

are grappling with an enormous, enormous number of very serious problems and challenges for that society and that country, and stability is their number one concern. If you were to stack the environmental issues, the other issues, they are significant, but they are harming themselves and eventually I think they will understand that.

The last comment I would make because the other commissioner and I talked about this: personally I would still rather be doing business in China today and believe it's more open and safer than dealing with Russia.

HEARING COCHAIR HOUSTON: Thank you very, very much, to both of you. You've been just marvelous. We appreciate your input.

In the interest of time, we are only going to take a break to the point as our next panel comes up and sits down. So we're just going to go right along.

[Whereupon, a short recess was taken.]

#### **PANEL IX: IP LAW AND BILATERAL NEGOTIATIONS**

HEARING COCHAIR HOUSTON: Our next panel will focus on the legal aspects of IPR protection both in China and in the international arena.

Our first panelist is Terry Stewart of Stewart and Stewart Law Offices here in Washington, D.C. Mr. Stewart's practice focuses on international trade matters and customs law. He has worked with various industries to solve trade matters in the U.S. and abroad including representing agricultural, industrial and service groups.

He has previously served as Chair of the U.S. Court of International Trade Advisory Committee on Rules and President of the Customs and International Trade Bar Association.

Next we have Professor Justin Hughes, Director of the Intellectual Property Program at Cordozo School of Law, Yeshiva University, in New York City.

Professor Hughes is formerly attorney-advisor at the U.S. Patent and Trademark Office. His areas of expertise in intellectual property include the Internet, WIPO copyright treaties, database protection, many more.

Andrew Mertha, our final panelist, is Assistant Professor at Washington University in St. Louis, Missouri. Mr. Mertha's current research and teaching interests include international trade, policy implementation and enforcement, and bureaucratic politics and political institutions, particularly within the context of contemporary China.

His book, "The Politics of Piracy: Intellectual Property in Contemporary China," was published by Cornell University Press in 2005.

He has worked in Shanghai and Hong Kong where he represents a U.S. toy importer in dealing with Chinese officials and factory managers.

I just want to note to my fellow commissioners as well as to our attendees that these three gentlemen have given us remarkable written testimony with quite a bit of detail, so it's certainly well worth a look at a later time. Gentlemen, I would ask you starting with Mr. Stewart to speak for about six or seven minutes, and then we'll go on to questions.

Thank you very much.

**STATEMENT OF TERENCE P. STEWART, ESQ.  
MANAGING PARTNER, STEWART AND STEWART  
WASHINGTON, DC**

MR. STEWART: Thank you, Commissioner Houston. I'd like to start by focusing on some of the questions that were asked, dealing with dispute settlement and the options that exist, just to lay out some options that are there that may not have been focused on.

One of the reasons the United States government has sought improved information on statistics as to the number of cases brought, the disposition of the cases, criminal actions pursued, et cetera, by the Chinese government is exactly to permit the government to determine whether the enforcement levels appear to be of a normal level, that would support not bringing a WTO action or whether the data would support a case that could be demonstrated through statistics, i.e., with no company having to have their name on the line, if you will.

For the central government of China, cooperating with the U.S. and providing that information can be a very positive way to help deal with the problems that you heard earlier about-- control over the provincial and local governments and how you get improved enforcement down at that level.

A second point, you should be aware that in the context of the ongoing Doha negotiations, there is an effort to get agreement--I may be wrong and they may already have agreed--to ban the bringing of nonviolation cases under TRIPS, and if you think about options for the U.S. down the road, if one is not able to either get compliance from the provincial and local governments, and if the activities that are going on are deemed not to be violations, a nonviolation case would be the strongest action the United States could bring because basically the deal that was cut, the benefits that we assumed we were going to get, are not being received.

So that is an important issue, an important recommendation that the Commission could make to the Congress, that this is an area that should be kept open so that the United States is not denied the benefit of the deal

members of the Commission to understand, tell about the kind of judicial system that the country must provide but not the application of those judicial tools, and so a main United States case would be built around a couple Articles which you've probably heard before in these hearings and will hear again, and that is Articles 41 and 61.

Article 41 provides, and this is the most general and most important provision:

Members shall ensure that enforcement procedures as specified in this part are available under their laws so as to permit effective action against any act of infringement,... including expeditious remedies to prevent infringements and remedies which constitute a deterrent to further infringements.

So while I agree with Mr. Stewart that it would be possible if the ministerial moratorium were lifted to bring a nonviolation or what's sometimes called a nullification case, a general case that under the GATT are privileges that are not being enjoyed by the United States at the WTO because of the level of infringement in China, I actually think that that would be a very, very difficult case.

There is no precedent at WTO for that interpretation, and that we'd have a much better time, but hardly an easy road, in making a case under Article 41, that there is not sufficient enforcement procedures to constitute a deterrent to further infringements.

So in questions and answers, I'd love to talk about that more, and the kind of narrow case or the kind of broader case you might be able to build at the WTO to show that China is not providing enforcement procedures that constitute a deterrent to further infringements.

Thank you.<sup>7</sup>

HEARING COCHAIR HOUSTON: Thank you very much, Professor Hughes. Professor Mertha.

**STATEMENT OF PROFESSOR ANDREW C. MERTHA  
ASSISTANT PROFESSOR, DEPARTMENT OF POLITICAL SCIENCE  
WASHINGTON UNIVERSITY, ST. LOUIS, MO**

DR. MERTHA: I'd like to thank the members of the Commission for inviting me to share my thoughts on intellectual property in China, and what I'd like to do before I do anything is to echo what Dan Chow said about the role of U.S. industry in terms of providing or in this case not providing the data necessary to pursue a credible case.

I can share maybe a small fraction of the government's frustration in this regard because I've been working on a scholarly article on

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<sup>7</sup> [Click here to read the prepared remarks of Professor Justin Hughes](#)

precisely this issue. And it's been rejected by just about every peer-reviewed journal based on the comments that, well, can you give us some actual cases of people not coming forward, and of course the answer is, no, I can't, that's the point.

But in any case, my comments are based upon having lived and worked in China for almost seven years, from 1988 to the present, and before returning to academia in 1994, I worked for a U.S. toy and piece goods importer as production manager in China from 1991 to 1994.

And I've been researching the issue of intellectual property in China since 1998, but not from a legal standpoint but more from a bureaucratic politics standpoint.

Before I get into the actual recommendations, and I want to keep those brief because I hope to respond to questions during the exchange part of the testimony, I want to address what I see as a tendency to conflate the notion of political will with the notion of state capacity.

As far as political will is concerned, it's my considered opinion that many of Beijing's elite decision-makers genuinely believe in the importance of protecting intellectual property rights, say for nationalistic or other self-interested reasons, economic growth, the strategic payoffs from a vibrant, innovative and protected knowledge base, et cetera. And I argue that insofar as this problem persists, much of the reason is due to the limitations in state capacity. That is to say China's top leadership can only expend the necessary resources to sustain two or maybe three major campaigns over the long-term. And this, I think, helps explain the paradox of why China can regulate the most intimate behavior of 1.3 billion people through its stringent population control policy, but yet cannot crackdown in a sustained manner on a problem as seemingly straightforward and obvious as copyright.

Therefore, intellectual property and other policy priorities fall under the workings of China's individual bureaucracies, most of which are decentralized and fall under the jurisdiction of local governments, as Professor Chow laid out, and I would like to, hopefully have the opportunity to expand on that point because I think it's absolutely critical to our understanding of patterns of enforcement or patterns of non-enforcement.

Moreover, several of the most important intellectual property enforcement bureaucracies straddle the line between being fully centralized to being fully decentralized bureaucracies and this leads into the first point that I wanted to make, and that is that as I argue in my book, "The Politics of Piracy," we must understand China's bureaucratic landscape to understand enforcement today and in the medium term.

And this is the context in which intellectual property and other policies are managed and enforced or alternatively neglected and

overlooked. Not all Chinese bureaucracies are the same. In fact, there is considerable variation in their budgets, their manpower, their freedom of action as well as specific incentives they face in enforcing their official mandates or not.

It is only by identifying and understanding the strengths and weaknesses of the specific structures of political bureaucracies that we can propose credible and meaningful solutions to the enforcement of intellectual property in China.

On this first point, I go into I think mind-numbing detail including the various organization charts, which the purpose of which was precisely to provide mind-numbing detail, which is to show how difficult and how intractable this problem really is organizationally.

Second, as I've discussed extensively in my written comments, I believe that we must help China push its criminal prosecution apparatus to take on more of a role to prosecute current intellectual property violations and deter against future ones, and this is another point that I talk about in some detail in my written comments.

So I'll just be brief here. I believe we must encourage China to be increase prosecuting pirates and counterfeiters under the IPR provisions of the existing criminal law because IPR violators will only change their behavior if they anticipate a high probability of being caught, prosecuted, and/or face stiff penalties if they are caught.

This would also help bring about much needed normative change among the ordinary populace by reminding them that intellectual property theft is exactly that, theft.

Third, we need to recognize that intellectual property violations are based first and foremost on economic calculations, not necessarily legal, cultural or political ones. Most Chinese, and I should also add most expatriates living in China as well as the tourists who flock to the Xiushuijie Shichang, which is the Silk Market in Beijing, long before they plan to visit the Forbidden City or the Great Wall, so that they can buy counterfeit goods, by pirated software, motion picture and music CDs because they are cheaper by several orders of magnitude than their legitimate counterparts.

Indeed, it is often extremely difficult to even locate a legitimate product in the Chinese marketplace. I believe that by bringing the legitimate price closer to the black market price, at least temporarily, U.S. companies can use their comparative advantages of providing virus-free software, product upgrades, and support services. This may mean losing money in the short-run, but in the long run these losses pale in comparison to the continuation of the status quo.

Fourth, we should maintain pressure on Beijing because by now it is an accepted, indeed, expected part of the Sino-U.S. relationship.

Stopping or even reducing it, I think, would lead to the conclusion in Beijing that we do not consider the issues sufficiently important and would hurt our credibility.

But we must also recognize limits of such pressure and the fact that it can easily become counterproductive. Beijing responds best to respectful engagement, albeit with a demonstrated degree of backbone on our end.

We should be tough, but we must be careful not to force Beijing to defensively dig in its heels.

Finally, we need to establish and maintain evolving adaptive, but realistic expectations. It is important that we carefully calibrate our demands in terms of what is possible in the short run, the medium term, and in the long term. We must be patient because developing the normative framework necessary for intellectual property protection to take root in China and Chinese society takes time.

Of course, this argument can be and often is used disingenuously, but this does not make it wrong. Therefore, although it may be frustrating, we must continue to have a set of clearly articulated long-term goals as well as realistic expectations of what actual Chinese state capacity is at any given moment along what I see is our mutually beneficial trajectories of bilateral engagement. Thank you for taking the time to listen to my prepared comments.<sup>8</sup>

### **Panel IX: Discussion, Questions and Answers**

HEARING COCHAIR HOUSTON: Thank you very much. I have one quick question and then we'll go to Commissioner Wessel. I think mine is a yes or no answer. Any of you are welcome to answer it.

We've heard a lot of testimony about fake products and particularly pharmaceuticals, auto parts, things that can actually cause physical harm or illness to anyone who is using them. And one of the things that has been brought up in the last couple of days is the use of tort liability as far as this goes.

So if I'm Pfizer and a patient gets a fake pill from China with the Pfizer logo on it, Pfizer gets sued. If I'm an auto repair shop, and I use what I believe is legitimate part in someone's car and then that person is harmed because of that part, but I didn't know it was a defective part, is there anything codified at this point to protect American businesses who would be in some sense the end-user of these pirated or counterfeited parts from general liability claims?

[Panelists shake heads indicating no.]

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<sup>8</sup> [Click here to read the prepared remarks of Professor Andrew C. Mertha](#)

HEARING COCHAIR HOUSTON: No? Okay. We need to talk to Congress. Thank you very much.

Commissioner Wessel.

COMMISSIONER WESSEL: Thank you and thank you to all of our witnesses. You have tremendous knowledge and we appreciate your sharing it with us and hope we can continue to avail ourselves of that knowledge in the future.

Before I go into a question, Professor Mertha, I want to say that it's the first time I've really heard the challenge of unwillingness versus inability as it relates to China, and it seems their willingness to address the one-child policy, to go after the Falun Gong, to have their Internet cops, they've set their priorities, and as you seem to indicate they can't walk and chew gum at the same time, so they've chosen what they want to proceed against, and that's a major challenge for us.

Mr. Stewart, you seem to raise what I consider to be not only a new issue but would dramatically increase estimates of what the impact is of IPR violations in what I guess would consider downstream dumping.

You talked about the use of machine tools and the inputs that go into manufacturing, that those could, in fact, be pirated or counterfeited so that a textile manufacturer, where our textile manufacturer might have to pay \$30 million for a piece of equipment, the Chinese may be knocking it off, getting it for four or five million, that are current laws or current concepts aren't really thinking about that in terms of what the impact of IPR violations are.

Can you talk us through how we might go about addressing this and if the other scholars could talk about what we should be looking at here?

MR. STEWART: Thank you very much for the question, Commissioner. It's exactly that type of situation that has been communicated to me by a number of U.S. companies that have investigated what seemed to be impossible cost structures or pricing structures coming out of China, and one of the things they found was that where they were capital intensive businesses that relied on state-of-the-art technology/equipment, that equipment might run 50 percent of the cost of manufacturing for them, and they were buying, as you would expect they would have to in the United States, from equipment manufacturers whose products were subject to patents, and their investigation suggested that there had been reverse engineering, copying of the patents in China, with the effect that they were facing a 30 percent price differential or cost differential, solely on the basis of the equipment.

Now, if you look at U.S. patent law and you look at Section 337, there is already the authority for upstream holders of process patents to pursue downstream products if they chose to do so.

But to the extent the country views it as important to uphold

intellectual property, it can't say to American industries that you lose not because the other side has a better mousetrap but because they've chosen to knock off the equipment necessary to make the product.

So the TRIPS Agreement is a benchmark; it is the lowest standard that you can have. You can provide greater protections and certainly there are examples already, both in patent law and Section 337, for permitting some downstream use, and so it needs to be debated, whether in the Congress for U.S. law or whether in the WTO in terms of a modification to TRIPS if it's viewed as not permissible.

But in my view, this potentially is an order of magnitude of the counterfeit issue that already exists.

COMMISSIONER WESSEL: This is something the administration could self-initiate in terms of a 337 action?

MR. STEWART: They would have to change the statute.

COMMISSIONER WESSEL: They would. Okay.

MR. STEWART: The statute presently doesn't permit a downstream industry to go after a product where the processing or the equipment used to make it is viewed to violate a patent. I was in China the last two weeks, and I noticed that the German Chancellor was there and one of the issues high on her agenda with the Chinese was IP issues and specifically IP issues as it pertained to machine tools. Obviously, European companies are some of the world leaders as are Japanese companies as are still a number of U.S. companies.

HEARING COCHAIR HOUSTON: Thank you very much. Commissioner Mulloy.

COMMISSIONER MULLOY: Thank you, Madam Chairman. Thank you all of you panelists for being here. Just two quick things to get out of the way and then my main question.

Mr. Stewart, you do mention that need for the change in the law on Section 337. If that is something that you have a suggestion on how that should be done, that would be enormously helpful to have that.

MR. STEWART: Be pleased to supply it.

COMMISSIONER MULLOY: Professor Mertha, this article that you were talking about, if and when you do get that published, could you make sure we get a copy of it because I think, again, that's the area, a real problem in trying to bring a WTO case, the fact that the companies are afraid to bring forth the complaints?

DR. MERTHA: I'll be happy to. I can supply you with a draft, and I imposed it on an unedited volume so it may see the light of day outside the chambers--but I'd be happy to supply that to you.

COMMISSIONER MULLOY: That would be great. Thank you very much. I don't know whether you were here earlier when we were asking the panels how do we bring a WTO case. The concern that this is

the only remedy we have, because Section 301, we gave away when we joined the WTO and, in fact, we can't use Section 301 without first winning a WTO case. So we only have the WTO as the instrument to try and get some relief in this area, at least within the legal framework that we're now in.

And then USTR tells us they can't bring the WTO case because they don't have the evidence and the reason they don't have the evidence is because the companies are afraid to bring it to them because the Chinese would retaliate.

So I was delighted with your suggestion--I hadn't seen it before, Professor Hughes, about a nullification and impairment case under Articles 22 and 23 of the GATT.

Can you and Mr. Stewart comment on that? Does that seem like a realistic way to go ahead if we can't bring just the TRIPS case in the WTO? Terry, you might start and then Professor Hughes because I think we got to do something.

MR. STEWART: Well, when I was suggesting it, I was suggesting it more, I believe, that to the extent the United States does not get the movement from China that it is seeking-- and I believe that there are certainly at the central government level efforts to try to move where they can to improve the situation. But if there is not improvement, I believe that there are likely bona fide violation cases that are out there that USTR has identified, and I believe it was communicated to China where their basic concerns are.

Those can be brought regardless of whether they get the level of cooperation from private industry that you might need in a different situation.

My comment about a nonviolation case, a nullification and impairment case, is that the United States should not permit the Doha Round to conclude and lose that opportunity under TRIPS because if you get to the situation that was described where there is nothing that can be done from a violation point of view, it is very clear that the benefit of the agreement bringing China in is far less than the United States contemplated, and there would be, while difficult to prove, a very interesting and I believe a very important nullification and impairment case.

COMMISSIONER MULLOY: Professor Hughes, you talk about this in your testimony on page ten and 11.

MR. HUGHES: Yes, sir, I do. It's important to remember that in that provision of the GATT, there are three elements. There is element (a) and this is described on page 11 of the testimony, a failure of another contracting party to carry out its obligations under this agreement. That would be a straightforward normal case.

And then (b) the application of another contracting party of any measure whether or not it conflicts with the provision of this agreement; or (c) the existence of any other situation.

And I point out (b) and (c) because in GATT jurisprudence, there have been a few cases of (b) where a country applied positively a measure, and the GATT said no, that measure nullifies another party's advantages under the trade agreement.

But to the best of my knowledge, there is no case under (c) where there was simply a nullification case about a "situation". And the problem would be that this might be cast as just a "situation".

I think that should the moratorium on bringing these cases under TRIPS be lifted, that this would be a very difficult--it's a possible case, but a very difficult true crap shoot kind of case.

Now, may I say something about what it appears you've been hearing for the last couple days that I find troubling? One thing that needs to be explored on this issue about how much evidence USTR needs, and I'm surprised, I haven't heard it in the hallways here and I haven't heard it in this room, is the question of burden of proof. All of you who are lawyers know that the key issue, a issue that really sets a case, is who has the burden of proof and what is the burden of proof?

We have never had an enforcement case at WTO under these provisions. We don't know what they would establish as the burden of proof. So when USTR says we don't have the evidence, I largely concur with that. But I want you think as lawyers think: evidence for what? How much evidence? What burden of proof are you being required to meet?

And the reason I say that is because it's quite possible, and I think we could make the case, that in all of the TRIPS cases to date, the issue has been a positive. It's law on its face. Very easy for a panel, very easy for the appellate body to look at the law on its face.

So the burden of proof hasn't been critical, but there has been in GATT jurisprudence and WTO jurisprudence some movement in where the burden of proof lies. And when you get to an enforcement case, the United States is really being asked to prove a negative. We're being asked to prove that something doesn't exist. Well, when you ask a party to prove something doesn't exist, you quite possibly would establish a very low burden of proof, and then say to the respondent or the defendant can you show that the thing exists?

So I'm not so convinced that we have to take existing TRIPS and WTO jurisprudence and say we use the same burden of proof for an enforcement case.

COMMISSIONER MULLOY: Thank you. That's very important because the WTO just completed their review of China and they cited them in their review in this area as being delinquent. So I'm always

thinking, gee, can't you take judicial notice and then proceed from there, and there should be kind of a burden of proof for them to show the other way.

I think personally that USTR has been much too cautious, that they created this instrument and they love it so much, they don't want to denigrate it in any way by showing that you bring a case, you may lose it, because they people might want to do other things.

So they've created something that they're afraid to use and I think we ought to use it, and if it doesn't work, then we do something else, but we can't let this go on.

HEARING COCHAIR HOUSTON: Thank you very much. Commissioner D'Amato, you had a question?

HEARING COCHAIR D'AMATO: Yes, thank you, Madam Chairman. I have a couple quick questions. First, for Mr. Stewart. What would you think about the concept of shareholder derivative suits with regard to companies that expose valuable IP deliberately in China, reduce their value of their product as a result of counterfeiting?

Do the shareholders have a case here to go after the company for diluting the value of that product through the behavior of exposing the IP in China? That's first.

Secondly, do you have a view on the viability of using Article 41 for cases in terms of the enforcement mechanism?

MR. STEWART: I'm not an expert in shareholder derivative suits, but certainly if the conversation in the last panel, which looked at what is the loss, what is the value, where management wastes assets, there's always the risk that shareholders who perceive that they've not acted in the best interest of the company could bring a suit.

Whether you could set up a situation where that would be true by making a decision to invest and move some of your top technology to China, there would be a lot of facts and there would be a lot of issues in terms of what the company did or didn't do when they got there, what kind of protections they put up.

But a possible type of action would be my uninformed view, Commissioner.

On the second issue, I absolutely believe that there are viable cases that could be brought. There is the policy issue that you always have as to whether now is the time, now is the correct time to bring an action. It is the case that the bilateral approach, pursued not only by the United States but by other major trading partners with China, has gotten China to take affirmative steps.

The action plan that was put together for 2006, the announcements with regard to software, some of the targeting that's been going on to get businesses involved, those are all positive steps.

When I was in China, I had a chance to meet with a number of parts of MOFCOM and, not surprisingly, you're now seeing resources being devoted to preparation for a possible case that the United States might bring against them on TRIPS. So there is always the question of whether you're engaged.

The pressure is important. Where there is no action and where we have stopped getting forward movement, cases can be important, but cases take a long time, as important as they are, and at the end of the day, if you kind of freeze that part of forward movement for the duration of a case, you have to evaluate whether you are getting more forward movement by the result of the case or not.

That's the exercise USTR is charged with evaluating. But I firmly believe that there are bona fide cases that could be brought and the question is will there be enough change, will there be improvements, and I think part of what we have to think about is whether there are things that can move enforcement ahead in leaps like the statutory change to require legitimate software to be preloaded on computers when sold, which, to me, is a very positive thing.

And I think the kind of issues that I identified are possibilities there. That doesn't rule out doing cases, and I think there are meritorious cases.

HEARING COCHAIR D'AMATO: Thank you very much. In the interest of time, I'll withhold my question, but I do have a question for Professor Mertha on the record as to the tension between bureaucracy and the court system. But I will do that for the record, if that's all right with you.

Thank you, Madam Chair.

HEARING COCHAIR HOUSTON: Thank you very much, Commissioner, and I do apologize. Unfortunately, we do have another event coming in this room, and we have to be out right at one o'clock. So I'm so sorry we had to abridge this session.

But thank you very much. We really appreciate all of you coming and giving us your time, and we're only going to take a break up to the point that we have our next panel seated.

So we'll move very swiftly along. Thank you very much.

[Whereupon, a short recess was taken.]

## **PANEL X: CONCLUSIONS: THE FUTURE OF PROTECTING U.S. IP**

HEARING COCHAIR HOUSTON: In the concluding panel to this hearing, we are pleased to be joined by Timothy Trainer, President of Global Intellectual Property Strategy Center.

Mr. Trainer founded this IP consulting firm in March of 2005 after