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THE SINCEREST FORM OF FLATTERY: CHINA AND PROTECTION OF INTELLECTUAL PROPERTY RIGHTS

By

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Imitation, it is said, is the sincerest form of flattery. When imitation consists of unpaid and unauthorized copying of the products, designs, and creations of others, it also is referred to as piracy. Presently, China is flattering the hell out of the U.S., Europe, and Japan – in the manner least appreciated by those whose work is being copied. In this context it's clear that another old saying doesn't hold – as China is learning, flattery of this sort definitely will not get you everything.

Background Changes. Intellectual property – the subject of patents, copyrights, trademarks, and trade secrets – is the domain of creativity, innovation, and artistic expression. It accounts for a large and growing share of the economies of developed nations, such as the United States. At the turn of the eighteenth century, the U.S. was an agriculture-based economy. A century later, the industrial revolution transformed the U.S. into a manufacturing economy. Instead of needing two-thirds of the workforce to produce food, only one-third of workers were in agriculture by the start of the twentieth century. By the twenty-first century, about three percent of the workforce was agricultural and three-quarters of the workforce was engaged in providing services.

This change was driven in large measure by the revolutions in information and communication that dramatically expanded the scope of available information and sliced the cost of accessing it, analyzing it, and communicating it to others. There is no accepted figure for the proportion of the economy that IP accounts for, or of the economic growth generated by IP. But the U.S. Bureau of Economic Analysis does track the contribution of the information-communication-technology sector (one of the heavily IP-dependent sectors), finding that it contributed nearly 15 percent to U.S. economic growth in 2004 although accounting for less than 5 percent of the economy. IP is one of the engines driving improvements in productivity and in the quality of the goods and services in advanced economies like the U.S. The advent of personal computing,

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cellular telephony, improved drug therapies, micro-surgery, and numerous other advances that make it easier to communicate and that give us longer, healthier lives is testament to the IP revolution of the last century.

Related to these transformations of our personal and professional lives was a change in the economy's engagement with the rest of the world. Since 1960, our two-way trade has grown from less than 50 billion dollars to more than 3 trillion dollars and increased from 9 percent of our GDP to 26 percent. The United States is part of a global commercial world, with trade rising strongly – both in finished goods and in component parts – as the value of goods has grown relative to the cost of transporting them and communicating directions about them.

One of our fastest growing trade relationships is with China. With two-way trade expanding five-fold in a decade, China is America's third largest trade partner, and America is China's top trade partner.

The growing trade with China is a testament to a complementary relationship between two of the world's powers. The U.S. economy is largely driven by high value-added work, including services and other work on complex products. Some of these products, like aircraft, find a large and growing market now in China. On the other side, both U.S. production and consumption benefit from engagement with the Chinese economy. Most complex products also incorporate components, assembly, and other goods and services that depend on lower value-added work, work requiring less technological sophistication or special knowledge or skill. The Chinese economy is growing in significant part because it has a huge labor market and is able to provide large amounts of lower-skilled but technically competent labor. With the increasing sophistication of production equipment and techniques, the skill level needed for some types of industrial production can be reduced significantly. Having goods designed in the U.S. produced in China, or components to be incorporated in complex goods produced in China, advantages both economies.

Chinese IP Protection – and Derogation. The U.S.-China economic relationship, while increasingly strong, is troubled. One of the key issues is enforcement of intellectual property rights in China. Much of U.S. export trade consists of goods that incorporate intellectual property. The most obvious examples are movies, television shows, music recordings, and software. These core “copyright” goods account for approximately \$90 billion of U.S. exports, according to figures compiled by the International Intellectual Property Alliance. Anyone who travels abroad knows how popular U.S. entertainment fare is – witness the ongoing re-runs of shows from “Baywatch” to “Dallas” to “Sex and the City” and the ubiquitous presence of MTV around the world. US software for computers sets the standard for the world, with Microsoft systems running PCs in Paris and Prague, Calcutta and Caracas, just as they do in Peoria and Chicago.

These copyright industries are only the most visible tip of a massive iceberg of intellectual property embedded in export goods. Kate Spade and Dooney & Bourke handbags; Calvin Klein and Ralph Lauren clothes; Mickey Mouse watches; Boston Red Sox caps; and scores of other trademarked goods are further examples of goods that incorporate intellectual property. Patented goods and processes also are in automobiles, electrical equipment, the machinery that produces silicon chips, the apparatus that makes flat screens for televisions, and other important manufactured goods.

Selling goods overseas, producing goods overseas, or collaborating on production with partners abroad, all require protection of intellectual property rights. After all, who would want to sell a copy of a music recording in China if the recording could be copied with impunity and re-sold to all of the recording artist's potential customers? Who would put a manufacturing plant in China if anyone employed there could copy the production processes and use them to set up a competing business?

Intellectual property rights laws exist to encourage innovation and creative investment. Legal regimes have evolved over several centuries to protect copyright, patent, trademark, and trade secret rights. These laws strike a balance between promoting investment in the creation of new discoveries, ideas, new technologies, and works of art, while encouraging disclosure of advances that can be the basis for further developments in science, technology, and the arts. The network of national laws and international agreements that governs the recognition, licensing, and use of intellectual property in most of the

industrialized world has encouraged additional innovation and widespread dissemination of technology and creative works. That's why the industries built on intellectual property have become so valuable.

China, however, has shown little concern for protecting intellectual property rights. Estimates relied on by the U.S. Trade Representative's Office, in reviewing China's standing under the special trade law provision addressing support of intellectual property rights, are that more than 90 percent of the software used in China is pirated, as are more than 90 percent of the movie DVDs, videocassettes and music CDs. Estimated losses to U.S. business from these violations of intellectual property law amount to more than \$2.5 billion per year, with about \$1.5 billion lost from software piracy alone. Eric Smith, President of the International Intellectual Property Alliance, noted in testimony to Congress last spring that China is the world's 6th largest market for personal computers, but only the 26th largest market for sales of legitimate computer software. As damaging as the losses from piracy in China are, the harm is compounded by the fact that China exports illegally copied goods. Pirated copies of U.S. software, movies, and music produced in China have been seized by customs authorities in dozens of nations around the world.

Although the government of China has announced periodic crackdowns on piracy – and publicly trumpeted its seizures of pirated goods – the government has had difficulty ending use of pirated software even in the most obvious places. It is emblematic of the problem that in late 2004, the Vice Premier touted as a dramatic step to improve IP protection an initiative designed to end *government* use of pirated software by the end of 2005.

China has taken some steps to address its piracy problem. It has signed on to various international protocols committing to protect intellectual property rights and to recognize reciprocal rights of foreign citizens and firms. China also has changed numerous provisions in its laws to conform to the requirements of international intellectual property regimes. It has, for example, joined the Paris Convention on protection of trademarks and the Madrid Protocol to that accord, obligating China to respect international trademark rights.

Despite these steps, however, China's law remains inadequate to protect intellectual property such as trademarks. One illustration is that Chinese law requires that the owner of a mark endeavoring to prevent infringement show that the alleged infringer is using an identical mark, not merely one that is so similar that consumers are confused. That is an open invitation to counterfeiting. Another problem is that China allows persons or firms to register trademarks without showing any use of the mark in trade. This means that a well-known mark can be registered by someone other than its user and the copier then can claim priority under China's filing-registration system. Although China has recognized hundreds of well known marks and canceled registration of many Chinese marks "poaching" on established brands, the law remains a potential stumbling block for foreign mark owners. The problem isn't confined to trademark law, of course. So, for instance, in patent law, China has no independent inquiry into the novelty of an invention, allowing award of numerous patents to domestic filers who have nothing original to protect. That, obviously, undercuts the protection for valid and novel patents, as the unoriginal patent may well simply duplicate the original one.

More troubling than the legal provisions themselves are some practical aspects of the Chinese system for enforcing intellectual property rights. One problem is that the administrative mechanisms necessary to secure property rights are inadequate. For instance, the backlog of trademark applications is so great that it takes up to 12 years to secure registration.¹

Another practical problem is that while registration for most intellectual property rights is centralized in one administrative office, responsibility for enforcement of intellectual property rights is dispersed. Both administrative proceedings and civil litigation take place in a decentralized, inefficient, and at times corrupt system. The ability of U.S. officials in China to police the extraordinarily large number of enforcement decisions by administrative officials and minor judicial functionaries scattered across China is quite limited. And the U.S. officials cannot intervene officially once proceedings have been commenced; instead, they are limited to a monitoring function at that stage.

¹William New, Intellectual Property Watch, U.S. Official cites possible Chinese TRIPs Violation, Feb. 18, 2005.

The result of the deficiencies in China's enforcement system is that, according to the U.S. Embassy in China, about one in five consumer goods sold in China is counterfeit. And, as the *San Francisco Chronicle* reported: "counterfeit activity has been moving relentlessly upscale, with General Motors, Cisco, Sony and Pfizer, just to name the most high-profile companies, complaining that their designs or formulas for everything from cars and PlayStations to routers and Viagra, have been violated."² Chinese copying includes not only producing copies that look like branded goods, but copying the design of complex products, like automobiles. And the companies doing business in China are increasingly worried that equipment used for production there will be cloned for use by competitors. Although many firms find that the certain benefits of low-cost production in China dominate the risks of lost intellectual property, it is often a difficult calculus and one that firms should not be forced to make.

Where Do We Go? After years of bilateral talks, listing China as one of the nations meriting special attention as a flagrant violator of intellectual property rights, we have achieved only the most modest success. Perhaps that is inevitable, given the interrelationship of the U.S. and Chinese economies – we won't push too hard, because we'll hurt ourselves in the process. But for those whose intellectual property is being taken, the fact that other considerations will temper our stand in negotiations is hardly comforting.

There is, however, an avenue we have not used: the WTO complaint process. China campaigned vigorously over an extended period to secure entry into the World Trade Organization, the body that oversees compliance with trade obligations among the world's major trading nations. With accession to WTO, China took on not only responsibilities for open trade in goods, but also obligations under the accord on Trade Related Intellectual Property (TRIPs). Those obligations can be enforced by any signatory nation filing a complaint against another signatory for WTO decision on the consistency of conduct with the international treaties administered by WTO.

Over the past year, members of the U.S. Congress have indicated a desire to take action against China unilaterally. The House of Representatives, for example, passed a bill last summer specifically prohibiting a takeover of a US corporation by a Chinese firm. Congressmen justified that action in part on the ground of Chinese violations of U.S. intellectual property rights. Despite opposition from the administration, the bill passed by a vote of 333-92. Supporters of the bill included 177 Democrats who usually are strong supporters of deferring to almost any international body. The message was clear: when it comes to China, the politicians want credit for taking strong action.

Direct legislative action may make it easier for individual politicians to take credit, but the WTO complaint process is the method consistent with *our* international undertakings for addressing assertions that a trade partner isn't playing by the rules. Admittedly, formal complaint under the WTO and the TRIPs dispute resolution mechanism is not a panacea. The process for resolving complaints is lengthy and at the end of the process a favorable ruling is not a judgment you take to the bank. Instead, it is akin to a note you serve for collection, and if payment isn't forthcoming, you go to the sheriff to see whether he'll let you try to attach some of the debtor's assets.

Still, given the size of the infringements taking place in China, a complaint about China's failure to live up to its TRIPs obligations would certainly get the country's attention. If successful, the WTO would authorize the U.S. to threaten imposition of tariffs on Chinese exports to the U.S. roughly equal to the dollar amount of the damage to U.S. businesses. In other words, the U.S. could impose tariffs raising the price of Chinese goods by billions of dollars. The history of WTO complaints has been that when the stakes are high enough, the violator usually finds a way to bring its practices into compliance. Perhaps it's time to see how compliant China can be.

²Howard French, *Chinese Firms Keep an Edge by Imitating Designs*, S.F. CHRON., Mar. 7, 2005, <<http://www.sfgate.com/cgi-bin/article.cgi?file=/chronicle/archive/2005/03/07/BUGUCBKRKG1.DTL&type=business>>.