raid occurred on November 11, 1998. The author accompanied officials from the local AIC on this raid and witnessed these events.

68. See *Zhejiang to Host Small Goods Fair*, CHINA DAILY, Sept. 21, 1998, available in 1998 WL 7598291.

69. See Lisa Gubernick, *Personal Journey: Back Home in a Chinese Orphanage*, ASIAN WALL ST. J., Sept. 3, 1999, available in 1999 WL-WSJA 20530764 (discussing Yiwu's new prosperity).

At the center of town, two large transportation companies occupy two open-area transport areas, both the size of football fields, ringed with representative local transport offices from cities and towns all over China.<sup>70</sup> Operating continuously day and night, trucks and lorries unload counterfeit products made in South China in one open transport area for storage and sale in Yiwu's wholesale markets, while other trucks and lorries load counterfeit products already bought from these wholesale markets in the other open transport area for delivery to all parts of China. The roads to and from Yiwu are heavily congested night and day with large trucks and other vehicles continuously in traffic. Distributors in Yiwu are engaged in an aggressive expansion scheme and have already established a number of representative offices around China, overseas branches in Brazil and South Africa,<sup>71</sup> and plan additional expansion to Nigeria, Uruguay, Pakistan, Korea, and Thailand.<sup>72</sup> One distributor has also established an export trading company that may be engaged in the export of counterfeit goods to various countries and locations abroad through its representative offices and other channels. Yiwu's rapid development has now become famous in the PRC as a model of economic success that other locations wish to emulate.

## II. ENFORCEMENT AGAINST COUNTERFEITING IN CHINA

While China has made recent progress in providing more effective protection for trademark owners, a number of problems continue to hinder effective enforcement. The following discussion first provides an overview of the enforcement system in China and then turns to an examination of areas within the current system that can be improved in order to provide more effective enforcement against counterfeiting.

### A. Overview of the Enforcement System

The current enforcement system in China is marked by a number of enforcement entities with concurrent and sometimes overlapping jurisdiction over counterfeiting.<sup>73</sup> This is due to the design of China's government and

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70. Anyone seeking to ship goods to a particular location in China would simply arrange a transportation contract with one of the many representative offices located in the transport areas. The transport office would then work out all of the arrangements for a fee.

71. See *Private Firm to Open Bazaar in South Africa*, CHINA DAILY, Apr. 27, 1999, available in 1999 WL 5969163 (largest Chinese funded overseas market for light industrial products and small commodities to open in Johannesburg in addition to market already opened in Brazil).

72. See *Zhejiang to Host Small Goods Fair*, *supra* note 68 (noting that Yiwu has established trade ties with 53 countries and regions).

73. The same is true of intellectual property protection and enforcement in general. See Pitman

regulatory system, dating to the pre-reform socialist economy, which divides the economy into vertical sectors. A particular administrative entity will have complete authority over all aspects of its designated sector, including enforcement authority. Given that counterfeiting can cross several vertical economic sectors, several authorities will have concurrent enforcement authority over counterfeiting, leading to a series of parallel enforcement mechanisms.

For example, enforcement actions can be brought with the Administration of Industry and Commerce (“AIC”) under the Trademark Law<sup>74</sup> or the Anti-Unfair Competition Law,<sup>75</sup> or with the Technical Supervision Bureau (“TSB”) under the Consumer Protection Law<sup>76</sup> or the Product Quality Law.<sup>77</sup> The AIC’s enforcement authority is based on its jurisdiction over all aspects of trademarks. The TSB has jurisdiction over issues of product quality and consumer protection, including the authority to bring enforcement actions against inferior quality counterfeit products and products that defraud or cause harm to consumers. In addition to actions brought under these two authorities, enforcement actions can also be brought through the Patent Administration Office under the Patent Law<sup>78</sup> and where imports or exports violate trademark rights, companies can also turn to the General Administration of Customs which has authority to seize infringing goods under the Customs Law.<sup>79</sup> Less frequently pursued options include filing complaints with the Public Security Bureau (“PSB”), the principal police organization,<sup>80</sup> or filing a civil case with the courts.<sup>81</sup>

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B. Potter & Michel Oskenberg, *A Patchwork of IPR Protections*, CHINA BUS. REV., Jan.–Feb. 1999, at 8–9.

74. See Article 39, PRC Trademark Law (Revised), available in China Law Reference Service, *supra* note 10, at 5100/93.07.01; Article 42, PRC Trademark Implementing Rules, available in China Law Reference Service, *supra* note 10, at 5100/95.05.15.

75. See Zhonghua Renmin Gonghe Guo Fan Bu Zhendang Jingzheng Fa [PRC Anti-unfair Competition Law of the People’s Republic of China, Art. 21] (promulgated Sept. 2, 1993 and effective Dec. 1, 1993), available in China Law Reference Service, *supra* note 10, at 5400/93.09.02.

76. See Zhonghua Renmin Gonghe Guo Xiaofeizhe Quanyi Baohu Fa [Protection of the Rights and Interests of Consumers Law of the People’s Republic of China, Art. 34] (promulgated Oct. 31, 1993 and effective Jan. 1, 1994), available in China Law Reference Service, *supra* note 10, at 5400/93.10.31.

77. See Zhonghua Renmin Gonghe Guo Chanpin Zhiliang Fa [Product Quality Law of the People’s Republic of China, Art. 12] (promulgated Feb. 22, 1993 and effective Sept. 1, 1993), available in China Law Reference Service, *supra* note 10, at 5400/93.02.22.

78. See PRC Patent Law (Revised), Art. 60, *supra* note 10; PRC Patent Law Implementing Regulations, Art. 77, *supra* note 10.

79. See Zhonghua Renmin Gonghe Guo Haiguan Fa [Customs Law of the People’s Republic of China, Arts. 3 & 4] (adopted by the 19th Session of the Standing Committee of the 6th National People’s Congress on Jan. 22, 1987 and effective July 1, 1987), available in China Law Reference Service, *supra* note 10, at 5900/87.01.22.

80. Under recent legislative changes, the PSB, now has direct authority to conduct investigations

In practice, most companies choose to pursue enforcement actions in the form of quick-strike raids and seizure actions with the AIC<sup>82</sup> or the TSB.<sup>83</sup> In

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and raids in counterfeiting cases that are likely to involve criminal liability. This differs from the PSB's previous role of providing backup support to the AIC or TSB in certain cases. The PSB has the full range of police powers, including the authority to detain and arrest suspects and force entry into locked and secure areas. This is a major advantage over the administrative authorities such as the AIC and TSB, which have none of these powers. If the PSB finds that the case merits criminal prosecution, the PSB should then refer the case to the Prosecutor for further action. If the PSB finds that the case does not cross the threshold of criminal liability, then the PSB can issue fines or refer the case to administrative authorities. To date, with limited resources and without proper training in intellectual property matters, the PSB has not assumed a major role in enforcement against counterfeiting. The PSB also relies upon the brand owners to conduct their own investigations and collect evidence using private investigation companies and will rarely conduct an investigation on its own. As a result, the AIC and TSB continue for the present to carry out the bulk of enforcement work against counterfeiting.

81. The discussion in this part focuses on the PRC government entities involved in enforcement against counterfeiting. In addition, there is an entire private industry that provides support for enforcement efforts by brand owners. A detailed examination of this industry is beyond the scope of this Article, but a brief sketch of this industry provides a useful background of how much of an investment brand owners must make to enforce their rights. Almost all brand owners will enlist some outside help in the form of private investigation agencies, trademark agents, and law firms to help coordinate the enforcement actions discussed in the text. Brand owners do this for various reasons: some companies believe that they do not have the expertise for this type of specialized work while others believe that such work is potentially dangerous and prefer contracting out such work rather than subjecting their own employees to security risks. In general, private investigation agencies play a major role in all intellectual property work in the PRC because public authorities have limited resources and personnel and generally are not trained in investigation work. As a result, most brand owners employ private investigation agencies to do a preliminary background investigation of the suspected counterfeiter, including locating factories, equipment, existing stock of counterfeit goods, and when and where the counterfeit goods are being produced or sold. Other matters that private investigators will check include the business registration and license of the suspected counterfeiter as well as the responsible principal. Most brand owners first collect all of this information before going to the PRC enforcement authorities to request a raid or enforcement action. Trademark agents are also used for certain trademark matters involving foreign trademarks. *See infra* note 83. Some brand owners hire law firms to manage the entire investigation and enforcement process, especially where the brand owner does not have expertise in these areas. Other brand owners simply work with the private investigation agency or the trademark agent and hire lawyers only for more complex legal issues. For an indication of the fees involved for such work, see *infra* note 131. As counterfeiting and other intellectual property problems have grown, this private industry has also grown and prospered. While lawyers and investigators from Hong Kong once dominated this industry, competition from Mainland China firms has made this entire industry much more competitive.

82. Enforcement actions through the AIC are conducted either by the Trademark and Advertising Division under the Trademark Law or by the Economic Supervision Division under the Trademark Law, the Anti-Unfair Competition Law, and laws pertaining to general economic crimes. *See* Simone, *supra* note 3, at 14. In AIC enforcement actions, the trademark owner assumes a role similar to that of a plaintiff under the Trademark Law and the Anti-Unfair Competition Law. The AICs are not focused primarily on the private rights of the trademark owner, however, but primarily seek to protect public rights. For further discussion, see *infra* text accompanying note 89. Both of these laws empower the AIC to enforce actions not only against counterfeiting but also against the related offenses of trademark infringement, knockoffs, and copying the package design and artwork of the original product. The AIC has the power to order the counterfeiter to compensate the trademark owner and can suspend or cancel the defendant's business license. *See infra* note 125. In addition, the AIC is required to issue a written decision, with a copy going to the plaintiff, naming the plaintiff and stating whether

some cases, the plaintiff or complainant can obtain authorization for a raid action within minutes of filing an *ex parte* complaint and other documentary support with administrative authorities. The authorities then proceed immediately to the suspect premises accompanied by representatives of the trademark owner and in many instances seize all counterfeit product, machinery, and equipment found on site.

Once the AIC or the TSB concludes the enforcement action each should issue a decision based upon the violation of the substantive law in question, *i.e.*, Trademark, Unfair Competition, Product Quality, or Consumer Protection. Where the enforcement authority in question also determines that the harm caused exceeds a designated threshold, the authority has the discretion to forward the case to the Public Security Bureau for further investigation. Once the PSB determines that the case involves criminal liability, the PSB will transfer the case to the People's Procuratorate for criminal prosecution.<sup>84</sup> The Procuratorate will then file a criminal complaint with the People's Court, which will proceed to determine criminal liability.<sup>85</sup>

### *B. Civil Litigation*

The discussion in the previous section focused on administrative and criminal actions. Trademark owners have generally avoided civil litigation

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the defendant violated the plaintiff's rights. AIC decisions can become useful in subsequent criminal prosecutions for repeat offenders.

83. The TSB is charged primarily with protecting the consumer through enforcement of the Product Quality Law or the Consumer Protection Law. Thus, it does not directly enforce the rights of the trademark owner, who is not considered to be the plaintiff in TSB actions. As a result, the TSB is not required to give a copy of its decisions to the trademark owner and in many cases, because there is no party in interest pressing for a decision, the TSB may not even issue a decision. The TSB can levy fines but cannot order compensation or the cancellation of business licenses. In addition, the TSB cannot pursue actions for trademark infringements, knock-offs, or the copying of package design. Despite the TSB's limited powers in contrast to the AIC, many multi-national companies prefer the TSB because there is no need to employ a designated trademark agent as is generally the practice in actions before the AIC.

The trademark registration process is a dual track system. Domestic applications are handled directly by domestic industries whereas applications for foreign trademarks are handled by a few designated trademark agents, which gain a monopoly position and are able to charge higher fees. *See* FENG, *supra* note 29, at 260–61. China has been urged by the United States to abolish this monopoly and has been making efforts to reform its system. Fees for these designated agents tend to be higher by several multiples than fees for non-qualified agents.

84. For a review of the role of the People's Procuratorates, the principal PRC prosecutorial body, and the criminal process generally, see CHEN, *supra* note 5, at 124–27 & 152–68.

85. *See* Zhonghua Renmin Gonghe Guo Jianchaguan Fa [Public Procurators Law of the People's Republic of China, Art. 6(2)] (adopted at the 12th meeting of the Standing Committee of the Eighth National People's Congress on Feb. 28, 1995, promulgated by Order No. 39 of the President of the People's Republic of China on Feb. 28, 1995 and effective as of July 1, 1995), *available in* China Law Reference Service, *supra* note 10, at 1400/95.02.28(2).

because plaintiffs often find it difficult to obtain immediate relief from civil courts as courts rarely issue temporary restraining orders or preliminary injunctions preventing counterfeiters from disposing of existing stock and other evidence.<sup>86</sup> Some trademark owners have attempted to pursue litigation after raids, but have found it difficult to get evidence transferred from administrative authorities to courts and have found courts will give deference to factual findings on profits and turnovers, which are often very low.<sup>87</sup> Moreover, some courts will not accept jurisdiction while the case is still pending before an administrative authority. As a result, plaintiffs must wait until the AIC issues a final decision in the matter, which usually takes between three and six months. By the time the decision is issued, the evidence and the suspect may have long disappeared from the scene.

Compensation awards to successful plaintiffs have been generally low by western standards. Some plaintiffs have achieved positive results through the recently established Intellectual Property Divisions of the Intermediate People's Courts in some jurisdictions,<sup>88</sup> but the civil litigation system in the PRC continues to lag behind the public enforcement system in terms of resources, expertise, and power.

### *C. Public Enforcement and Private Rights*

The current system in the PRC emphasizes public enforcement, *i.e.*, protection of public interests through enforcement by government administrative entities and by police and prosecutorial organizations.<sup>89</sup> For example, the AIC is primarily a regulatory and enforcement body charged with the general administration of economic enterprises and the general development of commerce. The AIC is focused on imposing fines and penalties on the counterfeiter rather than protecting the rights and interests of the trademark owner. Similarly, the TSB is charged with protecting the rights of the consumer and is also not primarily concerned with protecting the rights of the trademark owner. As a result, neither body is focused on making the trademark owner whole by awarding compensatory damages commensurate with the actual losses suffered. Awards of compensation, when made, tend to

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86. For a review of the work of the civil courts and some of their systemic weaknesses, see CHEN, *supra* note 5, at 104-23.

87. Bureaucratic and political interests discourage administrative agencies from transferring jurisdiction over cases to other entities. See Potter & Oskenberg, *supra* note 73, at 8; see also *infra* text accompanying notes 107-12.

88. See FENG, *supra* note 29, at 24.

89. For a discussion of emphasis on public enforcement in the PRC on intellectual property matters, see generally Potter & Oksenberg, *supra* note 73.

be minor in comparison to actual losses suffered. In addition, neither entity is adept at follow-up documentary discovery, *i.e.*, tracing the dealings of the counterfeiter through account records of profits and sales, receipts, production orders, links with other associates, bank accounts, and other financial dealings. This is a major weakness because documentary discovery is critical to building a case for subsequent criminal or civil litigation.

In contrast with western nations, the PRC system has generally failed to create strong tools for private enforcement, whether civil litigation where the focus is on compensatory damages to the trademark owner or the development of remedies specifically geared towards the protection of the private plaintiff's rights. For example, remedies such as attachment and forced sale of the defendant's property, freezing bank accounts, and preliminary and permanent injunctive relief have not been fully developed in the PRC and are rarely used by brand owners. In countries like the United States, private enforcement through civil litigation or the threat thereof assumes a major role in the protection of intellectual property rights.

#### *D. Problems with the Current Enforcement System*

A number of problems within the current system hinder effective enforcement: local protectionism, bureaucratic rivalries, lack of sufficient criminal prosecution, and insufficient fines and penalties.

##### *1. Local Protectionism*

Local protectionism in China is widespread and poses probably the single most significant problem in enforcement against counterfeiting.<sup>90</sup> The trade in counterfeit goods has now become a vital portion of some local economies, providing employment for otherwise unemployable workers and

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90. See *Crackdown on Fakes Intensifies*, CHINA DAILY, Mar. 16, 1998, available in 1998 WL 7594529 ("regional protection and official complicity, lax law enforcement and inadequate official supervision and administration are major reasons" behind counterfeiting). Government corruption is generally viewed as one of China's most serious problems. See *Corruption Tops List of Business Problems in China*, ASIAN ECON. NEWS, SEPT. 14, 1999, available in 1999 WL 21276863 (62% of senior managers found corruption to be the most serious problem in doing business in China). During the first six months of 1999, over \$14 billion in state funds were misused or stolen by government entities and officials. See William J. McMahon, *China Admits US\$14 Billion in Government Funds Misused*, CHINA ONLINE NEWS, Aug. 19, 1999, available in 1999 WL 20785661. Many Chinese people believe that graft and corruption are simply endemic to government in China and impossible to change. See David Lague, *Corruption at the Heart of China's Boom*, AGE, Feb. 20, 1999, available in 1999 WL 2099700; see also O'Neill, *supra* note 50, at 2 (general public in Beijing suspects most of their leaders, with the exception of Premier Zhu, of corruption).

generating significant revenue for the local economy.<sup>91</sup> Certain political structures, discussed below, further contribute to this problem.

*a. Role of Local Governments*

Under China's pre-reform economy, the majority of economic activity was controlled and conducted by the government.<sup>92</sup> Government units both controlled and regulated economic activity and were participants in the marketplace through the ownership and management of economic enterprises.<sup>93</sup> These arrangements were consistent with China's pre-reform philosophy of a state-owned and operated economy. Thus, the government's dual roles as regulator and entrepreneur did not seem to create serious conflict of interest issues because all property was already owned by the State and was part of a "common pot" (*da guo fan*). These arrangements are more problematic under China's current mixed or transition economy, in which significant amounts of wealth and property are controlled by private parties,<sup>94</sup> and where the government may be able to exploit its role as regulator to benefit its status as entrepreneur. Under the current system, the government's multiple roles as regulator, entrepreneur, and law enforcer may create conflict of interests issues or, in more serious cases, issues of local protectionism and government corruption.

A prominent example of how these multiple roles create issues in the area of counterfeiting concerns the role of local AICs in establishing and regulating the wholesale distribution centers and markets that are responsible

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91. The performance of local government officials tends to be judged on the basis of the economic growth of the local economy. Because counterfeiting can be beneficial to the local economy, some local government officials may be encouraged to permit or tolerate counterfeiting. See O'Neill, *supra* note 50, at 2.

92. For a review of the characteristic features of a centrally planned economy, see SUSAN L. SHIRK, *THE POLITICAL LOGIC OF ECONOMIC REFORM IN CHINA* 24–25 (1993). China's economy, however, was subject to far less overwhelming state control than the Soviet economy upon which it was modeled. See Donald C. Clarke, *What's Law Got To Do With It? Legal Institutions and Economic Reform in China*, 10 UCLA PAC. BASIN L.J. 1, 5–6 (1991).

93. China's pre-reform economy was organized according to the socialist model of a centrally planned economy where the state controlled the bulk of economic activity. See Chow, *Reform of the Electric Power Industry in China*, *supra* note 24, at 391–94. For a general overview of the pre-reform economy, see Robert F. Dodds, *State Enterprise Reform in China: Managing the Transition to a Market Economy*, 27 LAW & POL'Y INT'L BUS. 695 (1996). China's fast-paced reforms have given rise to a new generation of "bicycle-to-Benz" entrepreneurs. See Joseph Kahn, *Private Takeover: Capitalists are Remaking China's Moribund Economy*, ASIAN WALL ST. J., July 21, 1995, available in 1995 WL-WSJA 8778778.

94. For a discussion of the conflicts of interest that may be caused by the government's dual role as regulator and entrepreneur in the context of China's recent reforms, see Chow, *Reform of the Electric Power Industry in China*, *supra* note 24, at 415–18.

for driving the recent growth in the counterfeit trade in the PRC.<sup>95</sup> In a typical case, the AIC will invest in the construction of buildings, in the refurbishment or construction of outlet stores, booths, stalls, and warehouse space and will charge rent and management fees to private businesses for the use of these facilities. The AIC will then charge management fees in the range of up to 1000 Renminbi (RMB), or \$120, for each vendor in a wholesale market.<sup>96</sup> In a large market of one thousand businesses, this results in total monthly revenues of about 1 million RMB or \$120,000 and total annual revenues of close to \$1.5 million. The AIC is empowered also to issue business licenses for all vendors that seek to do business in these wholesale centers and operating a business without a license is illegal under PRC law. Moreover, as discussed earlier, the AIC is responsible for enforcement against counterfeiting based upon its jurisdiction over trademarks. Overall, the AIC has assumed the roles of investor, manager, regulator, and law enforcer for these markets.

As discussed, these wholesale markets serve a vital role in the counterfeit goods trade and there is probably no such market that does not traffic in counterfeit goods.<sup>97</sup> It would seem disturbing then that the AIC, the very entity charged with enforcement against trademark counterfeiting, has played a key role in establishing these markets and has a financial stake in their continued operation.<sup>98</sup> However, under the pre-reform view, the AIC's role in establishing and managing these markets would be viewed as consistent with its general authority over industry and commerce, and with the PRC's system of dividing the economy into vertical sectors and allocating authority over the entire sector to the governing government entity. The AIC's role as regulator and manager would also be consistent with a state owned centrally planned economy. Moreover, prior to economic reform, the introduction of foreign brands, and the development of famous domestic trademarks, China did not have a notable counterfeiting problem. To some extent, then, certain problems concerning the counterfeit trade can be traced to problems of transition that China is facing as it continues to implement market reforms.

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95. See *supra* text accompanying notes 65-66.

96. The figures in this paragraph are based upon research done by investigation companies that the author was associated with during his stay in the PRC from 1997-99.

97. See *supra* text accompanying notes 63-64.

98. It is unclear whether the AICs actively encourage the private businesses it manages to sell counterfeit products. It appears that some local AICs do know about the trade and will tolerate it. Most local AICs will take enforcement actions at the behest of trademark owners but many impose light penalties that do not cause the individual proprietors to go out of business; or if an individual proprietor does go out of business, the AICs will simply rent out the same space to another individual proprietor.

Certain structural arrangements, suitable to China's pre-reform economy, are ill-suited to China's present transition economy and have contributed to the rise of the counterfeiting trade. Some efforts to limit the government to the role of regulator and law enforcer and to divest commercial activity have been made, but these changes are gradual and it is unclear how effective these reforms will ultimately prove to be at the local level.

Until effective and widespread structural reforms can be made at the local level, there can be little doubt that the AICs' economic interest in these markets, and the importance of these markets to some local economies, create incentives to protect them from any serious disruption that can be caused by the AIC's role in enforcing laws against counterfeiting.<sup>99</sup> While information is difficult to obtain, it appears that it continues to be the practice of the AIC to establish and regulate wholesale markets either directly or indirectly through an entity controlled by the local AIC. Other government entities may have similar conflicts of interest.

*b. Local Governments and National Control*

Current government and political structures in the PRC insulate local enforcement officials from control by higher level units within their administrative organizations. Although local enforcement officials report functionally to higher level units, these officials report administratively to local politicians. In jurisdictions at the municipal and county levels, local governments control appointments, dismissals, job transfers, salaries, housing, and other benefits for local AIC, TSB, public security bureaus, and judges. As a result of this government structure, efforts by higher level units at the provincial and national level to control excesses at the local level often meet with limited results. Higher level units of these same government bodies at the provincial and national levels may control policies or reverse erroneous decisions at a lower level, but are powerless to dismiss or sanction lower level officials for misbehavior. For example, a provincial or national AIC official may be able to reverse an erroneous decision issued by a municipal or county AIC, but cannot punish a lower level AIC that simply refuses to pursue a counterfeiter. Faced with the choice of disobeying a directive from a higher level unit that is powerless to sanction disobedience and a directive from the local mayor who can terminate employment or

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99. China does not appear to have developed a doctrine of conflicts of interest. It is common for the government to play a dual role as regulator and stakeholder in regulated activities. For a discussion of the enterprise group bureaucratic form that leads to potential conflicts in China's most important industries, see Chow, *Reform of China's Electric Power Industry*, *supra* note 24, at 415–18.

arrange an undesirable job transfer or salary cut, many local enforcement officials opt to protect local interests.<sup>100</sup>

Local protectionism can effectively undermine enforcement efforts.<sup>101</sup> For example, in some cases after a complaint is filed, the local AICs and TSBs may delay enforcement actions for several hours, until the next day, or even for several days. Officials simply say that they are too busy and ask trademark owners to come back later. There is little that company representatives can do in these situations and many simply wait at government offices or return at the designated time. By the time law enforcement officials finally arrive at the suspect premises hours or even days later, the counterfeiter, offending goods, machinery, and equipment have all disappeared. In addition, some local officials have been known to confiscate goods, machinery, and equipment only to return these materials to counterfeiters once enforcement actions have been concluded. Moreover, since local enforcement officials have broad discretion in determining the amount of fines and penalties and are not constrained by any mandatory minimum limits, local enforcement agencies are able to impose low penalties that fail to deter the counterfeiter.<sup>102</sup>

### *c. Case Fees and Other Payments to Officials*

Some local enforcement officials ask for payments, case fees, or gifts such as mobile phones from trademark owners in exchange for conducting enforcement actions.<sup>103</sup> Case fees range from RMB1,000 to RMB5,000

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100. China has recently enacted structural reforms to address the problem of local protectionism. At least some enforcement authorities at the local county and municipal levels no longer report to local governments but to provincial authorities that now are authorized to make all employment decisions and control all financial resources for local enforcement entities. Some reforms have already been implemented at the provincial level and others are currently in progress. It is too early to determine whether these reforms will effectively address the local protectionism issues raised in the text above. The observations in this paragraph are based upon discussions between the author and various Chinese authorities during Nov. 8-16. *See supra* note \*.

101. In other instances, ties with local governments can result in a more direct threat to the foreign investor. In one extreme instance, a local partner in a joint venture with a multi-national enterprise set up a competing enterprise across the street from the joint venture, using technology and know-how obtained from the joint venture in breach of confidentiality and technology agreements. With strong ties to local government, the local partner announced that it would “kill off big brother” so that “little brother could prosper.” The United States Embassy had to intervene and enlist the help of the local Public Security Bureau when the local partner had the U.S. general manager of the joint venture kidnapped. The matter was resolved when the local partner was arrested for illegally carrying firearms. *See* Interview with Robert D. Bannerman, Commercial Attaché, Foreign Commercial Service, in United States Embassy in Beijing, PRC (Jan. 27, 1998).

102. *See infra* text accompanying notes 125-29.

103. The information in this section is based upon the author’s own experiences in dealing with various government agencies and discussions with local counsel, investigation companies, and brand

(\$120 - \$600) depending upon the size of the case, but can be as high as RMB50,000 or \$6,000 for actions conducted by PSBs.<sup>104</sup> In one instance, a local PSB asked a brand owner for a reward of RMB 50,000 per arrest per suspected counterfeiter.<sup>105</sup> In other instances, local officials have been known to ask the trademark owner to demand compensation from the counterfeiter with the understanding that the enforcement authorities will retain some portion or the entirety of any compensation awarded.

These practices cause considerable consternation for many trademark owners because there is no effective avenue of redress against local authorities that make these demands. At the same time, many companies may be bound by internal policies prohibiting such payments. American companies are also mindful that such arrangements may be questionable under federal laws pertaining to payments to foreign government officials.<sup>106</sup>

## 2. *Bureaucratic Rivalries*

Rivalries have developed among the various parallel government entities charged with public enforcement against counterfeiting.<sup>107</sup> The authority to combat counterfeiting results in larger budgets and more staffing, power, and prestige.<sup>108</sup> Raids are also potential revenue generating activities because the authorities confiscate cash, goods, machinery, and equipment, including cars, and then sell the confiscated goods at public auctions. Fines imposed upon counterfeiters are paid into government coffers and some administrative agencies give cash bonuses to personnel who participate in successful raids. Government authorities also routinely ask companies to reimburse the cost of lodging where travel is required, the cost of hiring trucks to load and move confiscated goods, and the cost of storing the goods if a private warehouse needs to be rented. Some government authorities will also ask companies to pay case handling fees.

Budget limitations are the reasons most commonly given for these fees

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owners in China.

104. See Simone, *supra* note 3, at 16.

105. This occurred during a meeting with the local PSB in Yiwu on March 18, 1999. The author was present at this meeting.

106. See FOREIGN CORRUPT PRACTICES ACT OF 1977, 15 U.S.C. §§ 78dd-1-78dd-3 (West 1997 & Supp. 1999). No other nation in the world has similar laws so companies from countries other than the United States are not necessarily bound by their domestic law from making payments to foreign government officials.

107. The information contained in this section is based upon the author's personal experience in the PRC from 1997-99.

108. Trademark owners also frequently entertain enforcement authorities. See, e.g., Freedman, *supra* note 38, at 49 (describing a pre-raid karaoke party for enforcement officials).

and the reimbursement of costs, but subsequent increases in budgets and resources do not appear to affect these practices. According to one observer, there has now been a “commercialization of power and government” and “[g]overnment officials at all levels regard power in their hands as a rare resource, and those who come to them with requests as ‘clients’ with whom they will strike various deals of ‘power versus money.’”<sup>109</sup>

Concurrent and overlapping enforcement authority has created bureaucratic and political interests that discourage cooperation and coordination among various governmental entities.<sup>110</sup> For example, if the AIC, TSB, or Customs refer a case to the PSB for criminal investigation, they must then also transfer all confiscated goods, equipment, and materials, forgo all fines and bonuses, and have less to report on their annual statistics. A similar situation exists if the AIC were to transfer evidence obtained from the counterfeiter during a raid to a civil court for litigation.

A number of these entities continue to upgrade their enforcement tools against counterfeiting in an effort to increase their capabilities vis-a-vis their bureaucratic competitors in order to corner the market on intellectual property enforcement. For example, in Guangdong Province the TSB recently had its powers increased by local legislation leading to increased tensions with the AIC, which has primary authority over trademarks and believes that the TSB is encroaching upon its authority.<sup>111</sup> The TSB also took on responsibility for reviewing product design and content for intellectual property rights violations, adding powers possibly implicating patents to powers that already implicate trademarks. The Culture Market Administration, under the Ministry of Culture, has also recently entered the fray, asserting jurisdiction by arguing that products of popular culture such as magazines, CDs, and videotapes must conform to moral norms.<sup>112</sup> Current trends indicate that as pressure mounts for more enforcement against counterfeiting, the rivalries and competition between governmental entities

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109. He Qinglian, *Fatal Flaw: China's Political System Cripples Some Economic Reforms*, ASIAN WALL ST. J., Sept. 13, 1999, available in 1999 WL-WSJA 20531202.

110. Cooperation between parallel sectors of government is difficult to begin with under the Chinese bureaucratic structure. Lines of authority tend to run “vertically”: entities within a single line of authority have formal authority over and formal channels of communication with entities above or below them in the same line of authority, but there are few formal mechanisms for communication with or the exercise of authority over entities from parallel lines of authority. See KENNETH LIEBERTHAL, *GOVERNING CHINA: FROM REVOLUTION THROUGH REFORM* 169–74 (1995). This situation is exacerbated when bureaucratic rivalries for power and prestige develop among parallel government sectors.

111. This information is based on a conference attended by the author and organized by the Guangdong Provincial TSB on March 17, 1999.

112. See Potter & Oksenberg, *supra* note 73, at 9.

and the proliferation of new enforcement entities may increase.

### 3. *Criminal Prosecution*

Criminal enforcement is widely recognized as the single most effective deterrent against counterfeiting. However, few counterfeiters in China have received criminal convictions over the last few years due to a number of causes.<sup>113</sup>

One reason there are so few criminal convictions is that cases are rarely transferred from administrative authorities to police and prosecutors for criminal prosecution. For example, in 1997, of the 15,321 trademark infringement and counterfeiting cases brought by all levels of the AIC nationwide, only fifty-seven cases, or one in every 269 cases, were transferred to judicial authorities for prosecution.<sup>114</sup> In 1998, of the 14,736 trademark infringement and counterfeiting actions brought by AICs, only thirty-five cases, or one in every 421 cases, were transferred to judicial authorities for criminal prosecution.<sup>115</sup> One cause for such a low rate of transfer may be the lack of cooperation between parallel enforcement entities and the bureaucratic rivalries that have developed.<sup>116</sup>

Another reason criminal convictions are rare is that police and prosecutors find current evidentiary standards difficult to satisfy. Under Criminal Code provisions regarding the manufacture and sale of counterfeit and harmful products,<sup>117</sup> trademark infringement,<sup>118</sup> the knowing sale of

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113. For an overview of the criminal process in the PRC, see Chen, *supra* note 5, at 152–68.

114. See SAIC 1997 ANNUAL REPORT, *supra* note 35, at 11.

115. See SAIC 1998 ANNUAL REPORT, *supra* note 35, at 15.

116. See *supra* text accompanying notes 107-12.

117. Article 140 provides:

A producer or distributor who mixes up or adulterates products with fake and shoddy materials, passes fake imitations for genuine ones, sells second-class goods at first-class goods' prices, or passes unqualified products as qualified ones, when the sale amount is not less than RMB 50,000 yuan nor more than RMB 200,000 yuan, shall be sentenced to fixed term imprisonment of not more than two years or criminal detention, and may in addition or exclusively be subject to a fine of not less than 50% of nor more than two times of the sale amount. If the sale amount is not less than RMB 200,000 yuan nor more than RMB 500,000 yuan, the sentence shall be fixed-term imprisonment of not less than two years nor more than seven years and may also include a fine of not less than 50% of nor more than two times the sale amount. If the sale amount is not less than RMB 500,000 yuan nor more than RMB 2,000,000 yuan, the sentence shall be fixed-term imprisonment of not less than seven years, and may also include a fine not less than 50% of nor more than two times of the sale amount. If the sale amount is more than RMB 2,000,000 yuan, the sentence shall be fixed-term imprisonment of fifteen years or life imprisonment, and may also include a fine not less than 50% of nor more than two times of the sale amount or confiscation of property.

1997 Criminal Code of the People's Republic of China (adopted at the Second Session of the Fifth National People's Congress on July 1, 1979 and revised at the Fifth Session of the Eighth National

counterfeit products,<sup>119</sup> and manufacture of counterfeit trademarks,<sup>120</sup> criminal prosecutions are permitted when there is evidence of prior counterfeit sales over a specified value.<sup>121</sup> These evidentiary standards are difficult to satisfy because Chinese courts require physical evidence of prior sales in the form of account books, sales orders, sales receipts, tax receipts, or any other forms of direct physical evidence.<sup>122</sup> Counterfeit goods seized on the premises, packaging, or the equipment used in the manufacture of counterfeit goods are not considered evidence of sales.<sup>123</sup> As a result, the

People's Congress on Mar. 14, 1997) in WEI LUO, *THE 1997 CRIMINAL CODE OF THE PEOPLE'S REPUBLIC OF CHINA: WITH ENGLISH TRANSLATION AND INTRODUCTION* 85 (1998).

118. Article 213 states:

Anyone who uses a trademark identical to a registered trademark on the same type of goods without the permission of the owner of the registered trademark, and the circumstances are serious, shall be sentenced to fixed-term imprisonment of not more than three years or criminal detention, and may in addition or exclusively be sentenced to a fine. If the circumstances are exceptionally serious, the sentence shall be fixed—imprisonment of not less than three years nor more than seven years, and a fine.

1997 Criminal Code of the People's Republic of China in WEI LUO, *supra* note 117, at 125. The terms referring to serious and exceptionally serious consequences are not further defined in the statute. Under 1993 guidelines issued by the Supreme People's Procuratorate, these terms had been interpreted by authorities to indicate that profits of RMB 20,000 or total turnover of RMB 100,000 constitute serious circumstances. The author's recent discussions with the Supreme People's Court and the Ministry of Public Security indicate that these guidelines are no longer in effect after the enactment of the new Criminal Code in 1997 and there are currently no definitive guidelines for interpreting these terms. *See* Meeting with Supreme People's Court of the People's Republic of China, Beijing, PRC, on Nov. 9, 1999 and Meeting with Ministry of Public Security, Beijing, PRC, on Nov. 10, 1999. The same terms appear in other criminal provisions and are likewise without interpretive guidelines. *See, e.g., infra* note 120. Despite what appears to be the lack of interpretive guidelines, the PRC is likely to insist on bright-line standards, i.e., sales above a certain amount, before any criminal liability can be established.

119. Article 214 states:

Anyone who sells goods with the knowledge that they bear a counterfeit registered trademark, and the sales amount involved is relatively large, shall be sentenced to fixed-term imprisonment of not more than three years or criminal detention, and may in addition or exclusively be sentenced to a fine. If the sales amount is very large, the sentence shall be fixed-term imprisonment of not less than three years nor more than seven years, and a fine.

*Wei Luo, supra* note 118, at 125.

120. Article 215 states:

Anyone who forges or manufactures representations of the registered trademark of another person without authorization or sells representations of a registered trademark that have been forged or manufactured without authorization, and the circumstances are serious, shall be sentenced to fixed-term imprisonment of not more than three years or criminal detention of public surveillance, and may in addition or exclusively be sentenced to a fine. If the circumstances are exceptionally serious, the sentence shall be fixed-term imprisonment of not less than three years nor more than seven years and a fine.

*Id.*

121. For example, criminal liability can be imposed for sales over RMB50,000 under Article 140. *See supra* note 117.

122. *See* REPORT OF THE UNITED STATES DELEGATION, *supra* note 100, at 5.

123. On February 17, 1999, the author was present during a raid in Shenzhen where the authorities

requirement of direct physical evidence to establish sales creates a significant hurdle to establishing criminal liability because most counterfeiters do not keep records of their illegal activities and any such records are usually difficult to recover.

#### *4. Police Involvement and Support*

While the PSBs are empowered to conduct investigations and raids on counterfeiters, most PSBs still appear to lack the training, resources, and clear political mandate to pursue the full range of counterfeiting cases involving different types of products. Currently, it is common practice for trademark owners to engage private investigation companies to gather evidence of counterfeiting and prepare materials for presentation to government authorities.<sup>124</sup> Gathering evidence is difficult because counterfeiters keep few or no records and are cautious in dealing with anyone outside of their known circles. Private investigation firms do not have police powers and are limited in the methods that they can use to gather evidence. In addition, additional police involvement will also enhance the effectiveness of raid and seizure actions. Administrative authorities do not have police powers, cannot arrest suspects who often seek to flee the scene, and cannot force entry into locked areas or non-commercial establishments.

#### *5. Penalties, Fines, and Compensation*

Under Article 43 of the Trademark Law Implementing Rules, the AIC has the authority to impose a maximum fine of up to fifty percent of the illegal turnover or up to five times the profit obtained from the counterfeiting activity. The AIC also has the authority to order the counterfeiter to pay compensation based on the infringer's profits or damages suffered by the trademark owner.<sup>125</sup> In addition, the PRC empowers criminal and civil courts to impose fines and compensation awards on counterfeiters in accordance with these provisions. Available statistics indicate, however, that administrative fines imposed during the past two years are not sufficient to deter counterfeiters.

The 15,321 cases enforced by AIC at all levels nationwide in 1997 resulted in total assessed fines of RMB86.34 million or an average fine of

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found a warehouse loaded with counterfeit and infringing goods valued at over RMB250,000, more than sufficient for criminal liability under current PRC law. The authorities argued, however, that the law required proof of sales for criminal liability and that the product found on site had not been sold.

124. See *supra* note 81.

125. See PRC Trademark Law Implementing Rules, Art. 43, *supra* note 10.

RMB5,635 or US\$679 per case.<sup>126</sup> Total compensation paid to trademark owners was RMB5.1 million for an average of RMB333 or US\$40 per case.<sup>127</sup> In 1998, the 14,216 AIC actions resulted in total assessed fines of RMB85.5 million or an average fine of RMB5805 or US\$699 per case.<sup>128</sup> Total compensation was RMB5 million or an average of RMB339 or US\$41 per case.<sup>129</sup>

There are a number of reasons why these fines are relatively low. There are currently no provisions requiring mandatory minimum fines against counterfeiters and other infringers, even where they refuse to cooperate in investigations to determine prior sales and profits. In addition, there are no provisions requiring that fines imposed in counterfeiting cases be higher than in less serious trademark infringement cases. In addition, AICs and TSBs currently calculate fines on the basis of actual sales revenue from the sale of counterfeit products or profits earned, as opposed to the losses suffered by the brand owner based upon the retail cost of the genuine product. The current calculation method leads to relatively low fines that many counterfeiters may regard as the cost of doing business. Furthermore, because most counterfeiters do not keep business records, the AICs and TSBs will often rely upon the counterfeiter's oral representations of sales revenue, capital expenses, and profits and calculate fines based upon this basis, leading to extremely low fines.<sup>130</sup> Not only are awards of compensation low, but the brand owner will normally pay for the costs associated with the raid, including costs for the investigation and fees for lawyers and trademark agents.<sup>131</sup>

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126. See SAIC 1997 ANNUAL REPORT, *supra* note 35, at 11.

127. See *id.*

128. See SAIC 1998 ANNUAL REPORT, *supra* note 35, at 15.

129. See *id.*

130. As an example of how this calculation method leads to low fines, suppose that during a raid, the AIC confiscates 1000 boxes of counterfeit product from a manufacturer with each box containing 20 bottles of counterfeit shampoo. The AIC will routinely rely upon the counterfeiter's own representations of the actual value of the turnover or profits. Thus, the counterfeiter may state that each box of counterfeit product sells for RMB40 (about \$4.80) with a total turnover of RMB40,000 for the 1000 boxes, leading to a maximum fine of 50% of the RM40,000 or a fine of RMB20,000 or about US\$2,500. By contrast, if a bottle of authentic shampoo costs RMB40, the total loss to the trademark owner may be as high as RMB800,000 or nearly US\$100,000. If the AIC uses profits as a standard to determine fines, then the fines can be even lower since most counterfeiters will represent their profits to be very small. In addition, because the raid is unlikely to uncover more than a week's volume on site, a counterfeiter engaged in production for two months has produced goods that cost the brand owner several times that of any calculation of the damages based on the product on site.

131. The cost of an investigation is generally between \$1500 to \$2000, and the cost of a raid is \$4000 to \$5000 plus disbursements of 15–20% by the investigation agency and trademark agent for travel, means, and lodging. It is common practice also to have one pre-raid and one post-raid lunch or dinner for enforcement authorities. In total, an investigation, raid, and follow-up usually costs about

### *E. Suggested Measures*

This section proposes a number of specific steps to address the problems raised in previous sections of Part II of this Article. This section is brief and only intended to give some indication of the types of practical steps that may be undertaken to address these issues—an extended discussion of these practical measures and a detailed analysis of the legal provisions in the current laws that need reform are beyond the scope of this Article.<sup>132</sup> Moreover, the crucial issue concerning counterfeiting is one of political will and commitment by the Chinese government—as further discussed in the next Part, no amount of legal reform will be meaningful without adequate political support. The following affirmative steps should be considered in tandem with steps to lift some of the barriers to effective enforcement discussed in the preceding sections.<sup>133</sup>

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\$7500 to \$10,000 per case. Use of outside counsel in complex cases can add to this figure. Despite these costs, some companies conduct one or more raids per week.

132. Some of these issues are discussed in Daniel C.K. Chow, *Enforcement Against Counterfeiting in China*, 20 NW. J. INT'L L. & BUS. (2000) (forthcoming).

133. Specifically, China should give consideration to the following measures to facilitate current enforcement efforts and to strengthen the current enforcement system. First, it should issue guidelines that state that certain key legal terms, including “illegal turnover,” “profits,” and “compensation” under the Trademark Law Implementing Rules, are to be interpreted on the basis of harm suffered by the brand owner. Second, it should issue new regulations governing the anti-counterfeiting work of the PSB, the coordination of their activities with administrative authorities, the transfer of cases to prosecutors, and the conduct of joint enforcement actions. These regulations should encourage or require PSBs to accept cases for criminal prosecution transferred by administrative authorities and to initiate criminal investigations on their own accord by accepting complaints directly from brand owners, corporate bodies, and private citizens. Third, it should clarify whether brand owners are permitted to pay case fees to government enforcement authorities and whether other types of payment arrangements are permitted. Enforcement officials have been known to ask for case fees ranging from RMB1,000 to RMB5,000 depending upon the size of the case, but sometimes these fees can be much higher. In other instances, local officials have been known to ask the trademark owner to seek compensation from the counterfeiter with the understanding that the enforcement authorities will retain some portion or the entirety of any compensation awarded. Fourth, it should interpret or supplement existing laws relating to compensation so that brand owners can recover meaningful compensation based upon actual damages suffered, including investigation and legal expenses. Fifth, it should create legal mechanisms to impose some of the costs of counterfeit enforcement activities on counterfeiters. The costs of enforcement work are high if pursued through administrative authorities. *See supra* note 131. Shifting some of these costs to counterfeiters so that counterfeiting enforcement work can be self-sustaining will alleviate some of the additional burdens imposed by these high costs and allow brand owners to fight more effectively against counterfeiters. Finally, it should increase controls on the export of counterfeit products in a more effective and cost-efficient manner, especially at land border points between the PRC and neighboring countries.

### 1. *Unified Anti-Counterfeiting Law*

There is a growing trend among nations to enact comprehensive anti-counterfeiting laws. Counterfeiting simultaneously violates a number of different laws and entails a high degree of criminal malice and serious harm that outweighs the cumulative impact caused by each separate violation. In addition to violating the PRC laws previously mentioned, a single act of counterfeiting in China may also violate laws related to tax evasion, smuggling, organized criminal activity, money laundering, trafficking in illegal firearms, work and employment conditions, operating an enterprise without a license, and cross border criminal activity with Hong Kong and Taiwan. It is simply not practical or efficient to pursue the simultaneous or sequential enforcement of the various distinct laws violated by a single act of counterfeiting. At the same time, the enforcement of a single law does not fully vindicate all of the interests harmed. As a result, in a number of countries, including the United States, counterfeiting is viewed as a unique criminal offense, with special issues of proof and evidence, which merits specific legislation.<sup>134</sup> A comprehensive law adopted by the PRC should state a clear definition of what constitutes counterfeiting, clearly distinguish counterfeiting from other offenses, and address the bureaucratic, jurisdictional, administrative, and evidentiary issues that encumber the enforcement process.<sup>135</sup>

### 2. *Development of Civil Courts and Civil Litigation*

Strengthening the power and political influence of the Intellectual Property Divisions of the People's Courts should have long-term benefits for the rule of law in China. China should establish more of these specialized courts in jurisdictions around the country, and provide its judges with

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134. See Trademark Counterfeiting Act Of 1984, Pub. L. No. 98-473, 98 Stat. 2178 (codified as amended in scattered sections of 18 U.S.C. & 15 U.S.C.); Anti-Counterfeiting Consumer Protection Act of 1996, Pub. L. No. 104-153, 110 Stat. 1386 (codified as amended in scattered sections of 18 U.S.C. & 15 U.S.C).

135. For example, this law should: (1) clarify the different roles and inter-relationships of the various enforcement entities, including the TSB, AIC, Customs, the PSB, the Procuratorate, and the courts; (2) coordinate and unify the handling and disposition of counterfeit cases by these various authorities, including, for example, setting procedures for cooperation among the TSB, AIC and the PSB in raid actions and handling of evidence, and the arrest of suspected counterfeiters; (3) set forth clear guidelines and procedures encouraging or requiring administrative authorities to transfer cases to the PSB for referral to the Procuratorate for eventual criminal prosecution; (4) address the problems of proof and evidence created by a lack of physical evidence such as written records of sales and profits with practical alternatives for indirect evidence; and (5) establish mandatory minimum terms of imprisonment and fines for counterfeiters.

appropriate resources and training.<sup>136</sup> Strengthening the civil court system will encourage more trademark owners to pursue private enforcement through civil litigation against counterfeiters, to press courts for more fair and just compensation awards, and to help shape and create judicial remedies that are designed specifically to protect plaintiffs' rights.

Over time, civil litigation should play an increasingly important role in resolving intellectual property disputes. The increased use of civil litigation may result in greater deterrence against counterfeiting if counterfeiters are forced to pay substantial damage awards to successful plaintiffs. Such changes will help to make civil litigation a viable course of action against counterfeiters and will allow private plaintiffs to assume more of the enforcement burden and help shift some of the responsibility from overburdened public enforcement authorities.

### 3. *Conflicts of Interest and Government Corruption*

As China continues to implement market reforms, there should be some consideration of how to reduce the conflicts of interest that are created when government enforcement entities are both regulators and entrepreneurs engaged in profit-making commercial activity.<sup>137</sup> Separating government and entrepreneurial functions will not only help reduce conflicts of interest, but should also reduce local protectionism and government corruption at all levels.<sup>138</sup>

## III. POLITICAL WILL AND COMMITMENT

A firm political commitment—as opposed to mere political rhetoric—from the top echelons of the PRC government is probably necessary before any dramatic progress against counterfeiting can be made, at least in the short term. Certain problems—local protectionism and government involvement in profit-making and commercial activities in particular—are endemic to the system, seriously undermine enforcement efforts, and cannot be overcome without a strong political commitment from top leaders. Given other

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136. Many sitting judges in the PRC are not lawyers and have not received any formal legal training. See Chen, *supra* note 5, 121-22.

137. See *supra* text accompanying notes 92-99.

138. China recently announced new legislation for dealing with corruption and has intensified its efforts to combat corruption. See *China Issues New Codes on Prosecution of Corruption*, CHINA BUS. INFO. NETWORK, Sept. 17, 1999, available in 1999 WL 17731146; *Prosecutors Vow to Fight Fraud and Corruption*, CHINA DAILY, Sept. 12, 1999, available in 1999 WL 17782227. Most of the general populace in China, however, remains skeptical about efforts to rid China of corruption. See O'Neill, *supra* note 40.

problems such as bureaucratic rivalries and various other issues, none of the specific measures suggested in previous sections or any type of reform will likely improve the situation in China without the Chinese leadership's strong political will. This is necessary to overcome internal hurdles and crack down on counterfeiting.<sup>139</sup> Whether this commitment will be forthcoming or how this commitment can be obtained remains unclear. What follows is a discussion of the positions of the three actors most involved in securing such a commitment—the PRC government, brand owners and foreign investors, and foreign governments, most notably the United States.

### A. PRC Government

Although the PRC government is massive, cumbersome, and known for political intrigue,<sup>140</sup> swift and dramatic results against counterfeiting would be achieved if top-echelon PRC officials were truly convinced that counterfeiting is an urgent problem that seriously harms the national interests of China. In such an event, top-echelon officials would issue clear directives that would likely ride roughshod over certain established interest groups and practices. Such a crackdown would seriously address counterfeiting and severely punish all involved in the trade, including any government officials involved. To date, it appears that Beijing has not yet reached the conclusion that counterfeiting deserves this type of priority.

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139. For example, it is unclear that specific legal or structural reforms will be acceptable as a political matter because such measures may be viewed as diminishing the authority and power of existing enforcement authorities and existing laws. Measures dealing with local protectionism and government corruption may also meet with political resistance from local governments and interest groups. For most outsiders, it is difficult to even identify the government entities, interest groups, officials, and other individuals within the system that will play a pivotal role in obtaining any reforms. It is also difficult to identify any administrative or personal agendas at play or any personal loyalties, conflicts, or relationships involved that may be relevant to decisions by brand owners to approach a particular government entity or official for help. Any attempt at structural and legal reform may trigger some political maneuvering and strategic behavior and, given all of these unknown variables, it is difficult to predict the outcome of such a process. On the other hand, this unpredictability would be less important if top level PRC officials make a firm political choice to eradicate counterfeiting.

140. Chinese governance has long been marked by political intrigue and personal ambition. Two excellent studies of the intrigue that marked the Republican Era are PARKS M. COBLE, JR., *THE SHANGHAI CAPITALISTS AND THE NATIONALIST GOVERNMENT, 1927–37* (2d ed. 1986) and FREDERIC WAKEMAN, *POLICING SHANGHAI 1927–37* (1995). For an inside account of the intricate politics of the Mao era, see LI ZHISUI, *THE PRIVATE LIFE OF CHAIRMAN MAO* (1994). For a study of President Jiang Zemin as a master of political intrigue, see WILLY WO-LAP LAM, *THE ERA OF JIANG ZEMIN* (1999). In the early 1990s, political in-fighting existed between two factions, the Reform Group, led by Deng Xiaoping, which has driven the process of reform forward for the past decade and a half, and the Conservative Faction, led by Chen Yun, which continues to believe in a centrally planned economy. See CHI WANG, *Power Structure and Key Political Players in China*, in 1 *CHINA'S ECONOMIC DILEMMAS IN THE 1990S*, *supra* note 24, at 29, 33–34.

While most of China's top officials acknowledge that counterfeiting is a serious problem, China has a long list of problems of varying degrees of urgency that command the limited attention and resources of its top leaders. Any serious crackdown on counterfeiting, similar in magnitude to the crackdown on smuggling, would entail the expenditure of significant resources and of political capital by central authorities that would shift attention and resources from other pressing problems.

### *1. Political and Social Costs*

Consider the situation described in Yiwu in a preceding section.<sup>141</sup> The trade in counterfeit goods there has been integrated significantly into the legitimate local economy of this city with the consequence that shutting down counterfeiting is functionally equivalent to shutting down the local economy with all of its attendant social and political costs. Numerous hotels, restaurants, nightclubs, trucking and transportation companies, and warehousing and other storage facilities support the massive trade in counterfeit goods and would suffer as a result of a crackdown on the illicit trade.

Given the stakes involved, any attack on counterfeiting in Yiwu will be met with fierce local resistance and will find little sympathy from the local government. No amount of raiding activity by brand owners will result in a permanent reduction of counterfeiting and litigation brought in local courts will have little chance of success. To overcome the alliance of local business and government interests, direct intervention by the central government authorities in Beijing seems necessary.

Moreover, even intervention from certain central authorities will meet with some hurdles. For example, the State AIC has no direct authority over the local Yiwu AIC and any intervention by the State AIC is unlikely to result in a permanent improvement in the situation. More likely, under pressure from the State AIC, the local AICs would engage in a series of highly publicized raids over a period of several months, after which trade in counterfeit goods will gradually return to normal.<sup>142</sup>

What may be necessary is direct intervention by the most senior levels of the PRC government, similar to that which occurred in the case of

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141. See *supra* text accompanying notes 66-72.

142. Central administrative authorities do not have direct authority over local enforcement authorities under China's present political structure, *i.e.*, Beijing cannot dismiss local authorities in Yiwu. For further discussion, see *supra* note 100 and accompanying text.

smuggling.<sup>143</sup> Even if such intervention occurs, what of the social and political consequences of shutting down the major component of the local economy? The political instability associated with punishing well-known and powerful local interest groups and the resulting social turmoil caused by a major loss of jobs and local industry will create serious additional problems for central authorities. Moreover, any disruption of the trade in Yiwu will likely have a ripple effect throughout other areas of the PRC that have become dependent on trade with Yiwu. Finally, any central level intervention in Yiwu should lead to further action against other distribution centers. Although Yiwu is the largest wholesale distribution center, there are at least four others of similar size and many others operating on a smaller but still significant scale. The social and political cost associated with dismantling counterfeiting in all of these local economies are daunting, and the central authorities in Beijing will naturally avoid incurring such costs if possible.

## 2. *Counterfeiting and Smuggling Compared*

A comparison of smuggling and counterfeiting will be useful in highlighting the compelling factors that led the PRC government on its own initiative to make a significant commitment to controlling smuggling and why similar factors may not yet exist in the case of counterfeiting.

### a. *Smuggling*

At the outset, one distinction between smuggling and counterfeiting is that smuggling is a public offense, i.e., a direct offense against the the PRC itself, whereas trademark counterfeiting is an offense against the trademark owner and only indirectly harms the interests of the PRC. Laws against smuggling regulate and control what is allowed to cross national borders and implicate sovereignty and national security interests. Given this distinction, the PRC authorities will naturally tend to treat smuggling more seriously, but there are some additional factors that merit discussion.

First, although there is much that is unknown about smuggling, it is known that central authorities in Beijing became alarmed at the level of government corruption involved in smuggling.<sup>144</sup> Not only were local government officials actively involved in setting up transactions and falsifying importation documents, but of more concern was the participation of the People's Liberation Army (PLA), which by some accounts was

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143. See *supra* note 9.

144. See *id.*

earning massive amounts of revenue through smuggling.<sup>145</sup> Serious corruption within the PLA is of major concern to Beijing because the PLA has long played a critical role in helping the Chinese Communist Party maintain its power in the face of threats at home and abroad. For example, the PLA broke up the student protests at Tiananmen Square in 1989 when the Party felt its power seriously threatened and serves as a threat to deter Taiwan from declaring independence or engaging in other acts of defiance. Beijing's concern was the PLA's intentional violation of certain laws designed to protect China's national interests in order to earn vast sums of money would cause the kind of moral decay that would undermine discipline and compromise the PLA's ability to protect the Party and the nation's interests from future threats.<sup>146</sup> Beijing was probably also concerned that as the nation's most powerful military organization, the PLA should not set an undesirable precedent for other para-military units such as the Armed Police (wu jing) or the Public Security Bureau.

Second, there is a direct link between smuggling and substantial amounts of lost revenues in the form of unpaid customs duties. Beijing reasoned that preventing smuggling would result in an immediate and substantial increase

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145. *See id.*

146. Beijing's concern about the PLA's involvement in smuggling is part of a larger concern that "the unbridled commercial activities of PLA businesses had exacerbated corruption and endangered national security." Willy Wo-Lap Lam, *Army in Probe for Overseas Hoards*, S. CHINA MORNING POST, July 25, 1998, available in 1998 WL 14806813. Recently, the People's Liberation Army (PLA) and the Armed Police, a police organization, divested their commercial and money-making enterprises in exchange for compensation of \$6 billion as a result of pressure from Premier Zhu Rongji and President Jiang Zeming. *See China's Army, Police Stop Business Ventures*, ASIA PULSE, Dec. 15, 1998, available in 1998 WL 19986828. Estimates are that the PLA had 15,000 profit-making business, including hundreds of hotels, trucking companies, nightclubs, and karaoke bars. *See id.*; *see also* Andrew Tanzer, *The People's Liberation Army, Inc.*, FORBES MAG., Mar. 24, 1997, available in 1997 WL 9058761. The PLA has been described as a "fiefdom[] within a state" and "an entrepreneurial army, which has had its attention diverted from its stated purpose of defense. [PLA] units would rather raise profits than slog through the mud drilling." *See id.* at 2. Even casual observers in China notice that military officials drive imported luxury German automobiles and "in some cases, the perks—mistresses and luxury apartments—would put the highest-living U.S. corporate executives to shame." *Id.* Estimates are that the PLA had annual revenues of \$10 billion and profits of \$1–3 billion. *See id.* Among other activities, the PLA was involved in smuggling, money laundering, counterfeiting, and prostitution. *See China's Army*, ASIA PULSE, *supra* (smuggling and prostitution); Tanzer, *supra* (counterfeiting and money laundering); Lu Ning, *Guanxi May Become Ancient History*, BUS. TIMES (SINGAPORE), Oct. 15, 1998, available in 1998 WL 27109246 (well-publicized anti-smuggling campaign was in part targeted at elements in the PLA). In exchange for giving up its profit-making business, the PLA is reportedly going to receive a payment of \$3.6 billion a year for the foreseeable future. *See* Willy Wo-Lap Lam, *PLA Gets Payoff for Business Loss*, S. CHINA MORNING POST, Aug. 3, 1998, available in 1998 WL 22024391. While the PLA appears to have consented to divestment of its profit-making activities in exchange for these payments, there are indications that the PLA continues to maintain private banking accounts overseas. *See* Lam, *Army in Probe for Overseas Hoards*, *supra*.

in customs revenues—a theory that has so far been borne out in practice.<sup>147</sup>

Third, the smuggling into China of certain products, such as steel and petroleum, exacerbated the woes of state-owned enterprises producing the same products by introducing additional stock that created downward price pressures.<sup>148</sup> These state-owned enterprises were already struggling with new structural reforms directed at chronic economic losses in the state sector, a longstanding and intractable problem for the PRC government and one of the most important problems that the nation must ameliorate as it continues to implement market reforms.<sup>149</sup>

### *b. Counterfeiting Compared*

To date, the PLA does not appear to have played a significant role in counterfeiting. A possible explanation may lie in the control exercised by other entities over the main distribution centers that drive the trade in counterfeit goods.<sup>150</sup> These wholesale centers were originally established by local government entities leaving the PLA without a major role to play in the counterfeit trade.<sup>151</sup>

While industry groups have argued that the PRC loses substantial revenues in the form of unpaid taxes by counterfeiters, the connection between the reduction of counterfeiting and the increase in tax revenues is much more tenuous than the connection between smuggling and customs duties.<sup>152</sup> While there is some merit to this argument, the argument that a

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147. See *supra* note 9.

148. See *id.*

149. For a discussion of the woes confronting the state sector and attempts at reform, see Chow, *Reform of the Electric Power Industry*, *supra* note 24, at 397-401.

150. See *supra* text accompanying notes 63-65.

151. See *supra* text accompanying notes 95-99.

152. Industry groups have also argued that China is losing a significant amount of revenue on uncollected taxes from counterfeiters on income that would otherwise be generated by lawful enterprises. These losses include unpaid individual income taxes of counterfeiters and their employees at rates of approximately 5–45%, depending on the amount of taxable income earned. See *Zhonghua Renmin Gonghe Guo Geren Suodeshui Fa (Xiuzheng)* [Individual Income Tax Law of the People's Republic of China (Revised) at Tax Tables 1 & 2] (adopted at the 3rd Session of the 5th National People's Congress on Sept. 10, 1980, amended at the 4th Session of the of the Standing Committee of the 8th National People's Congress on Oct. 31, 1993, and effective Jan. 1, 1994), available in China Law Reference Service, *supra* note 10, at 3230/93.10.31, see also *Zhonghua Renmin Gonghe Guo Cengzhishui Zhanxing Tiaoli* [Value-added Tax Tentative Regulations of the People's Republic of China, Art. 2] (adopted by the State Council on Nov. 26, 1993, and effective Jan. 1, 1994), available in China Law Reference Service, *supra* note 10, at 3220/93.12.13(3) (value added tax). These losses also include unpaid consumption taxes, which can range as high as 45% on cigarettes and 25% on some alcoholic beverages. See *Zhonghua Renmin Gonghe Guo Xiaofeishui Zhanxing Tiaoli* [Consumption Tax Tentative Regulations of the People's Republic of China, Table of Consumption Tax Items and Rates (Amounts)] (adopted by the State Council on Nov. 26, 1993 and effective Jan. 1, 1994),

reduction in counterfeiting will lead to an increase in tax revenues is based upon a series of assumptions that are subject to debate. This argument is based upon the premise that counterfeiters do not pay taxes and that a reduction in counterfeiting will result in a corresponding increase in sales by the legitimate trademark owner and increased tax revenues in the form of payment of taxes by the legitimate owner. It is unclear, however, whether the premise that counterfeiters do not pay taxes is accurate.<sup>153</sup> It is also unclear whether the trademark owner will recoup the entirety of the market share lost to counterfeit goods. Such goods are generally sold at prices lower than that of genuine goods and not all of the consumers who shop for low priced counterfeit goods will make a replacement purchase of a higher priced genuine product if the counterfeit were no longer available. Instead, the consumer may shift to a lower-priced and possibly lower-tier genuine product of a different brand. Counterfeiters tend also to target well-known consumer brands and at least for the present, counterfeiting has not seriously targeted state-owned enterprises that tend to concentrate in heavy industry.

In addition to the factors discussed above, counterfeiting, unlike smuggling, has been integrated into a number of local economies and, as previously discussed, a crackdown on counterfeiting may cause serious social turmoil. So far, the crackdown on smuggling has focused on government officials and has not led to the type of social disruption that may occur if an entire local economy dependent on counterfeiting is shut down. Moreover, there is an argument that the type of government corruption involved in smuggling is more pernicious than that involved in counterfeiting. Government action in smuggling is a direct and intentional violation by government officials of sovereign interests, *i.e.*, smuggling

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*available in* China Law Reference Services, *supra* note 10, at 3220/93.12.13(2). There are also uncollected business taxes of approximately 3%, see Zhonghua Renmin Gonghe Guo Yingyeshui Zhanxing Tiaoli [PRC Business Tax Tentative Regulations, Table of Business Tax Items and Rates] (adopted by the State Council on Nov. 26, 1993 and effective Jan. 1, 1994), *available in* China Law Reference Service, *supra* note 10, at 3230/92.12.13(1), and other taxes for activities associated with counterfeiting. According to industry groups, assuming that the value of counterfeiting in the PRC is in the hundreds of billions of RMB per year, total tax revenues lost to the PRC are almost in the tens of billions, and possibly in the hundreds of billions, of RMB per year. These arguments, of massive tax losses, however, are based upon assumptions that are open to debate. See *infra* note 153 and accompanying text.

153. The author's experience indicates that many of the vendors and landlords involved in the wholesale markets and distribution centers do pay taxes to local governments and constitute an important source of government revenues. These landlords and distributors tend to negotiate a fixed sum to be paid to the local government in discharge of tax liabilities in lieu of a graduated rate based upon revenue. By paying local taxes, these landlords are able to integrate counterfeiting into the local economy, gain a certain air of legitimacy, and, perhaps most importantly, attain a certain stature as important economic actors in their local communities.

violates laws designed to regulate activities across China's national boundaries. Conversely, government action in counterfeiting is viewed as a passive failure to fully protect the interests of trademark owners, *i.e.*, failure to fully enforce laws against suspected counterfeiters. Smuggling involves expensive items such as luxury automobiles that may have been stolen from Hong Kong by criminal gangs or large shipments of stolen petroleum, whereas counterfeiting generally involves relatively inexpensive goods.<sup>154</sup>

### 3. *Lack of Internal Initiatives*

The discussion above suggests that the PRC is probably unlikely to undertake a serious political commitment to crack down on counterfeiting based upon its own initiative. The political and social costs are high, and except for the case of counterfeit money,<sup>155</sup> there does not appear to be a sufficient threat to Party and national interests to warrant such a significant political commitment. Whether external factors in the form of pressure from foreign investors and foreign governments is likely to trigger such a commitment is discussed below.

### B. *Brand Owners and Foreign Investors*

Although brand owners wish to eradicate counterfeiting and recover the financial losses attributed to counterfeiting,<sup>156</sup> it appears that brand owners are reluctant to commit the amount of resources necessary to achieve these goals or to risk seriously offending the Chinese government. Although many companies spend several hundred thousand dollars per year, and some spend as much as several million dollars per year, to battle counterfeiting in China, such sums tend to be only a fraction of the total revenue expended in China.

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154. There are exceptions to this rule. For example, counterfeiting money involves much higher stakes than most other types of counterfeiting and the PRC government treats it differently, meting out the death penalty where the sums involved are large. *See infra* note 155.

155. Counterfeit money involves copying proprietary government materials and involves a direct offense against the sovereignty of the State—this offense is different from the trademark counterfeiting that is the focus of this Article. In this sense, counterfeit money is more akin to smuggling than to trademark counterfeiting. The PRC has taken strong measures against counterfeit money. *See* Xu Xingtang, *China to Increase Measures Against Counterfeiting*, WORLD NEWS CONNECTION, May 5, 1999, available in 1999 WL 19376940. In one instance, a defendant convicted of counterfeiting money was given the death penalty. *See China: Police Crack Down on Counterfeiting*, CHINA DAILY, Dec. 18, 1998, available in 1998 WL 20480064. The PRC has taken such measures because of the perception that trafficking in counterfeit money can pose a threat to national interests by creating economic and social disorder and by affecting the stability of the Chinese currency. Beyond the specific problem of counterfeit money, there does not appear to be the same level of political commitment to controlling the general problem of counterfeiting.

156. *See supra* text accompanying notes 40-42.

These same companies routinely spend vastly greater sums per year on advertising and marketing alone, even for minor brands within their portfolio.<sup>157</sup> Despite their protests, foreign investors also continue to pour in new capital and establish new investments, although at a somewhat slower pace.<sup>158</sup> Even investors who face very serious problems with counterfeiting remain committed to China as a central part of their strategy for global expansion.<sup>159</sup>

Foreign investors are also not willing to alienate the PRC government over the issue of counterfeiting because of a fear that this might lead to retaliation by the PRC government that would damage their businesses in China. Local brand owners may be even more cautious than foreign investors about alienating PRC authorities and tend to focus most of their activities on enforcement. As a result, high profile foreign brand owners in China with serious counterfeiting issues have so far restricted their activities to raising the counterfeiting issue with PRC authorities in a cooperative, non-confrontational manner through informal meetings and lobbying.<sup>160</sup>

### *C. The United States Government*

To date, little or no pressure has been brought to bear by foreign governments on the Chinese government on the issue of counterfeiting. While the United States Trade Representative ["USTR"] played a pivotal role in dealing with the copyright piracy issue in the early 1990's,<sup>161</sup> the USTR has not been actively involved in dealing with the counterfeiting issue. The lack of active engagement by the United States can be attributed at least in part to concerns by brand owners that intervention by the United States might result in an escalation of tension between the two countries and have an overall negative impact upon foreign investment in China.

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157. This observation is based upon the author's own experience working as in-house counsel for a large multi-national enterprise where the budget for pursuing anti-counterfeiting activities, although large, was a fraction of the advertising budget for even the company's smallest brand in the China market.

158. See Shuchman, *supra* note 18 (number of foreign-investment contracts signed in 1997 fell 28% from 1996, but still totaled \$45.3 billion—more than any other Asian nation); see also *China: Swedish Firm to Expand Investment*, CHINA DAILY, July 23, 1998, available in 1998 WL 7597295 (Swedish drug maker increases investment in China despite counterfeiting problem).

159. See *Group to Raise Awareness of Counterfeiting; China Remains Focus of Henkel's Global Expansion*, HANDELSBLATT ENGLISH SUMMARY, Mar. 8, 1999, available in 1999 WL 17502415 (although German detergent maker Henkel finds that up to 30% of Henkel products sold in China are counterfeit, China still remains focal point of global expansion).

160. See *China: Economic Outlook Favorable, Experts Say*, CHINA DAILY, Oct. 21, 1999, available in 1999 WL 17783001.

161. See *supra* note 27.

The recent negotiations with China that led to the US-China agreement on WTO Accession did not raise the counterfeiting issue as a potential obstacle to China's entry into the WTO.<sup>162</sup> Prior WTO and TRIPS negotiations with China have focused on intellectual property issues, but not specifically on counterfeiting.<sup>163</sup> As a result, it would appear unlikely that China's imminent accession to the WTO will improve the counterfeiting problem unless the United States or other governments actively raise the issue before formal accession is granted. Counterfeiting has simply not been an issue in WTO negotiations in the past and without pressure from private industry, it appears unlikely that WTO member nations will raise the issue in the future as China's WTO accession is formally concluded.<sup>164</sup> Raising the counterfeiting issue—or other intellectual property issues—after China's formal accession to the WTO is granted will be less effective than conditioning China's entry on improvement of the counterfeiting and other intellectual property problems. However, but there appears to be no impetus for a move in this direction by the United States or any other government.

#### *D. The Future of Counterfeiting in China*

Top level PRC authorities publicly acknowledge the severity of the counterfeiting problem and acknowledge that counterfeiting is detrimental to

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162. Although United States Trade Representative Charlene Barshefsky has called the Sino-American agreement "absolutely comprehensive," there is no indication that the agreement specifically addresses counterfeiting. See *U.S., China Sign Historic Trade Agreement*, (visited Jan. 28, 2000) <<http://www.ustr.gov/releases/1999/11/99-95.html>> (USTR press release highlighting terms of the agreement); Mark O'Neil, *US and China Sign WTO Deal*, S. CHINA MORNING POST, Nov. 16, 1999, available in 1999 WL 28998496. Indeed, intellectual property rights did not appear to be a focus of the essential discussions preceding the formulation of the historic agreement. See, e.g., David E. Sanger, *Making a Career of Digging to China: Charlene Barshefsky*, N.Y. TIMES, Nov. 16, 1999, at A1 (discussing the eleventh-hour negotiations between USTR Barshefsky and Chinese trade representatives).

163. See Richard J. Anson, *International Intellectual Property Rights, the United States, and the People's Republic of China*, 13 TEMP. INT'L & COMP. L.J. 1, 10–14, 23 (1999) (discussing Sino-American negotiations on intellectual property issues, particularly software and movie piracy); see also, *supra* note 27 (discussing trade negotiations between the US and China in the early 1990s).

164. In fact, as of Jan. 1, 2000, 60 current, mostly developing WTO member nations have not yet complied with the TRIPs protocols. See Geoff Winestock, *Big Gains Not Expected at WTO Talks*, ASIAN WALL ST. J., Jan. 10, 2000, available in 2000 WL-WSJA 2932714. Despite this lack of compliance, member states such as the U.S. and the countries of the EU are "prepared to look the other way in the hope of bringing developing countries on board in a broader trade round." *Id.* Additionally, the American industry group, Business Software Alliance, is on record saying that it is not prepared to pursue action regarding TRIPs compliance at this time. See *id.* Further complicating matters is China's push to join the WTO as a developing nation, which would grant to it special concessions regarding TRIPs compliance. See David Blumenthal, "Reform" or "Opening"? *Reform of China's State-Owned Enterprises and WTO Accession—The Dilemma of Applying GATT to Marketizing Economies*, 16 UCLA PAC. BASIN L.J. 198, 206 (1998).

China's national interests. On the other hand, consumer markets continue to grow and consumer wealth and spending continue to increase dramatically.<sup>165</sup> While many consumers are concerned about counterfeit products, there is a less affluent and less educated portion of the population that has an appetite for all types of counterfeit products.<sup>166</sup> Foreign brand owners continue to invest in China's economy, which continues to grow and continues to receive positive forecasts for the future.<sup>167</sup> Most foreign and local brandowners wish to raise the profile of the counterfeiting problem but are wary of offending the Chinese government.<sup>168</sup> Government enforcement entities compete for resources and the prestige associated with the power to combat counterfeiting, and then mete out sanctions that in many instances fail to deter counterfeiters from repeating their offenses or serve as a deterrent for others who wish to enter the trade.<sup>169</sup> For the most part, the United States and foreign governments—taking their cues from their constituencies—have played a background role and have put little or no pressure on the PRC.<sup>170</sup> A major campaign against counterfeiting would involve an expenditure of significant political and economic resources that would shift such resources from other pressing concerns and likely lead to social and political costs that would be unpopular with local governments and constituencies.<sup>171</sup> Given the present scenario, there does not appear to be the internal or external pressures that would prompt the PRC to undertake a top-level political commitment to crack down on counterfeiting. Without such a commitment, it is unlikely that there will be a dramatic improvement in the counterfeiting problem in the short term.

What then are the future prospects for counterfeiting in China, and what does this mean for local brand owners and foreign investors who have the most at stake? If present circumstances do not change, one possible scenario is a series of incremental improvements over the short term, as brand owners

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165. See *supra* note 21.

166. See *supra* text accompanying notes 53-55.

167. See *China: Economic Outlook Favorable, Experts Say*, *supra* note 160 (senior economic planners forecasting that China will meet its target economic growth rate of 7% for 1999); Wang Xiaohui, *Academy Economists Predict 7.6 GDP Growth*, WORLD NEWS CONNECTION, Oct. 7, 1999, available in 1999 WL 26450558 (Chinese Academy of Social Sciences estimates that China's growth rate in 2000 will be between 7.5 and 8%). *But see* Wang, *supra* note 17 (China is experiencing an economic downturn triggered by domestic reforms, the Asian financial crisis and a recent reduction in foreign direct investment).

168. The author's experience suggests that local brandowners are even more reluctant to risk the ire of the Chinese government and will strictly avoid any actions that would seriously provoke PRC authorities.

169. See *supra* text accompanying notes 113-31.

170. See *supra* text accompanying notes 161-64.

171. See *supra* text accompanying notes 141-43.

lobby for the enactment of new laws and legal interpretations and develop more effective enforcement techniques through practice. To be sure, such incremental progress cannot be accomplished without a significant expenditure of effort and resources in the form of continued and sustained lobbying efforts by brand owners and the continuing pursuit by companies of extensive enforcement work to protect individual brands. Moreover, real progress probably cannot be achieved without obtaining criminal convictions and imprisonment for counterfeiters, results that are not easy to obtain under the present Chinese criminal system.<sup>172</sup> Any decrease in the current efforts by brand owners may embolden counterfeiters to act with abandon.<sup>173</sup> Whether such incremental progress will result in eventually reducing counterfeiting to levels acceptable to most brand owners is difficult to predict. Nevertheless, there may be some notable successes for individual companies and brands as particularly aggressive and effective strategies are implemented. However, these victories will be short-lived if brand owners do not continue to act with vigilance.

Another possible scenario is that there will be no or only very slight reduction of counterfeiting despite continued lobbying and enforcement efforts. If brand owners continue to operate under such conditions, then the costs associated with counterfeiting take on the effect of a tax or surcharge on the brand or trademark. This scenario may come close to describing the present situation in China for some brand owners as they witness the end of a decade of intensive attacks on counterfeiting with little improvement in their situation. Some companies seem almost resigned to the counterfeiting problem. They appear to factor the costs of counterfeiting into their business plans and seek to do just enough in the way of enforcement to keep the problem from getting worse.<sup>174</sup> While no brandowner will openly acknowledge this position, it seems to be the *de facto* policy of some companies doing business in China.<sup>175</sup>

A third possibility is that despite all the efforts of brand owners, counterfeiting will continue to increase. An increase in counterfeiting cannot

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172. See *supra* text accompanying notes 113-23.

173. Counterfeiters work swiftly and aggressively to capitalize on any opportunities for profits. See *infra* Appendix.

174. See, e.g., *supra* note 159.

175. This observation is based upon the author's own experience in China. Some brand owners find that recent significant increases in corporate budgets to combat counterfeiting—some companies now spend several million dollars per year—have not led to any noticeable improvements in the problem. As a result of frustration and a simple lack of viable alternatives, some companies are reluctant to commit any more resources to the problem and appear to be adopting a strategy of preserving the status quo, *i.e.*, keeping the problem from getting any worse by the using resources that have already been committed or even cutting back to previous levels.

be discounted because counterfeiting has been on the rise recently in spite of increased enforcement activity. One explanation for this increase is the rapid rise of several major distribution centers that now dominate the trade in counterfeit goods, with Yiwu as the most prominent example.<sup>176</sup> These centers are also responsible for the rise in the export of counterfeit goods from China. No effective strategy appears to have been developed by brand owners to deal with these distribution centers. Rather, enforcement has so far centered on individual counterfeiters or distributors. This approach may have little impact on these large organizations that have grown aggressively in the past several years and that may seek to continue to expand the trade in counterfeit goods in China and abroad.<sup>177</sup>

If counterfeiting continues to increase, the costs associated with counterfeiting will eventually outweigh the benefits of producing or selling the brand in China. At that point, brand owners will be confronted with the choice of discontinuing the brand in China or rethinking their current approach. Brand owners may take the drastic step of curtailing or withdrawing their investments from China or brand owners and foreign governments may adopt a confrontational approach with China. If brand owners and foreign governments attempt to pressure China with confrontational tactics, it is unclear that such an approach will achieve positive results in reducing counterfeiting.<sup>178</sup>

One other possible scenario is that over time, an increase in consumer affluence and education will lead gradually to a reduction of the counterfeiting problem in China and to the improvement in other intellectual property protections. As China's consumers achieve the ability to purchase genuine goods and are educated about the value of respect for intellectual property, counterfeiting may become less of a lucrative trade. Some counterfeiters may shift their operations to legitimate businesses, using the capital and skills acquired through years of counterfeiting. Other counterfeiters may set up operations in less developed countries, such as Vietnam, and concentrate on exporting their products.<sup>179</sup> A general rising of

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176. *See supra* text accompanying notes 63-72.

177. *See id.*

178. Attempts by the United States to pressure China over copyright piracy issues in the early 1990s almost led to a trade war on two occasions with both sides refusing to back down. *See supra* note 27. A trade war was averted by last minute maneuvering, but because China has made significant economic progress since the early 1990s and is in a stronger economic position in relation to other nations, China may be unwilling to back down in face of new pressures from the United States or other foreign governments over counterfeiting issues.

179. These observations are based upon the course of events in Taiwan from the 1980s to the present. The rise in consumer wealth and education in Taiwan led to a decrease in Taiwan's counterfeiting industry, which was very active in the early 1980s. Some counterfeiters in Taiwan

the economic tide may help to curb the counterfeiting problem, but it is difficult to predict how much time must pass before China will reach this level of development and whether and to what extent economic progress will curb the counterfeiting trade. Improvements in the counterfeiting problem may also be related to progress in China's treatment of other intellectual property problems, including copyright piracy, patent violations, trade secrets, and other types of proprietary information receiving legal protection.

#### IV. CONCLUSION

Counterfeiting in the PRC is a massive, complex, and intractable problem. This examination of the problem is necessarily incomplete because it is a fundamental aspect of the problem that a great deal of information about the trade in counterfeit goods and the various complex political and economic interests involved in any short- or long-term solution is unknown and inaccessible. This study has been completed based upon existing information, much of which is derived from the author's own experience. Further study of counterfeiting in China should reveal additional information about counterfeiting's role in China's growing illegal underground economy and may lead to new ways of combatting the problem.

This study suggests that foreign and local brandowners are the parties that suffer the most harm from counterfeiting. It is less clear that Chinese consumers consider counterfeiting to be a dangerous and urgent problem, although many consumers are concerned about the issue. At the same time, there appears to be a considerable appetite for certain types of counterfeit goods among China's less affluent and less educated population. The Chinese government publicly acknowledges that counterfeiting is a serious problem and harmful to China's long term interests, but appears to lack the political resolve or commitment to launch a serious crackdown on counterfeiting. This may indicate that the Chinese government, despite its rhetoric, does not consider counterfeiting to truly imperil its national interests, or at least not in the short term. A comparison of counterfeiting and smuggling highlighted why the latter is considered by China to be an urgent problem and may explain why China has pursued different strategies with

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turned to legitimate businesses while others shifted their operations to mainland China. Counterfeiting in Taiwan continues to exist but on a less significant scale and at levels deemed acceptable to many brand owners. *See* Interview with Moray Taylor-Smith, Director, Pinkerton Consulting Services, Dec. 30, 1999, in Taipei, Taiwan. Of course, it should be noted that Taiwan may not be an accurate model for China, given the vast differences in size and population between the two. For example, it is more likely that China will continue to have large areas of poverty even though the general economic conditions throughout the nation will continue to rise.

regard to smuggling.

The extent to which counterfeiting harms China's long-term national interests is unclear. A popular argument raised by brand owners and other interests groups is that counterfeiting is harmful to China's long-term national interests and that it is in China's own best interests to resolve this problem. This argument is appealing and is supported by history and by the general policies behind the protection of intellectual property. After all, no nation has been able to achieve high levels of modernization and industrialization without a strong regime protecting intellectual property rights. However, an examination of the present situation in China indicates that this historical lesson may be inapplicable to China, at least for the present. A scientific study of the economic impact of counterfeiting on China's economy might reveal that counterfeiting will lead to future harm, but at present all economic indicators of importance to the Chinese—overall growth of the economy, the influx of foreign investment, and the rise in Chinese wealth and spending—show that China continues to be on course despite a counterfeiting problem that has no parallels in world history. For now, China has not seen tangible evidence of the harm caused by counterfeiting on a national level. As China continues its journey down the path of modernization and industrialization, it remains to be seen whether China can defy history.

APPENDIX  
CASE STUDIES ON HARM TO BRANDS FROM COUNTERFEITING

Aside from significant quantifiable economic losses and harm to consumers, counterfeiting also causes harm to trademarks, brands, and business reputation that is difficult to quantify in economic terms and may be irreparable. In certain situations, counterfeiting leads to loss of consumer confidence in brands, which may result in the loss of significant market share by brands and can even lead to the extinction of the brand itself from the market. This harm is illustrated by the two actual case studies below. The author helped to construct these case studies and reviewed all supporting information and data for these two studies, but for reasons of confidentiality, the names of the brands and the brand owners have not been disclosed.

*1. Methodology*

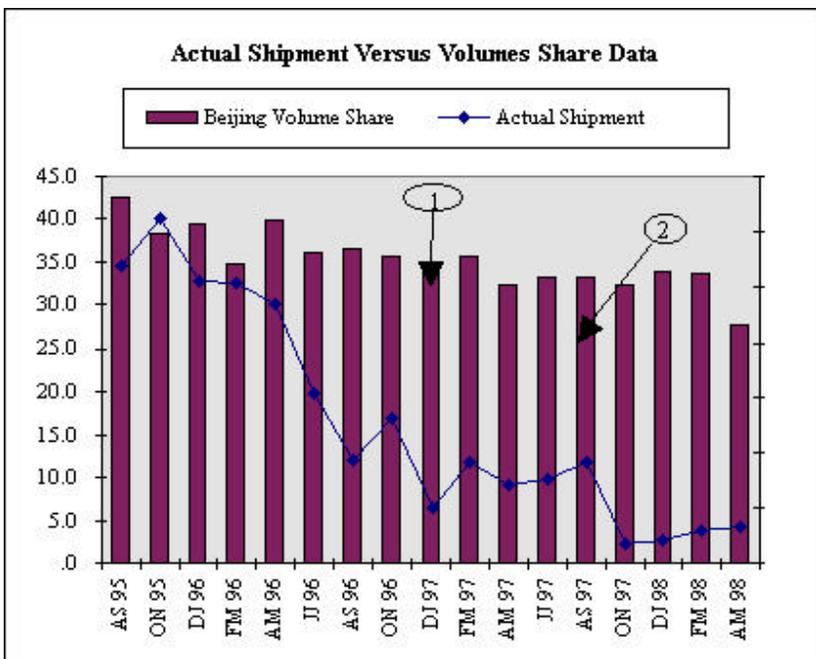
In the following graphs, the vertical axis represents the percentage of the market share for the product category. For example, a 35% share means that the product accounted for 35% of all sales of all products in the same category in a particular market. The horizontal axis tracks product volume on a bi-monthly basis. The vertical bar represents the total amount of all product, authentic and counterfeit, at any given time. The jagged line represents all genuine product in the market, which is determined according to the amount of actual shipments by the brand owner to its distributors to that market. In the cases below, the manufacturer was able to assert tight control over its distribution channels so that virtually no authentic product was able to reach the market other than through approved distribution channels. Parallel imports or smuggled goods were also not at issue in these cases. If all products sold in the market are genuine, then the amount of products actually supplied by the brand owner should closely approximate the total amount of the product available. By contrast, if the volume of the product in the market exceeds the volume of genuine goods shipped by the brand owner, the gap represents the amount of counterfeit products in that market. In both of these cases, these findings were later confirmed by extensive checks of stores in the field by professional market research companies hired by the brand owners.

*2. Beijing Case Study*

This study involves a well-established and famous brand that lost substantial market share due to counterfeiting. Data for August-September 1995 through February-March 1996 indicate that most of the product found in the market is genuine. Beginning in April-May of 1996, there is a

precipitous decline in actual shipments of the genuine product so that by December of 1997, shipments had declined by almost 20% as measured by market volume. Total market volume by product category for December 1997 has remained relatively constant, however, at about 35% because counterfeit product has entered the market filling the 15% gap between the product's total market share and the volume of genuine products shipped. By December 1997, there is almost a 30% gap between the market share of the product and the amount of genuine product shipped, with this gap being filled by counterfeit goods.

Figure One: Beijing Case Study



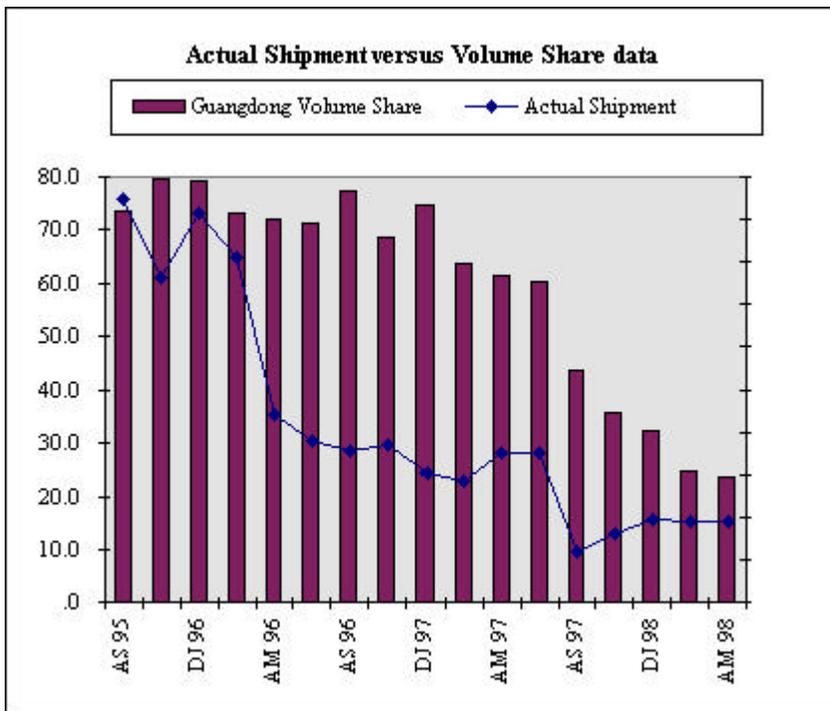
The brand owner made a minor price increase in December 1997 and a significant price increase in August-September 1997. The second price increase led to a sharp decline of about 10% of the market share of the genuine product in October-November 1997 as counterfeiters moved in immediately. By the end of November 1997, the genuine product had about a 3% share of market volume down from a high for this period of 40%, a decline of about 93% in market share. By this time, counterfeit products in the Beijing market outnumbered the genuine product by a ratio of six to one

and accounted for over 90% of all sales. At the same time, the market share of the product overall remained relatively stable at about 35% with most of it being counterfeit. An overall decline of about 12% in total market share occurred during the course of the entire period, some of which is attributable to the brand owner's decision to discontinue active advertising for the product. The small gains in market share in the December to May 1998 period can be attributed to a price decrease for the genuine product.

### 3. *Guangdong Case Study*

A second pattern of harm caused by counterfeiting is illustrated by examining sales figures for a well-known brand in Guangdong Province. At the beginning of this period, the product had a market share of 80% in Guangdong Province. Price increases by the brand owner in February-March 1996 and June-July 1997 were followed by sharp declines in market share as counterfeit products quickly entered the market. By December 1997, the product still maintained a 75% market share, but two-thirds of this volume was occupied by counterfeits. Many of the counterfeits produced in this case were of poor quality.

Figure Two: Guangdong Case Study



Significant price decreases by the brand owner, bringing the price below that originally charged at the beginning of the period in August-September 1995, have allowed the product to regain some market share, but the product now has a 25% market share compared to 80% at the beginning of this period.

#### 4. *Harm to Brands*

These cases represent two common types of problems suffered by brand owners. In the Beijing case, the market share of the brand remained relatively stable but the counterfeit product was able to overwhelm the genuine product in market share. This type of situation tends to occur where a high level of product quality is not of major significance to the consumer because of the type of goods involved, such as in the case of apparel, handbags, or shoes, or where the counterfeit is of a relatively high quality but is sold at a lower price than the genuine product. The decision by the brand owner to discontinue advertising is one illustration of how counterfeiting impedes the development of brands.

In the Guangdong case, poor quality counterfeits of a consumer product where quality is of significance to the consumer led to a shrinking market share for legitimate and counterfeit product due to a loss of consumer confidence in the brand itself. The loss of reputation and confidence may be irreparable, as it is uncertain whether the brand can recover a once leading market position.