

Press Release

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Trend Report No. 7: Counterfeiting in China

Counterfeiting in China – Just a Matter of Culture?

- **Substantial progress in the protection of intellectual property rights since China's WTO- membership**
- **China's biggest problem: implementing its many laws**

The crucial question for many companies active in China is that of legal security, particularly in connection with intellectual property rights. Since China embarked on its open-door policy in 1978 it is precisely in the area of economic law that the country has made tremendous progress. When China acceded to the WTO in December 2001 new economic fields were opened up for foreign investment and the legal basis for industrial property rights was significantly improved. But China's biggest problem is the implementation of its many, often very good, laws. Whereas in the past it was almost solely foreign companies that bore the brunt of property right infringement, today Chinese companies, too, are affected. Already in the run-up to the 7th AchemAsia International Exhibition-Congress on Chemical Engineering and Biotechnology and also during this largest international event for suppliers to the process industries from 14 to 18 May 2007 in Beijing/PR China this hot topic will be the focus of intensive discussion.

Who hasn't heard of it or even experienced it personally:

"At a trade show in China, we learned that we were not the only ones to display our products. We took a closer look at the reproductions and told the counterfeiter that we were the original manufacturers. He proudly slapped us on the back and showed us in minute detail how much his product resembled ours and was much surprised at our unenthusiastic reaction."

A typical example of a cultural misunderstanding: one is proud of his ability to produce a fine copy, while the other is flabbergasted.

Nothing but a misunderstanding?

One reason, just too often proclaimed, is that the pride of the imitator, based on his inability to perceive legal wrong, was part of the Chinese culture to "learn from the master" by copying him until on the verge of perfection; if successful, both might justly be proud of the achievement.

This is not totally unfounded, but even though it might explain a lax attitude toward industrial property rights (IPR), in no way does it excuse product piracy. Especially in the light of the sophistication of the counterfeits and the ingenious methods applied by counterfeiters to circumvent the law, this is a poor explanation and certainly not a justification. More often than not behind all this are sheer economic interests: high yields and next to no risk. Full steam ahead: a counterfeiter does not need to splash out on R&D or care about product safety and product liability, it is the original manufacturer who – as a rule – has to bear the responsibility and prove that a defective product that so closely resembles his own is in fact not his product at all.

Yet, if one has actually spent a fortune on research and development and the costs have not paid off so far, and expensive patent and copyright protection has been obtained, in brief: if the way to bring the product to market has been a long and hard one, it is bitter to see another person just walk along and buy the product merely to disassemble it and earn a fortune by selling nice, shiny counterfeits.

The dismay of the aggrieved party is not (only) based on the fact that he has a new competitor. Honest competition stimulates business and is a normal occurrence one does not need to fear. It is unfair competition that sets our teeth on edge. Counterfeiting is unfair competition to the detriment of others. True, reproduction is not totally unlawful. Protection from copying is available only as an exception to the rule: for owners of specific IPR such as patents, trademarks or, in the case of the copier's bad faith, such as betrayal or theft of trade secrets and, sometimes, in the case of so-called slavish copying.

The original manufacturer is not the only one to suffer, and not only economic aspects play a role. Although at first sight many counterfeits seem to be well made, and cheaper at that, which are good arguments in favor of the counterfeiter, on closer inspection, the low-priced ones come with more risk –for unrelated third parties, too. To reduce costs, cheaper and substandard materials, are used, the workmanship is poor, etc. At best, it is only the buyer who is left out in the cold when he buys a product of low quality. It is worse if the counterfeit represents a danger to the public. Just think of such problems occurring with welded joints of pressure vessels or valves in a chemical plant.

Are there any strategies that efficiently combat counterfeiting? China used to be a no-go area for IPR law enforcement. Has the situation improved since its accession to the WTO?

Answer to question No. 1: A reluctant “Ah, well....” Answer to question No. 2: Absolutely. At least the legal environment has significantly improved, which cannot be said for the problems encountered in business practice.

Most cases of piracy are detected at trade shows. As of March 1st, 2006, China has enacted “Measures for the Protection of Intellectual Property Rights during Exhibitions“.

Organizers of exhibitions and trade shows of four days and more are required to set up a special office to receive claims of alleged violations of IPR. Exhibitors infringing third-party IPR on two occasions in succession, may be permanently banned from subsequent trade shows. Exhibition organizers not complying with the anti-piracy policies will be officially cautioned. The competent authority may also refuse the organizer authorization for similar future events.

This office is the first port of call for all who detect counterfeits at exhibitions in China. The office has the power to establish the facts and impose penalties. It may bar exhibits from being displayed. It is required to cooperate closely with the local authorities. These may, on the premises, directly implement any legal consequences ensuing from the administrative proceedings.

It is still too early to assess how effective this process actually is.

Official intervention is of course subject to the condition that relevant IPR such as trademarks or patents have actually been obtained by the original manufacturer for Chinese territory and that the IPR protection can be proven to the local authorities. It is also crucial to gather evidence.

Independent of the sphere of exhibitions and trade shows, the original manufacturer has two further means of tackling IPR infringement: through civil-law action to be awarded damages and through administrative law with respect to cease and desist orders, destruction of counterfeits and even of production sites used for their manufacture, if appropriate, and fines payable to the authorities. Administrative law, where proceedings are initiated upon application to the administrative authorities, has proven to be more effective, especially as the damages awarded tend to be really low.

Legal redress could be improved, but it is available. China has really made an effort. And they deserve respect for this. Still, there is much to be done as legal theory and legal reality often do not coincide, officers in charge have not received adequate training, proceedings are ponderous and unclear, the damages awarded are so low that they neither satisfy the aggrieved party nor do they cover the legal costs, and they do not act as a deterrent as possible sanctions are irrelevant compared with the potential profit.

So what can be done? Companies with short innovation cycles face the least problems. But counterfeiting cycles are also becoming quicker to adapt. The best advice is probably to try and keep core technologies within the company and not make them accessible to third parties, then comes protection through IPR and subsequent IPR protection monitoring. "Not making accessible" also refers to appropriate license agreements, employment contracts and joint venture cooperation. Especially in China, trade secrecy undertakings are a must. If no such clauses exist, there is usually not even a chance of combating piracy based on the betrayal of trade secrets. Chinese law requires much from parties wishing to protect their secrets.

Apart from these measures, there are obviously also technological possibilities at hand: visible or non-visible features that on the one hand make counterfeiting more difficult and on the other enable the identification of copies for product liability and customs matters.

Although available in theory, anti-counterfeiting is still in its infancy in China. This is not likely to change until and unless profit margins dwindle and the risk of being sued increases.

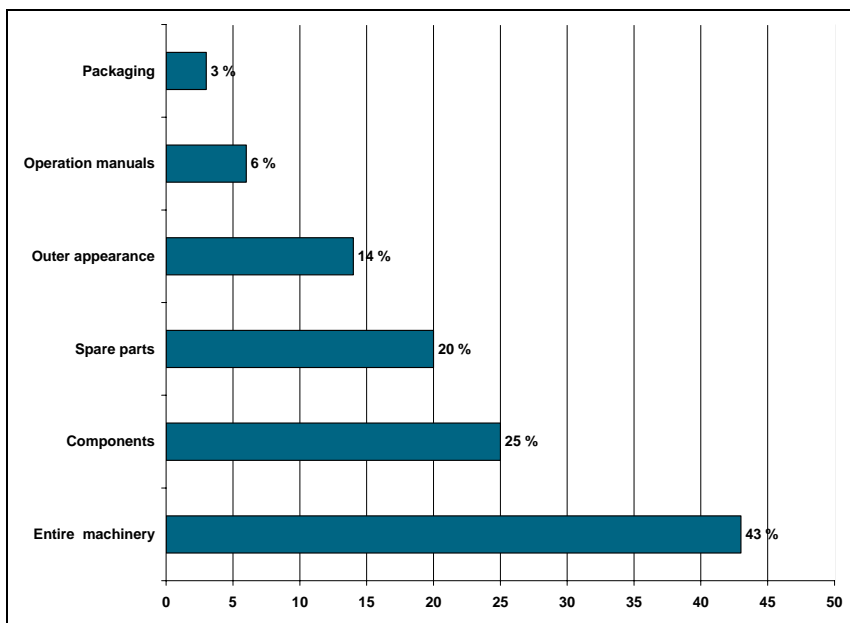
Overview: How to Combat Piracy in China

- Short innovation cycles
- Apply for IPR
- In the case of an IPR infringement:
 - Civil law: damages
 - Administrative law: order to cease and desist, seizure, destruction of product and production lines, public apology
 - Customs: seizure, destruction
 - If prosecution is successful: inform media
- Contractual context: non-disclosure agreement
- License agreement
 - Careful know-how transfer (no core technologies)
 - Limitations of license
- Technological solutions: Visible and non-visible distinctive features
- Exhibitions:
 - Official contact through anti-counterfeiting office of exhibitor
 - Training of personnel at stands
 - Proof of IPR status
 - Power of attorney for legal advisors
 - Gathering of evidence

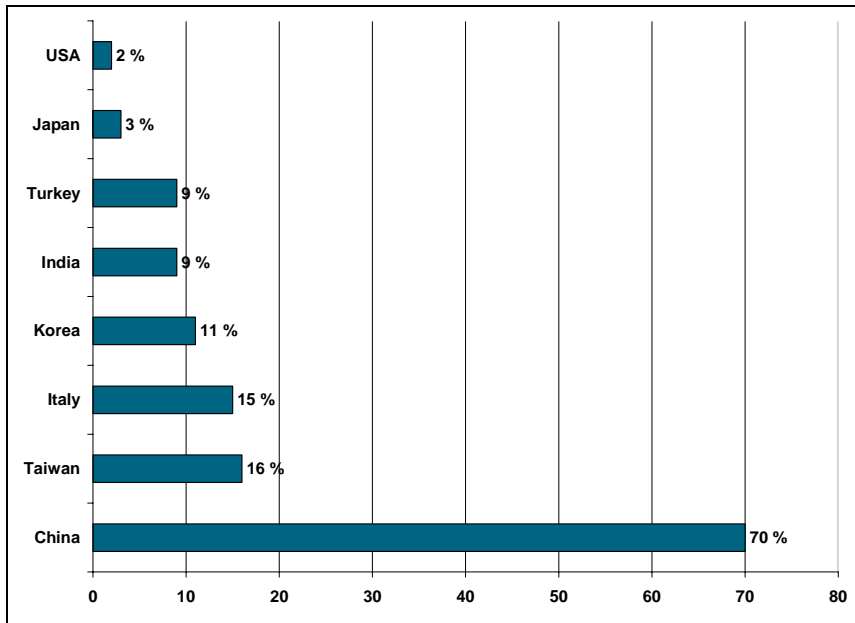
VDMA-Survey 2006 of product and trade mark counterfeiting in the capital goods industry

Following their survey in the year 2003, in March 2006 VDMA (German Engineering Federation) carried out a further survey of product and trade mark counterfeiting in the capital goods industry. In this survey, of the 565 companies questioned 21% responded. About two thirds of the participants stated that they had been affected by product piracy (in 2003 about one half). Feedback came from all fields of (mechanical) engineering in equal measure, thus it is safe to say that the capital goods sector in general has been affected.

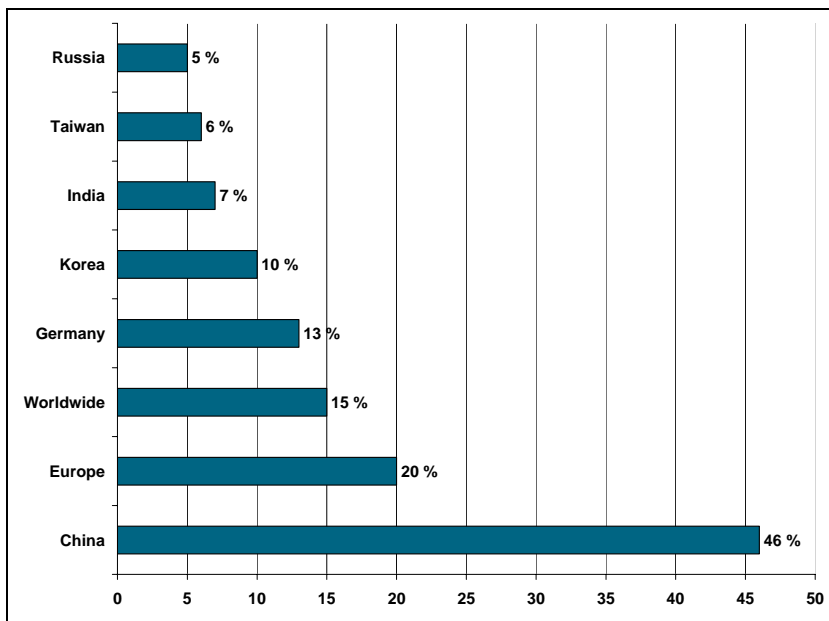
What Products have been Subject to Counterfeiting?



Counterfeits: Countries of Origin



Counterfeits: Salesmarkets



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(This report was made available as AchemAsia Trendreport 2007 by Veronika Häuslschmid, VDMA German Engineering Federation – Legal Services.)