

Fake Product Industry and Technology Theft in China

“In spite of urban China’s modern veneer, there’s still a deeply rooted cultural component at work. The whole idea of copyright is simply foreign.”¹

Wendy Nesbitt is Mike McCallen’s aunt who lives in HK.

As an expatriate living in Hong Kong for nearly 30 years, Wendy Nesbitt is very familiar with counterfeit goods produced in China and sold on the Hong Kong black market for bottom basement prices. Products range from suits to jewelry and are easily available. One of the most copied industries is that of women’s handbags.

In small markets, store vendors show a wide variety of imitation purses in the front of their shops. The handbags are not marked with brand names but have similar designs to designer bags of the current season. However, the most blatant fake product offenses are not on display. With her vast experience in these small shops in Hong Kong, Mrs. Nesbitt bypasses the bags in the shop, goes up the small staircase next to the store and gives the “secret” knock on the door. She is let in to a large room with tables full of handbags. Unlike the little store below, these bags are marked with names like Gucci, Burberry, etc. and are deliberate copies of this season’s best sellers. The bags here sell for roughly 5-10% of what the real bags would sell for in the United States.

The simple underlying motives and the government interactions that formed this underground handbag market in Hong Kong are representative of the conditions that surround most of the fake product manufacturing and technology theft in China. Money is power in the new Chinese culture and the local government enforcement agencies only pay lip service to the intellectual property and patent rights of international and Chinese firms alike. These factors combined together form a fertile environment for technology theft. While the low quality fakes in the handbag industry seem innocuous, other counterfeit products, like fake drugs and shoddy airplane parts, can have dire consequences for their unsuspecting consumers. The Chinese government has taken recent steps to curb this behavior, but it is still widespread in society today.

Cultural Differences / Joint Venture

The precise definition of counterfeit is “something that is forged, copied or imitated without the perpetrator having the right to do it, and with the purpose of deceiving or defrauding.”²

Although China has laws surrounding intellectual property protection and patent controls, technology theft and the production of counterfeits still runs almost unchecked. The following examples taken from *the Economist* help demonstrate the magnitude of the offenses:

- At least \$16 billion-worth of goods sold each year inside the country are counterfeit, according to one conservative estimate.³
- Procter & Gamble reckons that 10-15% of its revenues in China are lost each year to counterfeit products.⁴

¹ Seattle Times, February 12, 2006

² *The Economist*, May 15th 2003, http://www.economist.com/displaystory.cfm?story_id=1780818

³ Ibid.

⁴ *The Economist*, May 15th 2003, http://www.economist.com/displaystory.cfm?story_id=1780818

- The International Intellectual Property Alliance claims that 90% of musical recordings sold in China are pirated.⁵

There are several reasons, steeped in Chinese culture and history, for the lack of intellectual property control. The first is the relationship-driven system that governs much of Chinese business. This system calls for allegiance to individuals over state laws. Due to the tradition of providing personal gifts to friends, the line between gifts and bribes is vague. Personal relationships with government officials often offer protection from prosecution, promoting the pandemic of kickbacks that render the legal system ineffective. In addition, many Communist party officials are trying to maintain their prominent positions in society by illegally using their influence to collect money, the new source of status in China. One senior party official stated, “Being corrupt is not a big deal. Everybody is corrupt. But you can’t be corrupt and be politically incorrect at the same time. You don’t have to be clean as long as you are loyal to your political protectors above you. Honesty in China will always lose out to piety and loyalty.”⁶

A second reason for stealing intellectual property simply comes down to economics. Low compensation levels for workers in China provide plenty of incentive to produce counterfeit goods or to sell corporate secrets to competitors. This motivation has created a plethora of underground markets in China. Peasants have developed into tycoons by exploiting inconsistencies in between the political and economic systems internal to China. This entrepreneurship has carried over to exploiting opportunities that exist in the international market.

The final explanation comes down to the technological position of China after its years of isolationism. One of the main reasons cited for economic transformation in China is the gap between Western technology and China’s technology. To remedy this situation, prevalent thought asserted that an economic transformation was needed to bring in new technology. Technological theft helps to bring in this much needed new technology at a negligible price. Therefore, the government has little incentive to shut down this engine of advancement.

A Corporate Example - New Balance / New Barlun⁷

Boston, MA athletic shoemaker New Balance has become a victim in a new blatant, defiant level of counterfeiting. New Barlun is a Chinese company that has sprung up recently, copying New Balance in almost every way. From the shoe and shoebox design, to the catalog layout, to even the layout of the many domestic and international stores, New Barlun has less-than-flattered New Balance with its insidious imitation. It even has store franchises in key New Balance markets like Japan, thumbing its nose at the intellectual property implications of copying not only products, but whole stores.

Most Americans would not see this as too much of a problem because in English, New Barlun is obviously different from New Balance. In Chinese, however, the two names are nearly indistinguishable. This problem is further compounded by New Barlun’s catalog tagline “the

⁵ Ibid.

⁶ “One billion customers” – James McGregor, pg. 115

⁷ <http://edition.cnn.com/2005/WORLD/asiapcf/05/19/eyeonchina.fakes/index.html>

brand from the U.S.A.”, leading unsuspecting Chinese buyers to believe they may be getting the real American thing.

Like many other American companies, New Balance was originally lured to China by the seemingly low cost of doing business there. However, it is learning, as its production secrets and product components find their way out the backdoor of its Chinese factories, that doing business there is much more costly than originally anticipated.

New Balance has attempted legal action against the company it believes to be the owner of New Barlun, Qiuzhi, but Qiuzhi spokespeople vehemently deny being involved, saying it stopped using the New Barlun name years ago. Despite this, New Balance continues its strategy of expansion in the Chinese market, hanging its hopes on a growing Chinese economy to help consumers afford to buy the real thing.

How Companies are Dealing⁸

Companies have chosen to employ many strategies to deal with the growing problem of Chinese counterfeiting - some novel, some quite basic, but many are growing in effectiveness in a seemingly insurmountable battle against the vast stream of fakes.

The more novel approaches to combat piracy include incorporating technological measures into the products themselves to identify potential counterfeits. These approaches break down into two general categories: obvious markings on products that make it clear to the consumer whether or not an item is fake; and secret identifiers and tracking devices. Telesense, a Beijing company, clearly labels each of its items with a unique numerical identifier that consumers can use to confirm the authenticity of the product by calling the company. The company then can reference its 8 billion identifier database and confirm or investigate. The drawback of such measures, however, is that it relies on the consumer to care whether or not the item is fake, and then take action to contact the company. Similar measures may stop unsuspecting medicine buyers from buying fake and potentially dangerous drugs, but will not be very effective in stopping a thrifty shopper from purchasing a “Rolex” on the street corner. This is where the second type of techniques comes into play. Companies use hidden features to trace where their products have gone, and help them determine the real thing from the fakes. The level of sophistication for such devices is staggering, considering there are already products on the market now with molecular DNA tags embedded in them (or on their packaging) to provide such security measures. With broad adoption of these clandestine technologies, manufacturers like Callaway, who typically has to cut a golf club open to determine its authenticity, will be able to forego such destructive and costly measures of authentication.

Once companies have determined that their products are being counterfeited, they can take legal action, and at least one group has made landmark progress in stopping the activity using a rather novel approach. Gucci, Louis Vuitton, Prada, Chanel, and Burberry all filed suit in China to stop the counterfeiting of their merchandise. But, rather than going after the retailers or manufacturers directly, the companies chose to litigate against the landlord housing the retailers. On Dec. 19, 2005, a Chinese court awarded monetary damages to the group, and ordered the landlord to shut down the market. With this ruling as precedent, companies can now go after landlords of other markets in hopes of stemming the tide of fake goods making their way to Chinese streets.

⁸ http://www.economist.com/displaystory.cfm?story_id=1780818
http://www.businessweek.com/bwdaily/dnflash/jan2006/nf20060110_3904_db039.htm

Other companies such as Microsoft employ their own private investigators to find and prosecute counterfeits. Microsoft has also signed an agreement with computer-maker Lenovo to preinstall Windows software onto computers for the first time.⁹

Of course, there is always what some might consider the best way to beat a competitor, lower your price and beat them at their own game. For example, Yamaha is introducing a new motorcycle priced to directly compete with its counterfeit competitors.

Government Response

For years the Chinese government neglected the counterfeit problem entirely. However, deaths caused by fake pharmaceuticals and baby formula as well as the copying of China's own brands has caused the government to place increased importance on intellectual property laws. With China's entry into the World Trade Organization, other countries have also put pressure on China to prosecute offenders with some success. The World Health Organization said that in 2003 alone China's State Drug Administration closed 1,300 illegal factories and investigated cases of counterfeit drugs worth \$57 million.¹⁰ In December 2005, China lowered the threshold for criminal prosecutions, increased fines, and toughened prison sentences for property rights offenders. However the central government faces a difficult task. Police lack adequate resources, training and political support. Powerful local officials are resistant to the change and outside pressure to crack down on piracy runs up against internal pressures to keep people employed and prices affordable for the masses.¹¹

The Chinese government has had one success that has caused wide speculation: the successful prevention of counterfeiting products with the Olympic logo. In 2002 a national law was passed exclusively to protect the logo. U.S. Trade officials have complained that it is separate and unequal treatment but Chinese officials say China is just better in protecting the supply chain. They pay close attention to make sure manufacturers don't make an extra thousand products to sell on the black market.¹²

So what does the future hold for China and counterfeits? On March 7th, France and China signed a joint-agreement to work together to stop the piracy of French goods. This is a small step in the right direction and the beginning of what might be seen as an international effort to stop piracy in China. With the increasing production of fake medicines, fake car spare parts, and fake spare parts for aircraft engines, the world continues to put pressure on China to continue to crack-down on counterfeiters of all types. Meanwhile, foreign companies and governments are beginning to show how China can benefit from stronger IP protection.

⁹ Seattle Times. The scramble to outfox the fakes, Feb 13, 2006

¹⁰ Microsoft/ Insights Article – By Todd Datz, January 2006

¹¹ The China Business Review. Jan/Feb 2006 Vol 33, Iss 1. pg 16

¹² China's Logo Crackdown, Wall Street Journal 11/3/2005