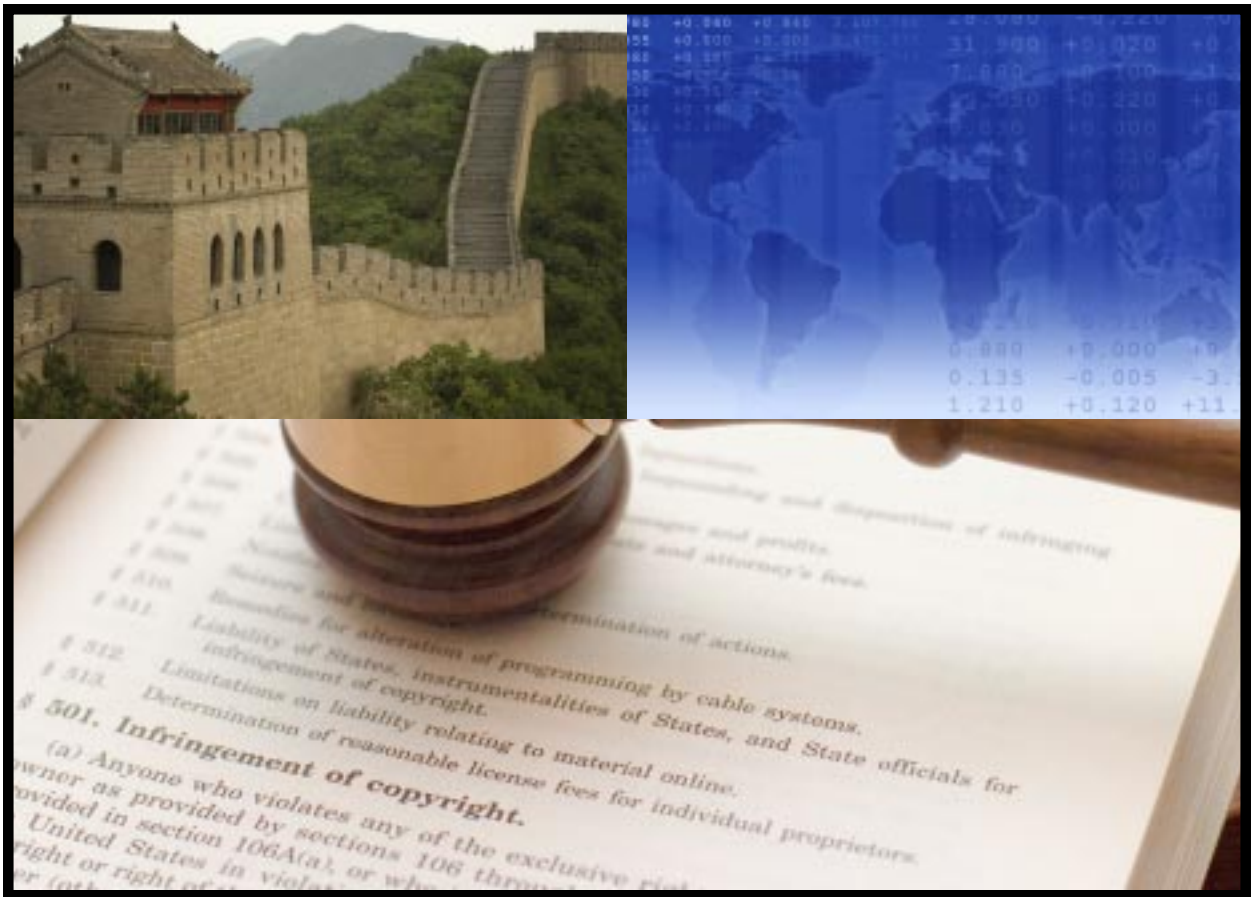

CHINA'S LAWS, REGULATIONS AND PRACTICES IN THE AREAS OF TECHNOLOGY TRANSFER, TRADE-RELATED INVESTMENT MEASURES, SUBSIDIES AND INTELLECTUAL PROPERTY PROTECTION WHICH RAISE WTO COMPLIANCE CONCERNS

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EXECUTIVE SUMMARY

When China joined the World Trade Organization ("WTO"), the Chinese government committed to far-reaching reforms to bring its laws and regulations into conformity with the WTO Agreements. China's final "accession package" also included specific commitments made during the Working Party to address particular concerns of negotiating Members. The commitments addressed the market access of goods and services and included commitments related to investment, intellectual property, and subsidies. While China has made extensive revisions to its laws and regulations since joining the WTO, many of its laws, regulations, and practices appear to be inconsistent with certain WTO provisions and specific commitments made by China. This paper reviews some of the problems China has had with respect to technology transfer, investment measures, subsidies, and intellectual property protection, which raise WTO compliance concerns.

As China has gradually reformed its laws and economic policies over the last two and a half decades, the extent of the central government's control over development and the economy has gradually diminished. The commitments made by China during its WTO accession required that the government further relinquish such control. Amendments to China's laws and regulations to make them WTO-compliant and consistent with specific commitments have decreased the level of direct government involvement in the economy. However, many interventionist policies, that the reforms were intended to alleviate, continue to be used.

Primarily, these policies have the effect of restricting foreign investment and promoting domestic companies. The Chinese government continues to use import substitution policies to direct and stimulate the economic development of certain sectors and to move the economy into

more technologically-advanced sectors. Specifically, these policies encourage technology transfer, export performance, and the use of local content requirements. China has also maintained indirect policy tools such as subsidies to guide resources into activities the government favors. Industrial policies maintain government involvement by "encouraging" practices that the government deems beneficial to economic development. This is true for new policies as well as those policies that were amended to remove WTO-inconsistent requirements. While "encouraging" economic development is not a WTO violation, many U.S. businesses have complained that, often, "encouraged" policies are, in effect, "requirements" for access to the Chinese market.

Since China's accession, the U.S. has worked with China at the bilateral and multilateral levels to address U.S. industry concerns over China's policies. Recently, the U.S. filed two requests for the establishment of panels under the WTO's dispute settlement mechanism to review allegations concerning China's automobile policies and certain subsidies that are not consistent with China's WTO commitments. However, there remain other Chinese programs and industrial policies that the Chinese government uses to restrict foreign investment and provide more favorable treatment to domestic businesses.

Additionally, with respect to intellectual property ("IP"), China committed to bring all of its laws and regulations into compliance with the obligations laid out in the Agreement on Trade-Related Aspect of Intellectual Property Rights (TRIPS). In the years following accession, China has made many substantive reforms to its IP laws, and there is now general agreement that such laws are not substantively inconsistent with the WTO obligations. However, the TRIPS

Agreement also contains specific provisions with respect to enforcement of IP rights, which lay out, *inter alia*, the general obligation that a Member must provide enforcement measures that allow for effective action against acts of IP infringement. This general obligation further provides that such enforcement measures must include remedies that are sufficient to deter future infringements.

There have been persistent concerns voiced by China's trading partners since the time of its accession that enforcement of China's IP laws is lacking and overall protection of IP rights is inadequate. Members have provided technical assistance to China and continue to engage in dialogues in efforts to decrease the high levels of IP theft. However, despite China's efforts to bolster its enforcement mechanisms, Members continue to be concerned with the lack of criminal prosecutions, low administrative fines and civil damages, and inadequate disposal of infringing goods and tools.

While the United States recently initiated a case at the WTO regarding certain aspects of China's laws relating to protection and enforcement of intellectual property rights, there are additional enforcement challenges that could be addressed through this venue. Multiple aspects of China's civil enforcement system appear to frustrate a right holder's ability to enforce its rights and, thus, do not actually permit effective action against any act of infringement. Chinese judicial authorities regularly award low damages in civil IP disputes, which fails to deter future infringements and generally fails to adequately compensate the right holders for their injury as a result of IP infringement. Additionally, Chinese judges rarely order that the infringing goods and production tools to be destroyed, which leaves the means for additional infringement in the

control of the infringer, and severely hampers the goal of deterring future infringements. All of these deficiencies are inconsistent with China's enforcement obligations under the TRIPS Agreement.

Given that certain aspects of China's laws, regulations and procedures remain inconsistent with various provisions of the WTO agreements, the United States should consider pursuing additional action through the WTO dispute settlement process in the following areas:

Deficiency in Law or Practice	WTO Articles Involved
China has failed to "eliminate and cease to enforce" technology transfer provisions in laws and industrial policies.	Paragraphs 1.2 and 7.3 of Part I of China's Accession Protocol
China has failed to abide by the terms agreed to in its Accession Protocol.	Article XII:1 of the Marrakesh Agreement Establishing the World Trade Organization
Differential tax policy discourages the use of foreign-produced products over domestically-produced products.	Article III:2 of GATT 1994
Differential tax policy nullifies or impairs benefits accrued to the United States.	Article XXIII of GATT 1994
China's Consumption Tax favors domestically-produced consumer goods over foreign-produced goods.	Article III:2 of GATT 1994
Low damages in civil disputes do not constitute a deterrent to future infringements, nor do they adequately compensate the right holder for the infringement.	TRIPS Articles 41.1, 42 and 45.1
China's evidentiary requirements in civil procedures effectively frustrate, rather than ensure, a right holder's ability to take action against infringement.	TRIPS Articles 41.1, 41.2, 42, and 43.1
Limited destruction of infringing goods and production tools in civil disputes fails to constitute a remedy that deters future infringements.	TRIPS Articles 41.1 and 46

PART 1:

TRADE-RELATED INVESTMENT MEASURES (TRIMS) AND SUBSIDIES

I. INTRODUCTION

When China emerged from the Cultural Revolution, the government introduced fundamental economic changes to help modernize the existing command economy. In implementing policies of reform and openness, China realized the importance of attracting foreign capital and advanced technology and the need for greater participation in international trade.[1] China also began using various policy instruments to promote exports and restrain imports, not to gain foreign exchange, "but strictly limited to realize the ultimate goal of import substitution."[2] In the mid-1980s, China's reforms spread to the manufacturing sector through the establishment of Special Economic Zones (SEZs) aimed at attracting foreign investment and technology, and oriented towards export processing. The SEZs offered foreign investors large subsidies in the form of land and preferential tax treatment.[3] However, foreign investors were then subject to laws and regulations that required technology transfer, use of local content, foreign exchange balancing, and minimum export performance. An important element of the SEZs, and an important step in decentralization of power in China, was that local authorities

1 Thomas Yunlong Man, *National Legal Restructuring in Accordance with International Norms: GATT/WTO and China's Foreign Trade Reform*, 4 Ind. J. Global Legal Stud. 471, 476 (1996-1997).

2 *Id. See also* Terence P. Stewart et al., *The Crisis in Intellectual Property Protection and China's Role in that Crisis*, The Trade Lawyers Advisory Group LLC (May 2007) at 27 [hereinafter *The Crisis in Intellectual Property Protection*].

3 For a more complete discussion on the development of Special Economic Zones and other "Special Areas", *see, e.g.* Elson Pow & Michael J. Moser, *Law and Investment in China's Special Investment Areas*, in *Foreign Trade, Investment, and the Law in the People's Republic of China* 199 (Michael J. Moser ed., Oxford University Press 2nd ed. 1987).

were given greater decision-making powers in approving investments and for providing tax benefits.[4]

When China reapplied for GATT membership in 1987, the government began the process of reforming China's laws and regulations to bring them into compliance with GATT Articles and Codes and with the demands of trading partners in the Working Party. In 1992, China and the United States completed a Memorandum of Understanding on Market Access, which included a commitment by China to eliminate all import substitution policies.[5] Despite China's commitment, two years later China introduced a new Automobile Policy with import substitution measures.[6] Similarly, while China claimed that direct financial subsidies on exports had ended in 1991, USTR reported in 1997 that China was continuing to use a variety of methods to support and promote exports, including preferential loan policies and preferential tax policies.[7] Additionally, China continued to promote exports using foreign exchange earnings requirements on foreign trade corporations and export requirements on foreign-invested enterprises.[8] Soon

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4 George O. White III, *Foreigners at the Gate: Sweeping Revolutionary Changes on the Central Kingdom's Landscape – Foreign Direct Investment Regulations & Dispute Resolution Mechanisms in the People's Republic of China*, 3 Rich. J. Global L. & Bus 95, 120 (2003).

5 In the *1998 National Trade Estimate Report on Foreign Trade Barriers*, USTR reported that in a 1992 Memorandum of Understanding, China confirmed that it had eliminated all import substitution measures and in the future would no longer use such methods. *See* United States Trade Representative, *1998 National Trade Estimate Report on Foreign Trade Barriers*, at 49 [hereinafter *National Trade Estimate 1998*].

6 "This policy, designed to foster development of a modern automobile industry in China, explicitly calls for production of domestic automobiles and automobile parts as substitutes for imports, and establishes local content requirements, which would force the use of domestic products, whether comparable or not in quality and price." *See Id.*

7 United States Trade Representative, *1997 National Trade Estimate Report on Foreign Trade Barriers*, at 52 [hereinafter *National Trade Estimate 1997*].

8 *Id.*

after the United States concluded its bilateral accession agreement with China in 1999, USTR commented that since the 1992 MOU there had been improvements but that "apparent import substitution policies by the Chinese government continue to occur" and that China continued to use export subsidies and export requirements.[9]

Since joining the World Trade Organization ("WTO") in December 2001, the Chinese government has continued to pass laws and regulations to bring China into conformity with its WTO commitments. A year after China's accession, China reported to the Committee on Trade-Related Investment Measures that China had revised the three Chinese laws that are most relevant to foreign investment "and their respective implementing regulations, including the elimination and cessation of enforcement or requirements on trade and foreign exchange balancing, local content, export performance, compulsory technology transfer, and etc."[10] However, there are concerns that reform efforts in China have stalled.

Members complain that some of the legislation revised during this period continues to provide export subsidies and to promote import substitution policies. Specifically, many of the policies encourage technology transfer, and are keyed to export performance and the use of local

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9 United States Trade Representative, *2000 National Trade Estimate Report on Foreign Trade Barriers*, at 47 and 49 [hereinafter *National Trade Estimate 2000*].

10 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/586 (12 November 2002) at Annex ¶6; The "*Law of the People's Republic of China on Chinese-Foreign Equity Joint Venture; Law on Chinese-Foreign Contractual Joint Venture; and Law on Wholly Foreign Owned Enterprises* are the three laws of fundamental importance concerning foreign investment administration." *Id.* at Annex ¶ 7.

content.[11] Direct intervention by the government has shifted toward the use of various indirect policy tools, including subsidies, to guide resources into certain activities. Of particular concern to USTR are China's subsidy practices in steel, petrochemicals, high technology sectors, forestry and paper products, textiles, wood, machinery and copper and other non-ferrous metals industries.[12] However, as China's subsidy programs are often the result of non-public administrative measures, the lack of transparency has made it difficult for China's trading partners to "identify and quantify possible export subsidies."[13] It is also difficult to know "whether particular provisions of the TRIMs Agreement may be implicated or not."[14]

Recently implemented industrial policies, such as the 2004 Automobile Policy and the 2005 Steel and Iron Industry Development Policy, have caused concern among China's trading partners, as they appear to provide some reforms, but do not live up to the obligations China took on in joining the WTO. In 2007, USTR reported that China continues to "resort to industrial policies that limit market access for non-Chinese-origin goods …., and that provide substantial government resources to support Chinese industries and increase exports."[15] The U.S. representative made a similar claim to the Committee on Trade-Related Investment Measures in 2006, characterizing "China's increasing use of policies that restrict foreign investment while

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11 United States Trade Representative, *2007 National Trade Estimate Report on Foreign Trade Barriers*, at 134 [hereinafter *National Trade Estimate 2007*].

12 *Id.* at 104-105.

13 *Id.* at 105.

14 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/792 (27 October 2006) at Annex I ¶ 55.

15 *National Trade Estimate 2007* at 80.

promoting domestic companies as a step backwards."[16] In a September 2006 report assessing the implementation of China's WTO commitments, the U.S. Chamber of Commerce stated that, in the previous 12 months, it had witnessed an "upsurge in industrial planning measures as tools of economic development by central government authorities."[17]

As might be expected, the primary purpose of these policies is to enhance the long-term economic growth of the country by stimulating development in certain strategic sectors favored by the Chinese government. The policies allow the government to intervene and promote sectors that are supported and encouraged by the State by limiting the market access of foreign goods, giving preferential treatment to domestic goods, and extracting technology from foreign investors.[18]

In China's first Trade Policy Review ("TPR") in 2006, the WTO Secretariat reported that China's "industrial policy remains an important feature of government policy and various measures are used to encourage investment in certain sectors and discourage investment in

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16 *Report of the Chairman, Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization*, G/L/792 (27 October 2006) at ¶ 12.

17 *China's WTO Implementation and Other Issues of Importance to American Business in the U.S.-China Commercial Relationship,* U.S. Chamber of Commerce Report (September 2006) at 7.

18 *Id.* at 23. The Chamber states that China's use of "industrial policies to foster the development of strategic sectors is of mounting concern to the Chamber and a broad cross-section of U.S. industry…A key aim of many such policies is to enable Chinese firms to obtain low- or no-cost access to patented technologies and other innovations owned by foreign rights holders." The Chamber continues that it believes that "the use of such reforms to advance a single industrial policy goal – namely to gain advantages for Chinese domestic companies at the expense of overseas economic interests – undermines the U.S.-China" trading relationship. *Id.* at 24.

others."[19] In 2005, then Assistant U.S. Trade Representative Charles Freeman stated that the "objective of these policies seems to be to support the development of Chinese industries that are higher up the economic value food chain than the industries that make up China's current labor-intensive base, or simply to protect less-competitive domestic industries."[20] Similarly, the WTO reports that to "encourage domestically owned firms to move up the value-added chain, China is currently encouraging investment in high technology based manufacturing and uses 'guidance' as well as trade policy instruments for this purpose."[21]

While the majority of these policies provide specific industries and enterprises with preferential tax benefits to promote the exportation or use of local products, no longer mandated policies such as technology transfer remain in the text of China's laws, regulations, and, industrial policies as an "encouraged" policy.[22] However, U.S. companies have complained "that this 'encouragement' in practice can amount to a 'requirement' in many cases, particularly in light of the high degree of discretion provided to Chinese government officials when reviewing investment applications."[23] Some critics complain that Chinese officials are able to make "encouraged" policies mandatory by using access to the burgeoning Chinese market as the

19 *Trade Policy Review: China, Report by the Secretariat,* WT/TPR/S161/Rev.1 (26 June 2006) at p. xii.

20 Statement of Charles W. Freeman III, Assistant U.S. Trade Representative of China Affairs, Office of the U.S. Trade Representative, Testimony Before the Full Committee of the House Committee on Ways and Means (April 14, 2005).

21 *Trade Policy Review: China, Report by the Secretariat,* WT/TPR/S161/Rev.1 (26 June 2006) at p. xiii.

22 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman,* G/L/586 (12 November 2002) at ¶ 69.

23 *National Trade Estimate 2007* at 134.

stick to obtain agreement.[24] Specifically, U.S. businesses have alleged that Chinese government officials consider factors such as local content and export performance in the investment approval process and for recommending the approval of loans from Chinese banks, "which is often essential to the success of an investment project."[25] Similarly, there are allegations that "various Chinese officials" continue to pressure foreign investors to transfer technology.[26]

When China joined the WTO, the Chinese government committed itself to far-reaching reforms that required it to lower trade barriers, provide national treatment, improve market access, and, in light of the government's large role in the economy, to adopt special rules regarding the operation of state-owned enterprises.[27] However, six years after joining the WTO, many of China's industrial policies and subsidy programs appear to be inconsistent with China's WTO commitments contained in the WTO Agreement and/or China's Protocol of Accession (including specific Commitments made by China in the Working Party which are incorporated in its Protocol of Accession).

This report begins with a discussion of the general and specific commitments made during China's accession to the WTO that pertain to industrial policies and subsidy programs

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24 Written Statement of Anthony Rock, Principal Deputy Assistant Secretary of State Bureau of Oceans and International Environmental and Scientific Affairs, Hearing on China's High Technology Development Before U.S. – China Economic and Security Review Commission, April 21-22, 2005.

25 *National Trade Estimate 2007* at 134.

26 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman,* G/L/586 (12 November 2002) at Annex ¶ 59.

27 Statement of Charles W. Freeman III, Assistant U.S. Trade Representative of China Affairs, Office of the U.S. Trade Representative, Testimony Before the Full Committee of the House Committee on Ways and Means (April 14, 2005).

discussed herein. The report then contains a summary of the concerns expressed by China's trading partners regarding these policies and programs. This is followed by an explanation of the specific provisions from Article III of GATT 1994, the TRIMs Agreement, and the SCM Agreement that are potentially violated by Chinese policies, how these provisions are interrelated, and how they have been interpreted by the WTO's dispute settlement system of panel and Appellate Body decisions. The report then looks at two recent WTO requests by the United States for the establishment of panels in disputes involving Article III, the TRIMs Agreement, and the SCM Agreement. Finally, the report examines other policies and programs that potentially violate these same provisions and which could be challenged by the U.S. at the WTO.

II. CHINA'S ACCESSION TO THE WTO

The final "accession package" for an acceding WTO Member consists of the schedule of market access commitments in goods and services, the Protocol of Accession and the commitments identified in the Working Party Report which are then incorporated in the Protocol. Generally speaking, commitments made by an acceding country during the Working Party are responses to concerns expressed by Member countries. During the Working Party, China made many specific commitments, including a number of commitments pertaining to investment measures, subsidies, and "national treatment."[28]

[28] Certain commitment paragraphs from the Working Part Report are incorporated in China's Protocol of Accession and are an integral part of China's obligations. *See Accession of the People's Republic of China, Protocol on Accession*, WT/L/432 (10 November 2001) at Part I, ¶ 2 [hereinafter *Accession Protocol*].

With respect to "national treatment," China agreed to abide by the rules in Article III of GATT 1994 and confirmed to the Working Party that in the implementation of laws, regulations, and administrative requirements that the "principle of non-discrimination between domestically produced and imported products would be ensured…[and], by accession, China would repeal and cease to apply all such existing laws, regulations and other measures whose effect was inconsistent with WTO rules on national treatment."[29] Additionally, China confirmed that in order to provide full national treatment, all measures would be taken at the "national and sub-national level."[30]

Foreign individuals and enterprises and foreign-funded enterprises would be accorded "treatment no less favorable" than that accorded domestic companies in the "procurement of inputs and goods and services necessary for production and the conditions under which their goods are produced, marketed or sold, in the domestic market and for export."[31] Specifically, laws and regulations relating to the assessment of fees, charges, or taxes on imports and exports would conform with China's obligations under Articles III:2 and III:4, and XI:1 of GATT 1994.

In addition to the general commitment to comply with the TRIMs Agreement, China gave specific commitments for implementing the Agreement and for amending its laws. Paragraph

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29 *Report of the Working Party on the Accession of China*, WT/MIN(01)/3 (10 November 2001) [hereinafter *Working Party Report*] at ¶ 22.

30 *Id.* at ¶ 23 "China's local regulations, rules and other measures of local governments at the sub-national level shall conform to the obligations undertaken in the WTO Agreement and this Protocol." *See* also *Accession Protocol* at Part I, ¶ 1.3

31 *Id.* at Part I, ¶ 2(D)3.

7.3 of China's Protocol of Accession incorporates commitments made by China to the Working Party. The paragraph states that:

> China shall, upon accession, comply with the TRIMs Agreement, without recourse to the provisions of Article 5 of the TRIMs Agreement. China shall eliminate and cease to enforce trade and foreign exchange balancing requirements, local content and export or performance requirements made effective through laws, regulations or other measures. Moreover, China will not enforce provisions of contracts imposing such requirements. Without prejudice to the relevant provisions of this Protocol, China shall ensure that the distribution of import licenses, quotas, tariff-rate quotas, or any other means of approval for importation, the right of importation or investment by national and sub-national authorities, is not conditioned on: whether competing domestic suppliers of such products exist; or performance requirements of any kind, such as local content, offsets, the transfer of technology, export performance or the conduct of research and development in China.[32]

Although China assumed a commitment to abolish its TRIMs, effective the date of joining the WTO, "China never made any *formal* notification of its TRIMS to the relevant WTO bodies."[33] However, on June 16, 2000, China did provide the working party with a draft table of Chinese legislation that it planned to amend to ensure conformity with the TRIMs Agreement.[34]

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32 *Id.* at Part I, ¶ 7.3, *See also Working Party Report* at ¶¶ 49, 83(a).

33 *Committee on Trade-Related Investment Measures: Communication from the European Community and its Member States*, G/TRIMS/W/21 (24 September 2002) at 1.

34 *See* Tables in Exhibits 1 and 2. Table 1 lists the laws and regulations that were contained in the draft table and their dates of amendments. In this same draft document, China submitted two tables labeled Local Content Requirement and Foreign Exchange Balance Requirement. These tables are purportedly notifications, pursuant to Article 5 of TRIMS, of Chinese investment measures that were not in conformity with the TRIMs Agreement. *See Working Party on the Accession of China, Communication from China,* WT/ACC/CHN/20 (16 June 2000) at 22-25, Table AII.2; *see also* Agreement on Trade-Related Investment Measures, April 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, The Legal Texts: The Results of the Uruguay Round of Multilateral Trade Negotiations 143 (1999), 1868 U.N.T.S. 186 [hereinafter TRIMS Agreement].

China made additional commitments to the Working Party with respect to amendments to China's Industrial Policy for the Automotive Sector to ensure consistency with WTO rules and principles.[35] Specifically, China stated that it would "unify its laws, regulations and standards applied to domestic and imported automobiles and parts…[and] establish a transparent system under which all the laws and regulations would be applied so as to accord imported products treatment no less favorable than that accorded to like products of national origin."[36]

With respect to subsidies, China promised to "eliminate all export subsidies, within the meaning of Article 3.1 (a) of the SCM Agreement, by the time of accession."[37] Upon accession, China would "cease to maintain all pre-existing export subsidy programmes and, upon accession, make no further payments or disbursements, nor forego revenue or confer any other benefit, under such programmes."[38] China's commitment covered subsidy programs at all levels of the Chinese government.[39] Additionally, China made a specific commitment to eliminate subsidies that are contingent upon the use of domestic goods over imported goods.[40]

III. POLICIES AND SUBSIDY PROGRAMS THAT POTENTIALLY VIOLATE CHINA'S COMMITMENTS

Since China's accession to the WTO, China's trading partners have used several multilateral and bilateral mechanisms to monitor the implementation of China's accession

35 *Working Party Report* at ¶ 204.

36 *Id.* at ¶ 196.

37 *Id.* at ¶ 167.

38 *Id.*

39 *Id.*

40 *Id.* at ¶ 168.

commitments.[41] At the multilateral level, the primary mechanism for monitoring China's progress has been the Transitional Review Mechanism ("TRM"). Pursuant to Paragraph 18 of China's Accession Protocol, "subsidiary bodies of the WTO" must review annually, within their mandate, the implementation by China of the WTO Agreement and the related provisions of China's Accession Protocol.[42] Specifically, in the Committee for Trade-Related Investment Measures, China's trading partners monitor the changes and implementation of China's investment laws, regulations, and policies.[43] In the Committee on Subsidies and Countervailing Measures, trading partners are given the opportunity to question China's subsidy practices and monitor China's commitment to phase-out certain subsidy programs.[44]

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41 The Joint Commission on Commerce and Trade was established in 1983 and is the primary bilateral forum for the United States and China to discuss trade issues and to promote bilateral commercial opportunities. *See The Crisis in Intellectual Property Protection* at 136-150.

42 Pursuant to Article 18.4, China agreed to annual reviews for eight years, beginning in the first year and with a final review in year ten or at an earlier date decided by the General Council. *See Accession Protocol* at Part I, ¶¶ 18.1-18.4.

43 Under Article 18 of China's Accession Protocol members are allowed to ask China questions and China is required to provide relevant information. Under Annex 1A of the Protocol, China must notify the Committee of Trade-Related Investment Members of:

> (a) elimination and cessation of enforcement of trade and foreign exchange balancing requirements, local content and export performance offsets and technology transfer requirements made effective through laws, regulations or other measures
>
> (b) amendments to ensure lifting of all measures applicable to motor vehicle producers restricting the categories, types or models of vehicles permitted for production (to be completely removed two years after accession)
>
> (c) increased limits within which investments in motor vehicle manufacturing could be approved at the provincial government at the levels outlined in the Report

See Accession Protocol, Information to be Provided by China in the Context of the Transitional Review Mechanism, Annex 1A.

44 Pursuant to Article 25 of the Agreement on Subsidies and Countervailing Duties, Members are required to provide an annual notification of subsidy programs.

This section reviews Chinese industrial policies and specific subsidy programs that appear to be inconsistent with China's WTO commitments and the issues presented by China's trading partners within the TRM.

A. Enforcing Technology Transfer Agreements

During China's accession, Working Party members expressed concern about Chinese laws, regulations, and measures affecting technology transfer.[45] The Members were concerned that investment decisions were being made with government interference – conditioning investment approval upon technology transfer.[46] The Members requested that China ensure that there would be no government interference in developing the terms and conditions for technology transfer and any such agreement would be between only the investment parties.[47] Chinese officials confirmed that China "would only impose, apply or enforce laws, regulations or measures relating to the transfer of technology, production processes, or other proprietary knowledge" if it were not inconsistent with TRIPS and TRIMs.[48] The "terms and conditions of technology transfer, production processes or other proprietary knowledge, particularly in the context of an investment, would only require agreement between the parties to the investment."[49] Thus, the government would not condition investment approval upon technology transfer and the

45 *Working Party Report* at ¶ 48; Exhibit 19 contains selected trade statistics, including certain high-tech products.

46 *Id.*

47 *Id.*

48 *Id.* at ¶ 49.

49 *Id.* at ¶ 49.

"Chinese authorities would not enforce the terms of contracts containing such requirements."[50] Nonetheless, the Chinese representative stipulated that China would respect the freedom of contract.[51]

The conditioning of investment approval on technology transfer and the Chinese government's role in such an agreement has consistently been an issue throughout the TRM process. Members have continued to question China's enforcement of contracts, signed before China became a member of the WTO, which contain technology transfer clauses and revised laws, regulations, and investment policies which continue to encourage the practice.

Just prior to joining the WTO, China amended its laws and regulations concerning Sino-Foreign Equity Joint Ventures.[52] These amendments removed exchange balancing requirements and local content requirements. The laws also removed mandatory technology transfer, but they appear to still encourage the practice. Specifically, Article 5 of the Sino-Foreign Equity Joint Ventures Law states that equipment provided in a joint venture "must be advanced technology and equipment that suit" China's needs.[53] In Chapter IV of the Regulations, Articles 41 and 43, respectively, require that the technology acquired be "appropriate and advanced" and that "technology transfer agreements signed by a joint venture shall be submitted for approval to the

50 *Id.* at ¶ 203.

51 *Id.*

52 Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures, Order of the President of the People's Republic of China No. 48 (entered into force March 15, 2001); Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment (entered into force July 22, 2001), *available at*: www.fdi.gov.cn, attached as Exhibits 3 and 4.

53 Law of the People's Republic of China on Sino-Foreign Equity Joint Ventures, Order of the President of the People's Republic of China No. 48 (entered into force March 15, 2001).

examination and approval authority."[54] Thus the EC has noted that these Articles still "impose[] requirements on technology transfer agreements concluded by Joint Ventures."[55] Additionally, the agreement must comply with seven stipulations, including limiting the agreement to ten years and giving the importing party continuous use of the technology after the expiration of the agreement.[56]

China's trading partners have also expressed concern about the enforcement of contracts entered into before China's accession to the WTO, when China's laws contained mandatory technology transfer provisions.[57] The parties questioned whether the technology transfer provisions would be enforced and if that enforcement was "mandated by legislation, guidelines or other measures."[58] Specifically, the EC delegation wanted to know if such contracts are now considered null and void and if there were measures in place to protect foreign investors from a lawsuit or administrative action for refusing to follow contracts made under previous laws that require technology transfer.[59] The EC has consistently held the view that the enforcement of

54 Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment (entered into force July 22, 2001).

55 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/792 (27 October 2006) at Annex 1, ¶ 16.

56 Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment (entered into force July 22, 2001).

57 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman,* G/L/586, (12 November 2002) at Annex ¶ 57.

58 *Id.*

59 *Id.*

such contracts violates China's commitment "to ensure that contracts which contain TRIMs-incompatible commitments and obligations are no longer enforced."[60]

China has responded that previous laws contained mandatory technology transfers and the current laws only encourage technology transfer. Parties to contracts made under the previous law are welcome to renegotiate, but any amendment must be approved by a "competent authority." Otherwise, the foreign investor should continue to honor the contract.[61] In 2004 China stated further that:

> all existing commercial contracts on joint venture operation and technology transfer, since they had been signed by the relevant parties in consideration of their own business interests, the parties involved should negotiate about the amendment of those contracts themselves on the basis of fairness, justice and equality. The contracts should not be regarded as invalid automatically or be annulled through or by government actions or interference.[62]

In 2005, China elaborated on this statement, but confirmed that "without the consensus reached through consultation between the consenting parties on any terms of an existing contract,

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60 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Communication from the European Community and its Member States*, G/TRIMS/W/36 (13 September 2004) at ¶ 8.

61 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/586 (12 November 2002) at Annex ¶ 25.

62 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/708 (8 November 2004) at ¶ 20.

the contract itself or some of its articles could not be altered or invalidated by a Chinese court or any other administrative body through a mandatory order."[63]

However, the EC has continued to push China on this issue, reminding China that "Paragraph 3 of the Protocol of accession lays out a clear obligation for China to not only abolish or amend TRIMs-incompatible legislation, but also to ensure that any contracts containing TRIMs-incompatible commitments and obligations would not be enforced."[64] Additionally, if contracts are not considered invalid and must be renegotiated, how is China able to "ensure that the 'approval for investment by national and sub-national authorities' is not conditioned on performance requirements of any kind?" In the most recent TRM, the representative of China refused to address this issue and referred the EC to previous responses.[65]

B. 11th Five-Year Plan for Utilizing Foreign Investment

In November 2006, China published the 11th five-year plan for utilizing foreign investment.[66] The plan gives priority to quality investments rather than the quantity of investments, focusing less on bringing large amounts of money into the Chinese economy and

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63 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/751 (24 October 2005) at ¶ 22.

64 Committee on Trade-Related Investment Measures, *Communication from the European Union*, G/TRIMS/W/41 (1 August 2005) at ¶¶ 5-6.

65 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/792 (25 October 2006) at ¶ 33.

66 *New Policy Stresses Quality of Foreign Investment* (November 9, 2006), available at: http://english.gov.cn/2006-11/09/content_437842.htm.

more on investments that bring with them valuable skills and technology.[67] At the same time, the policy criticizes foreign investors for abusing intellectual property laws, which allegedly stymies "Chinese enterprises' capacity for independent innovation."[68] To increase value-added production, the policy "stresses the need for more foreign investment in areas such as research and development as well as sophisticated design."[69] Additionally, "[p]riority shall be given to the introduction of advanced technologies, management expertise and high-quality talents, rather than the use of foreign capital."[70]

China's trading partners have questioned how China will be able to promote foreign investment in higher value-added activity and encourage greater technology transfer in a manner that is consistent with China's WTO commitments.[71] "While the foreign investment plan states that foreign investment will continue to be welcome in China, it enunciates policy tools that may be used to halt foreign investment that is inconsistent with China's stated investment goals."[72]

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67 Andrew Batson, *Beijing Redraws Road Map on Foreign Investmen*t, Wall St. J., November 10, 2006.

68 *New Policy Stresses Quality of Foreign Investment* (November 9, 2006), available at: http://english.gov.cn/2006-11/09/content_437842.htm.

69 *Id.*

70 *Id.*

71 *Constants and Variables: The Evolving Context for Foreign Investors in China*, remarks of Sharon J. Mann, Global Business Dialogue, Washington D.C., (May 11 2007), (copy on file with author).

72 *Id. citing* Art 4(7).

C. 2004 - Revised Automobile Policy

Before China's accession to the WTO, "China's automobile industrial policy offered significant advantages for foreign-invested factories using high levels of local content."[73] During its WTO accession, China committed to issuing, within two years of accession, a revised automotive policy that was compatible with WTO rules and principles.[74] Pursuant to Article of 5 of the TRIMs Agreement, China notified the Working Party of the Articles within the 1994 Automotive Policy that would be amended to make them compliant with the TRIMs Agreement, which forbids foreign exchange requirements and local content requirements.[75] Just before acceding to the WTO, China issued Bulletin No. 13 which provided that local content requirements would be abolished upon China's accession.[76]

Additional commitments made during the Working Party included China's commitment, within two years of accession, to lift measures that restrict the categories, types or models of vehicles permitted for production.[77] However, China retained the right to "continue to distinguish between trucks and buses, light commercial vehicles, and passenger cars (including multi-purpose vehicles and sport utility vehicles)."[78] The level of investment, where only local government approval is necessary, would be incrementally raised after one-year, two-years and

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73 *National Trade Estimate 2007* at 83.

74 *Working Party Report* at ¶ 204.

75 *Id.* at 22-25.

76 *National Trade Estimate 2007* at 83.

77 *Working Party Report* at ¶ 205.

78 *Id.*

four-years after accession from $30 million to $60 million, $90 million, and $150 million, respectively.[79] Finally, China also agreed to remove, on the date of accession, the 50 percent foreign equity limit for joint-ventures.[80]

Two years after China's accession, a new Automobile Policy had not been issued and, notwithstanding the issuance of Bulletin No. 13, U.S. automobile manufacturers reported that "local government officials continued to require local content and cited the old automobile industrial policy's standards."[81] In May of 2004 the Chinese government issued a new Policy on the Development of the Automotive Industry.[82] According to the Chinese government, the new policy contains major improvements over the old Policy by removing inconsistent provisions, such as the "requirements on foreign exchange balance, local content and export performance" and deregulating administrative approvals.[83]

However, China's trading partners have questioned certain provisions in the new policy.[84] Specifically, the U.S. has questioned Article 47, which requires a "minimum investment of RMB 2 million, of which owned capital should not be less than RMB 800

79 *Id.* at ¶ 206.

80 *Id.* at ¶ 207.

81 *National Trade Estimate 2007* at 83.

82 *Policy on Development of Automotive Industry*, State Development and Reform Commission, Order No. 8 (May 21, 2004), attached as Exhibit 5.

83 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/708 (8 November 2004) at ¶ 19.

84 Exhibit 19 contains selected trade statistics, including statistics on auto parts.

million"[85] The article also requires the establishment of an R&D facility with an investment of no less that RMB 500 million.[86] Article 3 states that auto production "enterprises shall be encouraged to improve the research and development ability and technological innovation ability, and positively develop products with self-owned intellectual property rights and pursue the strategy of famous-brand operation. In 2010, the auto production enterprises shall form some famous-brand products of automobiles, motorcycles and components and parts."[87] Additionally, in Annex II of the new Automobile Policy is a requirement that technology transfer agreements be filed by parties seeking approvals for new production plants.[88] The U.S. has specifically questioned China on how these Articles are consistent with China's commitments in paragraph 7.3 of China's Protocol of Accession and paragraph 203 of China's Working Party Report.[89]

Article 48 of the new Policy requires that foreigners not gain majority ownership in joint ventures and allows for a foreign investor to establish no more than two joint ventures producing the same class of vehicle (passenger car, commercial cars, and motorcycles).[90] The EC has argued that no such caps exist in the export processing zones, and thus "in order to obtain

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85 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Questions from the United States to China Concerning Trade-Related Investment Measures*, G/TRIMS/W/47 (26 September 2006) at ¶ 1.

86 *Id.*

87 *Policy on Development of Automotive Industry*, State Development and Reform Commission, Order No. 8 (May 21, 2004), attached as Exhibit 5.

88 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Additional Questions from the United States to China Concerning Trade-Related Investment Measures*, G/TRIMS/W/37 (23 September 2004) at ¶ 4.

89 *Id.* at ¶ 3.

90 *Policy on Development of Automotive Industry*, State Development and Reform Commission, Order No. 8 (May 21, 2004), attached as Exhibit 5.

approval of investment beyond 50% foreign ownership, foreign producers will have to locate their production in an export processing zone…[where] the approval or actual right could be conditional upon acceptance and fulfilment of an export performance requirement."[91]

With respect to local content requirements, Articles 55, 56, and 57 of the new Automobile Policy give a "strict definition and scope of complete vehicle features." Members have requested that China "confirm that these stipulations did not aim at increasing the rate of localization of automobile products, and that they would not constitute new trade barriers on vehicle imports."[92] Additionally, Article 58 requires that imported complete automobiles enter from one of only four ports.[93] Questions were raised as to why these four ports were picked and their significance.[94]

In 2005, the National Development and Reform Commission ("NDRC") began issuing measures to implement the new automobile policy. The measures require auto manufacturers that use imported parts to register with China's Customs Administration and provide a list of both the imported and domestic parts used in production, the value of those parts, and the supplier.[95] A 25 percent tariff rate is assessed on the imported auto parts when the completed car

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91 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China, Communication from the European Community and its Member States*, G/TRIMS/W/36 (13 September 2004) at ¶¶ 10-12.

92 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/708 (8 November 2004) at ¶ 18.

93 *Id.*

94 *Id.*

95 *National Trade Estimate 2007* at 83.

exceeds a threshold amount of imported parts.[96] Typically auto parts entering the country are assessed at 10 percent.[97] The U.S. has complained that these measures "impose charges that unfairly discriminate against imported automotive parts and discourage automobile manufacturers in China from using imported automotive parts in the assembly of vehicles."[98]

China has responded to the criticisms of its new Automobile Policy by arguing that its auto industry is in its initial stage of development and is well behind developed countries in terms of technology and competitiveness.[99] China claims that, since its WTO accession, the auto industry has been under extreme competition and shareholding requirements were implemented merely to help the development of the industry.[100] The limitation on the number of joint ventures is to "prevent investors from over-stretching their investment, opening multiple production sites and competing viciously with one another."[101] The Policy allows for an exemption on this limitation for "investors which, in association with their Chinese joint-equity partners, acquire or merge with other auto production companies in China."[102] Finally, China has argued that it is legitimate for the government "to provide guidance on the development of

96 *Id.*

97 *Id.*

98 *Id.*

99 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman,* G/L/751 (24 October 2005) at ¶ 26.

100 *Id.*

101 *Id.* at ¶ 27.

102 *Id.*

the industry based on its independent judgement of the maturity of the industry" and that this was in no "way related to WTO rules or China's accession commitment."[103]

Starting with Article 3, China has responded that the Article is merely a general outline of "China's goals, strategy, and direction in automobile industry development, without touching upon any detailed measures or restrictions on the volume."[104] Regarding the requirement to set-up an R&D facility, China has explained that this is necessary to "make sure that any new plant could meet the increasing technical and legal requirements on safety, environmental protection and energy saving….However, setting up an R&D facility itself did not constitute any mandatory requirement on transfer of technology."[105] The representative of China has explained that industry development policies issued by the government "aim at providing macro development guidance for the industries" but that they are not compulsory.[106] China also explains that Article 47 refers to the "automobile manufacturing project, instead of the foreign investment or investor that may be involved in the project."[107] Since foreign investors may exceed 50 percent, "China

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103 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/792 (27 October 2006) at ¶ 34.

104 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/708 (8 November 2004) at ¶ 21.

105 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/751 (24 October 2005) at ¶ 29.

106 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/792 (27 October 2006) at ¶ 31.

107 *Id.* at ¶ 32.

did not see that this was a mandatory requirement on the foreign investor, or that the right of investment of foreign investors was conditioned upon the conduct of R&D."[108]

In addressing complaints about the 2005 measures implementing the automotive policy, China has argued that, due to the tariff differences between complete cars and auto parts, it was necessary to devise a clear definition for a "whole vehicle."[109] The measure contains no "mandatory requirement on domestic whole-car and auto part manufacturers" and, thus, does not violate China's accession commitments.[110] Furthermore, the measure's definition of a "whole car" does not go against the principle of national treatment because it is applicable to both foreign-invested producers and domestic-funded producers.[111]

D. Steel and Iron Industry Development Policy

In July, 2005 NDRC released the Steel and Iron Industry Development Policy. China's trading partners have reacted harshly to this policy, arguing that the policy restricts foreign investment by requiring technology transfer, the use of domestic products, and discriminating against foreign investors. The U.S. has stated that Articles in the Policy "discriminate against

108 *Id.*

109 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/751 (24 October 2005) at ¶ 28.

110 *Id.*

111 *Id.*

foreign equipment and technology import by encouraging the use of domestic products when competing domestic suppliers exist."[112]

Specifically, Article 16 provides that the Chinese government will support iron and steel projects that use "home-made equipment" by providing tax refunds, interest subsidies, and research and development funds.[113] Article 18 encourages the use of domestic equipment and provides that if equipment or technology must be imported the "the introduced equipment or technology shall be advanced and practical."[114] USTR has commented that this particular provision calls "into question China's implementation of its WTO accession agreement commitment not to condition the right of investment or importation on whether domestic suppliers exist."[115]

Questions have also been raised about Article 23 of the policy which appears to discriminate between domestic and foreign companies by mandating certain requirements as conditions for investments.[116] Article 23 provides that for all investments into iron smelting, steel smelting, and steel rolling facilities, 40 percent of the capital must be self owned and the

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112 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Communication from the United States*, G/TRIMS/W/42 (14 September 2005) at ¶ 10.

113 *Policies for Development of Iron and Steel Industry*, Order of the National Development and Reform Commission No. 35 (8 July 2005) [here in after *Iron and Steel Policy*], attached as Exhibit 6.

114 *See Iron and Steel Policy.*

115 *National Trade Estimate 2007* at 84.

116 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/751 (24 October 2005) at ¶ 18.

investor must meet minimum steel production levels for the previous year.[117] Foreign investors are prohibited from investing in new business sites, and are limited to the "reform and relocation of domestic iron and steel enterprises" and to non-controlling stakes."[118] A foreign steel company is required to have produced at least 10 million tons of common steel or 1 million tons of special high alloy steel and a domestic company is only required to produce 5 million tons or half a million tons, but only if the domestic company's other production facilities are outside the area the company is trying to invest in.[119]

Article 23 also requires that a foreign investor have "intellectual property rights and techniques of its own."[120] As the policy requires that foreign investors possess proprietary technology, but does not allow for foreign investors to have controlling shares in iron and steel companies, the U.S. has characterized this requirement as a *de facto* technology transfer requirement.[121] The U.S. has asked China to explain how this investment restriction is consistent with China's commitments in paragraph 7.3 of its Protocol of Accession and paragraph 203 of its Working Party report.[122]

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117 *See Iron and Steel Policy.*

118 *See Iron and Steel Policy; See also Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Communication from the United States,* G/TRIMS/W/42 (14 September 2005) at ¶ 11.

119 *See Iron and Steel Policy.*

120 *See Iron and Steel Policy.*

121 *National Trade Estimate 2007* at 84.

122 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Communication from the United States,* G/TRIMS/W/42 (14 September 2005) at ¶ 12.

The United States has also questioned allegations that the Chinese steel industry receives direct and indirect subsidies from the Chinese government.[123] Specifically, the U.S. reports that there are allegations that steel companies receive "direct cash grants, land grants, transfer of ownership interest on terms inconsistent with commercial considerations, conversion of debt to equity in steel companies on non-market terms, debt forgiveness, preferential loans, tax incentives, including a variety of income tax exemptions and reductions."[124] Such programs were not included in China's Notification of subsidy programs and the U.S. has asked China to provide notification on such programs.[125]

E. Programs Appearing in China's Notification of Government Subsidies

Pursuant to Article 25 of the SCM Agreement, Members are required to annually give Notifications of government subsidy programs. For the first four years of China's membership, China never submitted an Article 25 Notification. However, using the Trade Review Mechanism, China's trading partners attempted to monitor China's subsidy programs and the implementation of its commitments by submitting questions to the Committee on Subsidies and Countervailing Measures concerning the phase out of certain subsidy programs and for clarification on certain laws believed to violate the SCM Agreement.

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123 *Committee on Subsidies and Countervailing Measures, Questions from the European Communities Regarding the New and Full Notification of China,* G/SCM/Q2/CHN/16 (25 July 2006) at 4.

124 *Id.*

125 *Id.*

Specifically, Members have requested that China confirm that the subsidies identified in Annex 5B of China's Accession Protocol have been phased out.[126] The subsidy programs in Annex 5B include: tax and grant benefits to certain state-owned enterprises that are running at a loss; priority in obtaining loans and foreign currencies to automotive enterprises that is contingent on the enterprise's export performance; and preferential tax treatment to automotive enterprises that use local content.[127] China committed to the phasing out of these specific programs by 2000.[128] However, according to press reports at the time, some of these programs remained active, and there were indications that the programs would not be completely phased out before 2005. [129]

Members have also complained that there are indications that subsidies are continuing to be provided by the central and provincial government that were "contingent upon export performance or upon the use of domestic over imported goods."[130] China was asked to clarify why some regional benefits were only given to "export oriented enterprises" which was defined as "enterprises whose product export volume accounts for over 50 per cent of its annual sales volume and who has a surplus of foreign exchange and has made a profit during the year."[131] In

126 *Committee on Subsidies and Countervailing Measures, Questions Posed by Japan to the People's Republic of China*, G/SCM/Q2/CHN/3 (23 October 2002).

127 *Working Party Report*, Annex 5B, at pages 164-166.

128 *Transitional Review Mechanism Pursuant to Section 18 of the Protocol on the Accession of the People's Republic of China*, G/SCM/Q2/CHN/8 (6 October 2004) at 3.

129 *Id.*

130 *Transitional Review Mechanism Pursuant to Section 18 of the Protocol on the Accession of the People's Republic of China*, G/SCM/Q2/CHN/7 (23 September 2004) at 1.

131 *Committee on Subsidies and Countervailing Measures, Questions Posed by European Communities to the People's Republic of China*, G/SCM/Q2/CHN/5 (2 October 2003) at 2.

2004, the U.S. alleged that China was administering programs "that may provide subsidies contingent upon export performance, which are prohibited under Article 3.1(a) of the SCM Agreement" and programs that "are contingent upon the use of domestic over imported goods, which are prohibited under Article 3.1(b) of the SCM Agreement."[132]

In July 2006, pursuant to Article 25.7 of the SCM Agreement, China submitted its Notification of information on subsidy programs granted or maintained by the central government between 2001 and 2004.[133] China's notification contained seventy-eight programs. However, the Notification did not include any government programs at the sub-central level.[134] Immediately, the U.S. and other countries asked China to explain how certain programs that appeared to give export-oriented foreign enterprises preferential tax treatment were "consistent with China's obligations under Article 3 of the SCM."

For several programs, the U.S. asked that China provide the Committee greater clarification. Although the U.S. did not allege a violation, the U.S. questioned whether numerous programs that gave preferential tax treatment to enterprises located in Special Economic or Technological Zones were "contingent upon export or the use of domestic over imported goods." Additionally China was asked to clarify terms used in specific Circulars for

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132 *Transitional Review Mechanism Pursuant to Section 18 of the Protocol on the Accession of the People's Republic of China, European Communities*,G/SCM/Q2/CHN/7 (6 October 2004) at ¶¶ 1, 13.

133 *Committee on Subsidies and Countervailing Measures, New and Full Notification Pursuant to Article XVI:1 of the GATT 1994 and Article 25 of the SCM Agreement, People's Republic of China*, G/SCM/N/123/CHN (13 April 2006).

134 *Committee on Subsidies and Countervailing Measures, Questions from the United States Regarding the New and Full Notification of China*, G/SCM/Q2/CHN/19 (26 July 2006) at ¶ 1.

expressing the program standards for the receipt of benefits. Terms found to be vague that China was asked to clarify included: "a production nature," "high or new technology," "recognized as high or new technology enterprises," "encouraged," and "consistent with the state industrial policies." A large number of the programs appear to give no clear, objective standard for conditioning benefits. The U.S. Chamber of Commerce has suggested that China needs to provide a more detailed report to the WTO on its subsidy programs, particularly with respect to "subsidies of state-owned companies provided through its banking system, provincial government-level subsidization, and the amount of subsidies involved."[135]

As many of the programs appear to be "contingent upon export or the use of domestic over imported goods" they potentially violate Article 3 of the SCM Agreement, Article 2.1 and 2.2 of the TRIMs Agreement, paragraph 1 of Article XI of GATT 1994, and Article III:4 of GATT 1994.

IV. WTO PROVISIONS THAT ARE POTENTIALLY VIOLATED BY CHINESE POLICIES AND PROGRAMS

As discussed above, when China acceded to the WTO, it committed to bring its legislation and policy into conformity with its WTO commitments. For the Chinese government, it committed to making a fundamental change in the level of government involvement and its role in the domestic economy. However, a trend has recently developed in China, where "[i]nstead of relying on the market to dictate outcomes, China increasingly was resorting to

[135] *China's WTO Implementation and Other Issues of Importance to American Business in the U.S.-China Commercial Relationship,* U.S. Chamber of Commerce Report (September 2006) at 11.

industrial policies that restrict foreign investment while promoting domestic companies."[136] Many of these industrial policies and subsidy programs violate China's basic WTO commitments and are inconsistent with commitments made by China during the Working Party.

Commitments and Articles that China's industrial policies and subsidy programs potentially violate include: Article 3 of the Agreement on Subsidies and Countervailing Measures; Article III:4 and III:5 of the GATT 1994; and Article 2 and Paragraph 1(a) of Annex 1 of the TRIMs Agreement. The measures also appear not to comply with obligations made by China during its accession, including: Paragraphs 7.2-7.3 and 10.3 of Part I of the Accession Protocol, as well as paragraph 1.2 of Part I of the Accession Protocol, to the extent that it incorporates paragraphs 167 and 203 of the Report of the Working Party on the Accession of China. This section of the report summarizes these Articles, what they provide and how they have been interpreted by dispute settlement panels and the Appellate Body.

A. Agreement on Trade-Related Investment Measures

Before the Uruguay Round of Multilateral Trade Negotiations, the focus of the General Agreement on Tariffs and Trade ("GATT"), the precursor to the WTO, was the liberalization of the international trade in goods. While investment was not explicitly covered by the GATT agreement, GATT did forbid investment measures that restricted and distorted trade in goods. In addition to the TRIMs Agreement, during the Uruguay Round, Members negotiated two other

[136] *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/792 (14 September 2005) at Annex ¶ 11.

agreements that contained specific investment provisions.[137] The TRIMs Agreement addresses measures that directly affect the trade in goods, reaffirming existing GATT obligations addressing investment measures which violate Article III (national treatment) or Article XI (general elimination of quantitative restrictions) of GATT 1994.

Generally, investment measures are seen as a tool for promoting development by increasing technology transfer, industrialization, and export expansion.[138] Historically, they tended to be concentrated in specific industries, such as automotive, chemical and petrochemical, and computer/informatics, and were implemented for the purpose of compelling multinational enterprises to meet certain performance requirements, promote domestic components industries and/or restrain the volume of imports.[139] However, the use of such investment measures has likely decreased over the past two decades as more liberal economic policies have been adopted and governments now seek to attract more foreign investment.[140]

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137 Additional investment related components of the Uruguay Round Agreement include the following: the Agreement on Trade-Related Aspects of Intellectual Property Rights, April 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, The Legal Texts: The Results of the Uruguay Round of Multilateral Trade Negotiations 320 (1999), 1869 U.N.T.S. 299, 33 I.L.M. 1197 (1994) [hereinafter TRIPS Agreement]; and General Agreement on Trade in Services, April 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, The Legal Texts: The Results of the Uruguay Round of Multilateral Trade Negotiations 284 (1999), 1869 U.N.T.S. 183, 33 I.L.M. 1167 (1994) [hereinafter GATS]. GATS recognizes the "commercial presence" of one Member in the territory of another, while TRIPS protects the investments of one Member in intellectual property from theft by another.

138 *Beyond TRIMSs: A Case for Multilateral Action on Investment Rules and Competition Policy,* in W. Martin and A. Winters, eds., *The Uruguay Round and the Developing Countries*, Cambridge Press (1986) at 385, *citing* Maskus, K. E. and D. R. Eby, *Developing New Rules and Disciplines on Trade-Related Investment Measures*, The World Economy 13(4): 523-53 (1990).

139 *Id.* at 380.

140 *Id.* at 389.

Proposals for including investment measures within a multilateral trade agreement were first discussed in 1947-1948 during negotiations of the Havana Charter for the International Trade Organization. However, what was eventually agreed to as part of the draft Charter was quite limited in reach. The Members agreed that "international investment…can be of great value in promoting economic development and reconstruction."[141] Even so, the Agreement gave countries the right to "take any appropriate safeguards necessary to ensure that foreign investment is not used as a basis for interference in its international affairs or national policies."[142] When the ITO was not accepted by the U.S., the Chapter on Commercial Policy was converted into the GATT.

Further negotiations for an investment agreement within the trade arena would not begin until 1986 with the Uruguay Round Negotiations. However, during the Tokyo Round Negotiations, an important dispute between the United States and Canada arose on existing GATT obligations that would lead to an interest in exploring trade-related investment measures as a topic in the Uruguay Round negotiations.[143]

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141 *See,* Article 12 of the Havana Charter, available at: http://www.wto.org/English/docs_e/legal_e/havana_e.pdf

142 *Id.*

143 *Canada – Administration of the Foreign Investment Review Act,* Report of the Panel, GATT Doc. No. L/5044 (25 July 1983).

In the Preparatory Committee to create an agenda for a new round of negotiations, the United States introduced the subject of trade-related investment measures.[144] The Punta del Este Declaration ratified the agenda giving the following TRIMs mandate:

> Following an examination of the operation of GATT articles related to the trade restrictive and distorting effects of investment measures, negotiations should elaborate, as appropriate, further provisions that may be necessary to avoid such adverse effects on trade.[145]

The Agreement that emerged from the Uruguay Round negotiations was modest in scope. The Agreement does not address investment policies generally and does not address "pure" investment issues such as the right of establishment, investment incentives, national treatment, and investor protection.[146] As stated above, the Agreement reaffirms obligations found under the GATT that relate to national treatment (Article III) and the prohibition on quantitative restrictions (Article XI). Under GATT, there were two TRIMs identified as being inconsistent with Article III (local content and trade-balancing requirements) and three TRIMs identified as quantitative restrictions (trade-balancing restrictions, foreign-exchange-balancing restrictions, and domestic-sales requirements).

The entire Agreement consists of nine Articles and an Annex, which contains an Illustrative List. Although the Agreement does not define what constitutes a trade-related

144 *The GATT Uruguay Round: A Negotiating* History (1986-1992), Volume II: Commentary, Terence P. Stewart, ed. (Kluwer Law and Taxation Publishers, Boston, 1993) at 2068.

145 *Ministerial Declaration on the Uruguay Round*, GATT Doc. No. MIN(86)/6 (Sept. 20, 1986) at 8.

146 *Beyond TRIMSs: A Case for Multilateral Action on Investment Rules and Competition Policy,* in W. Martin and A. Winters, eds., *The Uruguay Round and the Developing Countries*, Cambridge Press (1996) at 380.

investment measure, the Illustrative List provides measures that are inconsistent with Article III and Article XI of GATT 1994. Measures considered inconsistent "with the obligations of national treatment provided for in paragraph 4 of Article III" or inconsistent with the "obligation of general elimination of quantitative restrictions provided for in paragraph 1 of Article XI of GATT" are those which are "mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage."

According to the Illustrative List, a violation of Article III requires:

> a. the purchase or use by an enterprise of products of domestic origin or from any domestic source, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production (local content requirement); or
>
> b. that an enterprise's purchases or use of imported products be limited to an amount related to the volume or value of local products that it exports (trade balancing requirements).[147]

A violation of Article XI restricts:

> a. the importation by an enterprise of products used in or related to its local production, generally or to an amount related to the volume or value of local production that it exports (trade balancing restrictions);
>
> b. the importation by an enterprise of products used in or related to its local production by restricting its access to foreign exchange to an amount related to the foreign exchange inflows attributable to the enterprise (exchange balancing restrictions); or
>
> c. the exportation or sale for export by an enterprise of products, whether specified in terms of particular products, in terms of

147 TRIMS Agreement Annex at ¶ 1.

> volume or value of products, or in terms of a proportion of volume or value of its local production (domestic sales requirements).[148]

The Agreement requires that all countries notify the WTO of all inconsistent TRIMs in ninety days and provides a timetable for phasing out all specified TRIMs. Industrial, developing, and least-developed countries were required to phase out all GATT-inconsistent TRIMs in two, five, and seven years, respectively. During the transition period TRIMs could not be modified to increase their inconsistency and any TRIM introduced 180 days before the signing of the Agreement was not given a transition period. There is also a provision that permits countries to apply an equivalent TRIM to a new investment if there is an existing TRIM being applied to an established enterprise. This was done so as not to disadvantage established enterprises.

The final four Articles of the Agreement address Transparency, establishing the Committee on Trade- Related Investment Measures, Consultation and Dispute Settlement, and finally Article 9 mandates that there be a review of the TRIMs Agreement by the Council for Trade in Goods, to be commenced within five years of date of entry into force of the WTO Agreement, and which was to include proposals for amendments and consideration of whether provisions on investment policy and competition policy should be added to the Agreement.[149]

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148 *Id.* at Annex, ¶ 2.

149 The Council for Trade in Goods met and reviewed the operation of the TRIMS Agreement, but according to the Council's 2006 Report, the review appears to be ongoing. *See Report (2006) of the Council for Trade in Goods*, G/L/808 (4 December 2006).

1. Interpreting TRIMs Under GATT

In early 1982, the United States requested consultations with Canada concerning the legality of Canada's Foreign Investment Review Act ("FIRA").[150] FIRA provided that foreign investments would be subject to government approval on the basis of five factors and investments would be allowed to proceed only if it was likely to be of a "significant benefit to Canada."[151] The government looked at, *inter alia*, the benefits to Canadian employment, satisfying content requirements, and benefits to Canadian technological development. Additionally, under FIRA, investors may be asked to submit "written undertakings" to satisfy local content requirements, including producing goods in Canada that may have otherwise been imported, or export performance requirements, which became legally binding after the government approved the investment.[152] The United States questioned the Canadian government's practice of entering "into agreements with foreign investors according to which these are to give preference to the purchase of Canadian goods over imported goods and to meet certain export performance requirements."[153]

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150 The Foreign Investment Review Act was enacted by the Parliament of Canada. Under Section 2(1) the Act, the Canadian Parliament adopted the law "in recognition that the extent to which control of Canadian industry, trade and commerce has become acquired by persons other than Canadians and the effect thereof on the ability of Canadians to maintain effective control over their economic environment is a matter of national concern" and thus it was necessary that for Canadian businesses to come under the control of a foreign entity there must be a review and assessment to determine if the foreign acquisition would likely be a "significant benefit to Canada." *See Canada – Administration of the Foreign Investment Review Act,* Report of the Panel, GATT Doc. No. L/5044 (25 July 1983) at ¶ 2.2.

151 *Id.* at ¶¶ 2.2-2.12.

152 *Id.*

153 *Id.* at ¶ 1.1.

Before considering the issues, Delegates expressed their concern at the "terms of reference," doubting whether this dispute was one "for which the GATT had competence since it involved investment legislation, a subject not covered by the GATT."[154] Delegates believed that the "matter dealt with Canadian laws and practices related to investment'…[and] that the General Agreement did not prevent a contracting party from prohibiting foreign investment, even if this resulted in trade distortion."[155] The United States assured the Delegates that it "was not attacking Canadian investment laws directly but was complaining about the two specific trade-related issues mentioned in the terms of reference."[156] Canada also assured the Delegates that "the terms of reference ensured that the examination would touch only on trade matters which were within the purview of GATT, and that there would be no opportunity or reason for the Panel to examine Canadian investment policies."[157]

The United States argued before the Panel that the FIRA obligations requiring that foreign investors purchase domestic goods in preference to imported goods or to manufacture goods domestically which would otherwise be imported were inconsistent with Articles III:4, III:5, XI and XVII:1(c) of the General Agreement. Additionally, requirements to export specified quantities of production were inconsistent with Article XVII:i(c). In its findings, the Panel: (1) concluded that conditioning investment upon contracts for "investors to purchase

154 *Id.* at ¶ 1.4.

155 *Minutes of Meeting Held in Centre William Rappard on 2 November 1982*, GATT Doc. No. C/M/162, at 25 (19 November 1982).

156 *Id.* at 25-27.

157 *Id.*

goods of Canadian origin" or Canadian sources was inconsistent with Article III:4; (2) found insufficient grounds to examine certain "written undertakings" under Article III:5, concluding that they fell under the purchase requirements found inconsistent with Article III:4; (3) rejected the U.S. contention that the "undertakings were contrary to Article XI," stating that the "purchase undertakings" fell under Article III, which addresses measures affecting "imported products" and not Article XI, which addresses the "importation" of products; (4) did not find it necessary to make a finding with respect to Article XVII:1(c) since the purchase undertakings had already been found inconsistent with Article III:4; (5) did not agree with Canada that the purchase undertakings found to be inconsistent with Article III:4 "are necessary within the meaning of Article XX(d) for the effective administration" of FIRA.[158] Simply put, the Panel agreed with the U.S. that the local content requirements mandated by a "written undertaking" contravened the national treatment obligation of GATT Article III:4, but found that FIRA's export performance requirements were not inconsistent with GATT.

2. Interpreting TRIMs at the WTO

As mentioned, the TRIMs Agreement applies only to "investment measures" related to the trade in goods. Panels have interpreted "investment measures" broadly, and have not limited it to "measures taken specifically in regard to foreign investment."[159] "[N]othing in the TRIMS Agreement suggests that the nationality of the ownership of enterprises subject to a particular

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158 *See Canada – Administration of the Foreign Investment Review Act*, Report of the Panel, GATT Doc. No. L/5044 at ¶ 2.2 (25 July 1983).

159 *See Indonesia – Certain Measures Affecting the Automobile Industry*, Report of the Panel, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R (2 July 1998) at ¶ 14.73.

measure is an element in deciding whether that measure is covered by the Agreement."[160] To determine whether a measure is a TRIM, panels first consider whether the measure at issue is an "investment measure" and then consider whether the measure is "trade-related."[161]

In *Indonesia – Autos*, the Panel found that measures relating to internal taxes or subsidies may be considered investment measures, as they are "only one of many types of advantages which may be tied to a local content requirement which is a principal focus of the TRIMS Agreement…The TRIMS Agreement is not concerned with subsidies and internal taxes as such but rather with local content requirements, compliance with which may be encouraged through providing any type of advantage."[162] In making a determination as to whether the measures in question were "investment measures" the Panel reviewed the legislation related to the measures and found it to include investment features and investment objectives, with aim of encouraging the development of local industries.[163] Inherently, this objective and the resulting measures have a "significant impact on investment in these sectors."[164] The Panel's "characterization of measures as "'investment measures," [was] based on an examination of the manner in which the measures at issue in this case relate to investment."[165]

160 *Id.*

161 *Id.* at ¶ 14.72.

162 *Id.* at ¶ 14.73.

163 *Id.* at ¶ 14.80.

164 *Id.*

165 *Id.*

In analyzing whether local content requirements are "trade-related" the Panel found that "such requirements, by definition, always favour the use of domestic products over imported products, and therefore affect trade."[166] Examining whether the measures are covered by the Illustrative List, which refers to "measures with local content requirements, will not only indicate whether they are trade-related but also whether they are inconsistent with Article III:4 and thus in violation of Article 2.1 of the TRIMs Agreement."[167] Tax and customs duty benefits that are tied to the purchase and use of domestic origin products "are clearly 'advantages' in the meaning of the chapeau of the Illustrative List to the TRIMs Agreement and as such,…fall within the scope of the Item 1 of the Illustrative List."[168] Although businesses are free to decide whether to buy the domestic parts or not, the Panel found that the Illustrative List "makes it clear that a simple advantage conditional on the use of domestic goods is considered to be a violation of Article 2 of the TRIMs Agreement even if the local content requirement is not binding as such."[169]

B. Article III:4 of the General Agreement on Tariffs and Trade 1994

Article III:4 of the GATT provides, *inter alia* that:

> The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favorable than that accorded to like products of

166 *Id.* at ¶ 14.82.

167 *Id.* at ¶ 14.83.

168 *Id.* at ¶ 14.90.

169 *Id.* at ¶ 14.90.

> national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use.

A violation of Article III:4 requires that it be established that the domestic and foreign products are "like products," that the measure affect the "internal sale, offering for sale, purchase, transportation, distribution, or use" of the imported products, and that the imported products be accorded "less favorable treatment."[170] The Article does not require that it be shown whether measures "afford protection to domestic production."[171] When "asserting a fact, claim or defense" the burden of proof, is on the party making the assertion and "[o]nce that party has put forward sufficient evidence to raise a presumption that what is claimed is true, the burden of producing evidence shifts to the other party to rebut the presumption."[172]

Using the "general principle" of "likeness" enunciated in Article III:1, the Appellate Body has found that the term "like products" in Article III:4 is "fundamentally, a determination about the nature and extent of a competitive relationship between and among products."[173]

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170 *See Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, Report of the Appellate Body, WT/DS161/AB/R, WT/DS169/AB/R (11 December 2000) at ¶ 133, "For a violation of Article III:4 to be established, three elements must be satisfied: that the imported and domestic products at issue are 'like products'; that the measure at issue is a 'law, regulation, or requirement affecting their internal sale, offering for sale, purchase, transportation, distribution, or use'; and that the imported products are accorded 'less favorable' treatment than that accorded to like domestic products."

171 *European Communities – Regime for the Importation, Sale and Distribution of Bananas*, Report of the Appellate Body, WT/DS27/AB/R (9 September 1997) at ¶ 216.

172 *Japan – Measures Affecting Consumer Photographic Film and Paper*, Report of the Panel, WT/DS44/R (31 March 1998) at ¶ 10.372, *citing United States – Measures Affecting Imports of Woven Wool Shirts and Blouses from India*, Report of the Appellate Body, WT/DS33/AB/R (25 April 1997) at p.14.

173 *European Communities – Measures Affecting Asbestos and Asbestos-Containing Products*, Report of the Appellate Body, WT/DS135/AB/R (12 March 2001) at ¶ 96. The Appellate Body has also analyzed the relationship with "like products" under Article III:2, which "extends not only to 'like products', but also to products which are directly 'competitive or substitutable.'" *Id.* Without ruling on the precise product scope

Several Panels and the Appellate Body have adopted a framework for analyzing likeness on a case-by-case basis using four criteria: (1) the properties, nature and quality of the product (2) the end-uses of the products (3) consumers' perceptions and behavior – in respect of the products, and (4) the tariff classification of the products.[174] The types of evidence that may be examined in assessing the 'likeness' of products will "depend upon the particular products and the legal provisions…panels must determine whether that evidence, as a whole, indicates that the products in question are 'like' in terms of the legal provision at issue."[175] For a full examination of the evidence in making a determination of "likeness" all four of the criteria should be examined.[176]

Under Article III:4, laws, regulations, and requirements are interpreted as encompassing "a broad range of government action by private parties that may be assimilated to government action."[177] A requirement need not be mandatory, but may be merely a condition that must be

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of Article III:4, the Panel "conclude[d] that the product scope of Article III:4, although broader than the *first sentence* of Article III:2, is certainly *not* broader than the combined product scope of the *two sentences* of Article III:2." *Id.*

174 *Id.* at ¶ 101. The Appellate Body noted that "these four criteria comprise four categories of 'characteristics' that the products involved might share: (i) the physical properties of the products; (ii) the extent to which the products are capable of serving the same or similar end-uses; (iii) the extent to which consumers perceive and treat the products as alternative means of performing particular functions in order to satisfy a particular want or demand; and (iv) the international classification of the products for tariff purposes." *Id.*

175 *Id*. at ¶ 103.

176 *Id*. at ¶ 109. In *EC – Asbestos*, the Appellate Body found certain factors were relevant factors in evaluating the four criteria. The physical properties of products must be examined fully, especially those that are "likely to influence the competitive relationship between products in the marketplace." *Id*. at ¶ 114. [E]vidence about the extent to which products can serve the same end-uses, and the extent to which consumers are – or would be – willing to choose one product instead of another to perform those end-uses, is highly relevant evidence in assessing the "likeness". *Id*. at ¶ 117. Consumers' tastes and habits are also important, as a "manufacturer cannot…ignore the preferences of the ultimate consumer." *Id*. at ¶ 122.

177 *Japan – Measures Affecting Consumer Photographic Film and Paper*, Report of the Panel, WT/DS44/R (31 March 1998) at ¶ 10.376.

met in order to obtain an advantage.[178] Neither "legal enforceability or the existence of a link between a private action and an advantage conferred by a government is a necessary condition in order for an action by a private party to constitute a 'requirement.'"[179]

How a "requirement" might affect imported goods has been broadly interpreted to "cover not only laws and regulations which directly govern the conditions of sale or purchase but also any laws or regulations which might adversely modify the conditions of competition between domestic and imported products."[180] To give imported goods "treatment no less favorable" in relation to domestic goods requires "effective equality of opportunities" for imported products, allowing for regulatory differences between domestic and imported products.[181] Thus a regulatory difference in and of itself is not conclusive in establishing inconsistency with Article III:4…[but] "should be assessed instead by examining whether a measure modifies the conditions of competition in the relevant market to the detriment of imported products."

C. Article XI:1 of the General Agreement on Tariffs and Trade 1994

Article XI:1 provides that:

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178 *Canada – Certain Measures Affecting the Automotive Industry*, Report of the Panel, WT/DS139/R, WT/DS142/R (11 February 2000) at ¶ 10.73.

179 *Id*. at ¶ 10.106.

180 *Id*. at ¶ 10.80, *citing Italian Discrimination Against Imported Agricultural Machinery*, Report of the Panel, BISD 7S/60 (23 October 1958) at ¶ 12.

181 *See Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, Report of the Appellate Body, WT/DS161/AB/R, WT/DS169/AB/R (11 December 2000) at ¶¶ 135-137, *citing United States – Section 337 of the Tariff Act of 1930*, Report by the Panel, BISD 36S/345 (7 November 1989) at ¶ 5.11.

> No prohibitions or restrictions other than duties, taxes, or other charges, whether made effective through quotas, import or export licenses or other measures, shall be instituted or maintained by any contracting party on the importation of any product of the territory of any other contracting party or on the exportation or sale for export of any product destined for the territory of any other contracting party.

"The prohibition on the use of quantitative restrictions forms one of the cornerstones of the GATT system."[182] In showing a violation of Article XI the complainant must present a *prima facie* case that measures are inconsistent.[183] In determining what constitutes a violation under Article XI Panels have found that a complete ban on imports of certain foreign products is inconsistent,[184] and requiring certifications under certain policy conditions would be considered "prohibitions or restrictions" that are inconsistent.[185] Article XI extends to *de facto* and *de jure* "prohibitions or restrictions" and "the fact that an action is taken by private parties does not rule out the possibility that it may be deemed governmental if there is sufficient governmental involvement."[186] However, Members are not "under an obligation to exclude any possibility that

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182 *Turkey – Restrictions on Imports of Textile and Clothing Products*, Report of the Panel, WT/DS34/R (31 May 1999) at ¶ 9.63.

183 *India – Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products*, Report of the Panel, WT/DS90/R (6 April 1999) at ¶ 5.119, *citing Australia – Measures Affecting Importation of Salmon*, Report of the Appellate Body, WT/DS18/AB/R (20 October 1998) at ¶¶ 257-259.

184 *Canada – Certain Measures Concerning Periodicals*, Report of the Panel, WT/DS31/R (14 March 1997) at ¶ 5.5.

185 *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, Report of the Panel, WT/DS58/R (15 May 1998) at ¶ 7.16.

186 *Japan – Measures Affecting Consumer Photographic Film and Paper*, Report of the Panel, WT/DS44/R (31 March 1998) at ¶ 10.56.

governmental measures may enable private parties, directly or indirectly, to restrict trade, where those measures themselves are not trade restrictive."[187]

Like Articles I, II, and III of GATT 1994, Article XI "protects competitive opportunities of imported products, not trade flows…[thus parties] need not prove actual trade effects.[188] However, when a party alleges a "*de facto* rather than a *de jure* restriction… it is inevitable, as an evidentiary matter, that greater weight attaches to the actual trade impact of a measure."[189] Showing low export statistics does not prove, in and of itself, that an alleged measure constitutes an export restriction, especially when the alleged measure is a *de facto* restriction and there are possibly multiple restrictions.[190] It is "necessary for a complaining party to establish a causal link between the contested measure and the low level of exports."[191]

Panels have addressed, *inter alia*, whether certain measures such as using state trading enterprises and licensing requirements create restrictions that violate Article XI.[192] In reviewing whether the use of state trading enterprises resulted in a restriction, the Panel in *India* –

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187 *Argentina – Measures Affecting the Export of Bovine Hides and the Import of Finished Leather*, Report of the Panel, WT/DS155/R (19 December 2000) at ¶ 11.18.

188 *Japan - Taxes on Alcoholic Beverages*, Report of the Appellate Body, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R (4 October 1996) at p. 16.

189 *Argentina – Measures Affecting the Export of Bovine Hides and the Import of Finished Leather*, Report of the Panel, WT/DS155/R (19 December 2000) at ¶ 11.20.

190 *Id*. at ¶ 11.21.

191 *Id*., *citing European Communities – Measures Affecting the Importation of Certain Poultry Products*, Report of the Appellate Body, WT/DS69/AB/R (13 July 1998) at ¶¶ 126-127.

192 *See United States – Import Measures on Certain Products from the European Communities*, Report of the Panel, WT/DS165/R (17 July 2000) at ¶ 6.61. In this dispute, the measure at issue was a bonding requirement. The majority of the Panel found that the restriction fell under Article II, but one panelist found that the particular bonding requirement fell under Article XI.

Quantitative Restrictions found that the "mere fact that imports are effected through state trading enterprises would not in itself constitute a restriction," but rather it should be shown that the "operation of this state trading entity is such as to result in a restriction."[193] When the state trading enterprise has a monopoly, controlling both importation and distribution channels, "the imposition of any restrictive measure, including internal measures, will have an adverse effect on the importation of the products concerned."[194]

In *India – Quantitative Restrictions*, the panel interpreted Article XI as being comprehensive and broadly defined the term "restriction" as "a limitation on action, a limiting condition or regulation."[195] As such, the panel found that "discretionary or non-automatic licensing systems by their very nature operate as limitations on action since certain imports may not be permitted. Thus,…a discretionary or non-automatic import licensing requirement is a restriction prohibited by Article XI:1."[196] However, the Panel in *Korea – Various Measures on Beef* found that a "discretionary licensing system, used in conjunction with a quantitative restriction, [does not] necessarily provide[] some additional level of restriction over and above the inherent restriction on access created through the imposition of a quantitative restriction."[197]

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193 *India – Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products*, Report of the Panel, WT/DS90/R (6 April 1999) at ¶ 5.134, *citing Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, Report of the Panel, WT/DS161/R, WT/DS169/R (31 July 2000) at ¶ 115.

194 *Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, Report of the Panel, WT/DS161/R, WT/DS169/R (31 July 2000) at ¶ 751.

195 *India – Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products*, Report of the Panel, WT/DS90/R (6 April 1999) at ¶¶ 5.129-5.130.

196 *Id*. at ¶ 5.130.

197 *Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef*, Report of the Panel, WT/DS161/R, WT/DS169/R (31 July 2000) at ¶ 782.

D. Article 3.1 of the Agreement on Subsidies and Countervailing Measures

Article 3.1 of the Agreement on Subsidies and Countervailing Measures provides that prohibited subsidies include:

> (a) subsidies contingent, in law or in fact,[198] whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I;
>
> (b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.[199]

Article 3.1(a) has been interpreted by the Appellate Body to mean that the subsidy must be "contingent," meaning "conditional" or "dependent on something else."[200] Thus, the "grant of a subsidy must be 'tied to' export performance."[201] The Article "prohibits *any* subsidy that is contingent upon export performance, whether that subsidy is contingent 'in law or in fact.'"[202] While the "legal standard expressed by the word 'contingent' is the same for both *de jure* or *de*

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198 "This standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision." Agreement on Subsidies and Countervailing Measures, April 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, The Legal Texts: The Results of the Uruguay Round of Multilateral Trade Negotiations 275 (1999), 1867 U.N.T.S. 14. [hereinafter SCM Agreement], fn. 4.

199 SCM Agreement Art. III ¶ 1.

200 *United States – Tax Treatment for "Foreign Sales Corporations*," Report of the Appellate Body, WT/DS108/AB/R (24 February 2000) at ¶ 111, *citing Canada – Measures Affecting the Export of Civilian Aircraft*, Report of the Appellate Body, WT/DS70/AB/R (20 August 1999) at ¶ 166.

201 *United States – Tax Treatment for "Foreign Sales Corporations*," Report of the Appellate Body, WT/DS108/AB/R (24 February 2000) at ¶ 111.

202 *Canada – Measures Affecting the Export of Civilian Aircraft*, Report of the Appellate Body, WT/DS70/AB/R (20 August 1999) at ¶ 167.

facto contingency…there is a difference, however, in what evidence may be employed to prove that a subsidy is export contingent."[203]

"*De jure* export contingency is demonstrated on the basis of the words of the relevant legislation, regulation or other legal instrument."[204] [*D*]e *facto* export contingency must be *demonstrated* by the *facts.*..[but] what fact *should* be taken into account in a particular case will depend on the circumstances of that case …[and] there can be no general rule as to what fact or what kinds of facts *must* be taken into account."[205] The standard for determining *de facto* export contingency "requires proof of three different substantive elements: first, the '*granting* of a subsidy'; second, 'is … *tied to* …'; and, third, 'actual or anticipated exportation or export earnings.'"[206]

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203 *Id*.

204 *Id*.

205 *Id*. at ¶ 169. The Panel on *Australia – Automotive Leather II* held that "the fact of expectation [of a subsidy] cannot be the sole determinative fact on the evaluation. *Australia – Subsidies Provided to Producers and Exporters of Automotive Leather*, Report of the Panel, WT/DS126/R (25 May 1999) at ¶ 9.66. While finding that no one factual consideration should prevail over others, the Panel on *Canada – Measures Affecting the Export of Civilian Aircraft* held that "the closer a subsidy brings a product to sale on the export market, the greater the possibility that the facts may demonstrate that the subsidy would not have been granted but for anticipated exportation or export earnings." *Canada – Measures Affecting the Export of Civilian Aircraft*, Report of the Appellate Body, WT/DS70/AB/R (20 August 1999) at ¶ 174. However, this "should [not] be regarded as a legal presumption" and to take this factor into account requires "considerable caution." *Id.* at ¶ 174. Finally, a "Member's awareness that its domestic market is too small to absorb domestic production of a subsidized product may indicate that the subsidy is granted on the condition that it be exported." *See Canada – Export Credits and Loan Guarantees for Regional Aircraft*, Report of the Panel, WT/DS222/R (28 January 2002) at ¶ 7.372, *citing Australia – Subsidies Provided to Producers and Exporters of Automotive Leather*, *supra*, at ¶ 9.67.

206 *See Canada – Measures Affecting the Export of Civilian Aircraft*, Report of the Appellate Body, WT/DS70/AB/R (20 August 1999) at ¶ 169.

E. Relationships and Conflicts Between the TRIMs Agreement, the SCM Agreement and Article III of GATT

The *Indonesia – Autos* dispute concerned measures that gave special tariff and tax treatment to certain automobile parts for the purpose of encouraging domestic production.[207] The parties alleged that India's measures violated, *inter alia*, Article III of GATT 1994, the SCM Agreement, and the TRIMs Agreement. India argued that Article III and the TRIMs Agreement did not apply, as their application would reduce the SCM Agreement to "inutility." The panel first reviewed the relationship and potential conflicts between the SCM Agreement and Article III of GATT 1994, and then between the SCM Agreement and the TRIMs Agreement.[208] Since local content requirement complaints were raised under Article III:4 of GATT 1994 and the TRIMs Agreement, the Panel next reviewed the relationship between these two rules.[209]

1. Article III of GATT 1994 and the SCM Agreement

In analyzing the relationship between Article III and the SCM Agreement, the Panel reviewed the development of the provisions and determined that while Article III prohibits discrimination between domestic and imported products with respect to internal regulations, including local content requirements, it does not prohibit the provision of a subsidy *per se*.[210] By contrast, the SCM Agreement prohibits subsidies that are conditioned on export performance and

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207 *See Indonesia – Certain Measures Affecting the Automobile Industry*, Report of the Panel, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R (2 July 1998) at ¶¶ 14.29 – 14.93.

208 *Id*. at ¶¶ 14.28-14.56.

209 *Id*. at ¶¶ 14.60 – 14.63.

210 *Id*. at ¶ 14.33.

on meeting local content requirements it provides remedies for subsidies that cause adverse effects to another Member's interests, and exempts certain subsidies.[211]

"In short, Article III prohibits discrimination between domestic and imported products while the SCM Agreement regulates the provision of subsidies to enterprises."[212] Accordingly, the Panel determined that Article III and the SCM Agreement have different coverage and obligations and thus there is no general conflict between the two sets of provisions.[213] With respect to certain measures, there may be overlap, but the "only subsidies that would be affected by the provisions of Article III are those that would involve discrimination between domestic and imported products."[214]

2. The SCM Agreement and the TRIMs Agreement

Next, the Panel reviewed the relationship and possible conflicts between the TRIMs Agreement and the SCM Agreement.[215] With respect to obligations, the Panel determined that "with regard to local content requirements, the SCM Agreement and the TRIMs Agreement are concerned with different types of obligations and cover different subject matters."[216] The SCM

211 *Id*.

212 *Id*.

213 *Id*. at ¶ 14.36.

214 *Id*. at ¶ 14.39.

215 In this dispute, the Panel reviewed tax benefits and tariff concessions that benefit the production of cars that use a certain percentage value of domestic parts and components, which are alleged to violate the TRIMs Agreement, the SCM Agreement, and Article III. *See generally Indonesia – Certain Measures Affecting the Automobile Industry*, Report of the Panel, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R (2 July 1998).

216 *Id*. at ¶ 14.50.

Agreement prohibits granting subsidies contingent on the "use of domestic goods, not the requirement to use domestic goods as such" and TRIMs prohibits measures "in the form of local content requirements, not the grant of an advantage, such as a subsidy."[217]

To demonstrate that there is not a conflict between the Agreements, the Panel pointed out that a finding of inconsistency with the SCM Agreement may be remedied by removing the subsidy, but without removing the local content violation.[218] By contrast, an inconsistency with the TRIMs Agreement can be remedied by removal of the TRIM, even if the subsidy continues to be granted.[219] Conversely, if a TRIM conditions a subsidy on a local content requirement, the measure remains a violation of TRIMs if the subsidy element is replaced with some other form of incentive.[220] By contrast, if the local content requirements are removed, the subsidy remains subject to the SCM Agreement. "Clearly, the two agreements prohibit different measures."[221] The Panel concluded that the Agreements do not conflict, "as they cover different subject matters and do not impose mutually exclusive obligations."[222] While there may be overlapping coverage and both Agreements may apply to a measure or a single legislative act, the focuses of the agreements are different and they impose different obligations.[223]

217 *Id*. at ¶ 14.50.

218 *Id*. at ¶ 14.51.

219 *Id*.

220 *Id*.

221 *Id*.

222 *Id*. at ¶ 14.52.

223 *Id*.

3. The TRIMs Agreement and Article III of the GATT 1994

In examining the relationship between TRIMs and Article III of the GATT 1994, the Panel recalled *EC – Bananas III*, which noted that "with the exception of its transition provisions the TRIMs Agreement essentially interprets and clarifies the provisions of Article III (and also Article XI) where trade-related investment measures are concerned.[224] Thus the TRIMs Agreement does not add to or subtract from those GATT obligations."

The Panel first determined that the TRIMs Agreement, on its face, is a fully fledged agreement.[225] While both the TRIMs Agreement and Article III:4 prohibit local content requirements, "when the TRIMs Agreement refers to 'the provisions of Article III', it refers to the substantive aspects of Article III; that is to say, conceptually, it is the ten paragraphs of Article III that are referred to in Article 2.1 of the TRIMs Agreement, and not the application of Article III in the WTO context as such."[226] Thus, when Article III is considered not applicable for reasons "not related to the disciplines of Article III itself, the provisions of Article III remain applicable for the purpose of the TRIMs Agreement."[227]

While agreeing with the Panel in *EC – Bananas III* that the TRIMs Agreement helps to interpret and clarify the provisions of Article III, the Panel in *Indonesia – Autos* found that the

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224 *See European Communities – Regime for the Importation, Sale and Distribution of Bananas, Complaint by Mexico,* Report of the Panel, WT/DS27/R/MEX (22 May 1997) at ¶ 7.185.

225 *See Indonesia – Certain Measures Affecting the Automobile Industry,* Report of the Panel, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R (2 July 1998) at ¶ 14.61.

226 *Id*. at ¶ 14.61.

227 *Id*. at ¶ 14.62.

autonomous legal existence of the TRIMs Agreement, independent from Article III, is bolstered by the inclusion of a special transitional provision with notification requirements.[228] As Article III and TRIMs are "legally distinct and independent" provisions, if either were not applicable the other one would remain applicable.[229] "[T]o the extent that complaints have raised separate and distinct claims under Article III:4 of GATT and the TRIMS Agreement, each claim must be addressed separately."[230]

F. Addressing Allegations Made Under Several Provisions

As TRIMs articles refer to other Articles of GATT 1994, disputes alleging violations of TRIMs typically include allegations of inconsistencies with other Articles and Agreements. In disputes alleging inconsistencies with TRIMs and Article III:4, panels have taken different approaches as to whether their analysis should first begin under TRIMs or under Article III. The Panel in *EC – Bananas III* reviewed the claims made under Article 2 of the TRIMs Agreement together with the claims under Article III:4.[231] Finding the measures to be inconsistent with Article III:4, the Panel did not find it necessary to make a "specific ruling" with respect to the TRIMs Agreement.[232] The Panel reasoned that "a finding that the measure in question would not be considered a trade-related investment measure for the purposes of the TRIMs Agreement would not affect our findings in respect of Article III:4 since the scope of that provision is not

228 *Id*.

229 *Id*.

230 *Id*.

231 *See European Communities – Regime for the Importation, Sale and Distribution of Bananas, Complaint by Mexico*, Report of the Panel, WT/DS27/R/MEX (22 May 1997) at ¶ 7.168.

232 *Id*. at ¶ 7.187.

limited to TRIMs and, on the other hand, steps taken to bring…[the measure] into conformity with Article III:4 would also eliminate the alleged non-conformity with obligations under the TRIMs Agreement."[233]

However, the Panel in *Indonesia – Autos* found the TRIMs Agreement to be more specific than Article III:4 and thus began its analysis with claims made under TRIMs.[234] After finding the measures inconsistent with TRIMs, the Panel did not review the allegations under Article III:4.[235] More recently, the Panels in *Canada – Autos* and *India – Autos* first examined the complaints under Article III:4. The Panel in *Canada – Autos* reasoned that it would be more efficient to begin its analysis with Article III:4, as either analysis would likely require an analysis of Article III:4 and was "not persuaded that the TRIMs Agreement can be properly characterized as being more specific than Article III:4."[236] In *India – Autos* the Panel recognized that the TRIMs Agreement introduces rights and obligations that are specific to it but similarly was not convinced that the "TRIMs Agreement could inherently be characterized as more specific than the relevant GATT provisions."[237]

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233 *Id*. at ¶ 7.186.

234 *See Indonesia – Certain Measures Affecting the Automobile Industry,* Report of the Panel, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R (2 July 1998) at ¶ 14.63.

235 Under the principle of judicial economy, the Panel is only required to "address the claims that must be addressed to resolve a dispute or which may help a losing party in bringing its measures into conformity with the WTO Agreement." *See Indonesia – Certain Measures Affecting the Automobile Industry,* Report of the Panel, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R (2 July 1998) at ¶ 14.93.

236 *See Canada – Certain Measures Affecting the Automotive Industry,* Report of the Panel, WT/DS139/R, WT/DS142/R (11 February 2000) at ¶¶ 10.61-10.64.

237 *See India – Measures Affecting the Automotive Sector,* Report of the Panel, WT/DS146/R, WT/DS175/R (21 December 2001) at ¶ 7.157.

V. U.S. ACTION AT THE WTO

In the WTO, where a Member believes another Member is not in compliance with WTO obligations, Members will often work informally to seek a rectification of the problem. If a solution cannot be found or the Member who is not in compliance is unable to address the matter for internal reasons, the Member concerned with the law, regulation, administrative practice or government action can formally request consultations with the other Member in the WTO under the Dispute Settlement Understanding and pursue formal dispute settlement if resolution is not achieved in a relatively short period of time.[238] To date, the United States has filed requests for consultation with China on two occasions on matters that deal directly with the TRIMs Agreement.[239] The first is in relation to China's 2004 Automobile Policy and the second concerns Chinese legislation that allows refunds, reduction or exemptions from taxes to enterprises on the condition that those enterprises purchase domestic over imported goods or meet certain performance requirements.

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238 *See* Understanding on Rules and Procedures Governing the Settlement of Disputes, April 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2 [hereinafter Dispute Settlement Understanding].

239 In 2004, the United States filed a Request for Consultations regarding value added taxes on integrated circuits. The U.S. alleged that China provided enterprises in China a partial refund of the VAT on integrated circuits they have produced and on domestically-designed integrated circuits that, because of technological limitations, are manufactured outside of China. The U.S. believed that these measures were inconsistent with China's obligations under Articles I and II of GATT 1994, China's Protocol of Accession, and Article XVII of GATS. *See China – Value-Added Tax on Integrated Circuits*, Request for Consultation by the United States, WT/DS309/1 (23 March 2004). Following consultations in April 2004 and a series of bilateral meetings, the U.S. and China signed a Memorandum of Understanding and following its successful implementation, the U.S. and China agreed that a "mutually satisfactory solution has been reached to the matter raised by the United States." *See, China – Value-Added Tax on Integrated Circuits*, Notification of Mutually Agreed Solution, WT/DS309/8 (6 October 2005).

A. Measures Affecting Imports of Automobile Parts

On March 30, 2006 the U.S. requested consultations with China regarding measures that provide preferential treatment to domestic auto parts over imported auto parts by assessing an internal charge on vehicles manufactured using imported auto parts that is not assessed on vehicles manufactured using domestic auto parts.[240] On the same day, the EC also requested consultations, followed by Canada on April 13, 2006.[241] After joint consultations in May failed to resolve the dispute, requests were filed by the EC, the U.S. and Canada for the establishment of a panel.[242] On January 29, 2007, the Dispute Settlement Body established a single Panel to examine the complaints by the U.S., Canada, and the EC.[243]

As discussed above, in 2004 China issued the Automotive Policy Order, followed by a series of implementing measures that affect imported auto parts.[244] The measures provide for an

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240 *See China—Measures Affecting Imports of Automobile Parts, Request for Consultations by the United States*, WT/DS340/1, G/L/771, G/TRIMS/D/23, G/SCM/D68/1 (3 April 2006), attached as Exhibit 7.

241 *See China – Measures Affecting Imports of Automobile Parts, Request for Consultations by the European Communities*, WT/DS339/1, G/L/770, G/TRIMS/D/22, G/SCM/D67/1 (3 April 2006); *see also China – Measures Affecting Imports of Automobile Parts, Request for Consultations by Canada*, WT/DS340/6 (19 April 2006).

242 *See China – Measures Affecting Imports of Automobile Parts, Request for the Establishment of a Panel by the European Communities*, WT/DS339/8 (18 September 2006); *China – Measures Affecting Imports of Automobile Parts, Request for the Establishment of a Panel by the United States*, WT/DS340/8 (18 September 2006); *China – Measures Affecting Imports of Automobile Parts, Request for the Establishment of a Panel by Canada*, WT/DS342/8 (18 September 2006).

243 *Note by the Secretariat: Constitution of the Panel Established at the Request of the European Communities, United States, and Canada*, WT/DS339/9, WT/DS340/9, WT/DS342/9, circulated 30 January 2007.

244 *The Policy on Development of the Automotive Industry*, issued on May 21, 2004, by China's National Development and Reform Commission ("NDRC") as Order No. 8; *Administrative Measures on Importation of Automotive Parts Deemed Whole Vehicles*, Issued as Decree 125 on February 28, 2005 by China's General Administration of Customs, NDRC, Ministry of Finance, and Ministry of Commerce in accordance with the Automotive Policy Order; *Rules for Verifying whether Imported Automotive Parts are Deemed Whole*

internal charge of 25 percent on imported auto parts, with no comparable charge on domestic auto parts, which is applied to imported auto parts only when those parts are used to make a domestically-produced auto that exceeds a specified threshold (in volume or value) of imported auto parts. Additionally, the legislation requires burdensome procedures that are applied only to imported goods by requiring automobile manufacturers that use imported auto parts to keep records and report and verify their use of imported auto parts.

In its First Written Submission, the United States alleged that the additional charges on imported auto parts is inconsistent with Article III: 2, first sentence, Article III:4 and Article III:5 of the GATT 1994.[245] Additionally, the measures are inconsistent with Article 2 of the TRIMs Agreement and Paragraph 1(a) of Annex 1 of the TRIMs Agreement. Finally, the measures violate China's accession commitments as they are inconsistent with Part I.7.2 and I.7.3 of the Accession Protocol and Paragraph 203 of the Working Party Report.[246]

Article III provides that "internal taxes and other internal charges … affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the …use of products in specified amounts or proportions, should not be applied … so as to afford protection to domestic production."[247] The U.S. has

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Vehicles, issued as Public Announcement No. 4 by Customs on March 28, 2005 in accordance with Decree 125. *Infra Section* III:C– Discussing the 2004 Automotive Policy.

245 *See China – Measures Affecting Imports of Automobile Parts* (WT/DS340), *First Written Submission of the United States of America*, March 13, 2007, *available at*: ustr.gov [hereinafter *First Written Submission*].

246 *First Written Submission*

247 Marrakesh Agreement Establishing the World Trade Organization, April 15, 1994, The Legal Texts: The Results of the Uruguay Round of Multilateral Trade Negotiations 4 (1999), 1867 U.N.T.S. 154, 33 I.L.M. 1144 (1994) [hereinafter WTO Agreement], Art. III.

alleged that the measures "result in internal charges on imported parts in excess of those applied to domestic parts," "accord treatment less favorable to imported parts with respect to requirements affecting internal sale, purchase, distribution and use," [and] "directly or indirectly require that specified amounts or proportions of auto parts used in vehicle manufacturing must be supplied from domestic sources."[248] As such, the measures violate the national treatment provisions contained in Article III and, respectively, Articles III:2, III:4, and III:5.[249]

In the second allegation, the United States alleged that the Chinese measures are inconsistent with Articles 2.1 and 2.2 of the TRIMs Agreement.[250] Article 2.1 provides that "no Member shall apply any TRIM that is inconsistent with the provisions of Article III or Article XI of GATT 1994."[251] Since, as alleged, the measures violate Articles III:3, III:4, and III:5, the measures must also violate Article 2.1 of TRIMs. Article 2.2 refers to the "illustrative list of TRIMs that are inconsistent with the obligation of national treatment provided for in paragraph 4 of Article III of GATT 1994."[252] The U.S. argues that China's measures fall within the types of measures covered by the Illustrative List of the Annex of the TRIMs Agreement. Illustrative List 1(a) provides:

> 1. TRIMS that are inconsistent with the obligation of national treatment provided for in paragraph 4 of Article III of GATT

248 *First Written Submission* at 1.

249 For a complete discussion on the Article III allegations made by the United States see the *First Written Submission* at pp. 30-44.

250 *First Written Submission* at 42.

251 TRIMS Agreement Article 2.1.

252 TRIMS Agreement Article 2.2.

> 1994 include those which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage, and which require:
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> a. the purchase or use by an enterprise of products of domestic origin or from any domestic source, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production.[253]

Since the measures give manufacturers that produce automobiles using domestic parts an exemption from internal charges, an advantage is given over manufacturers that choose to produce automobiles using foreign parts. The U.S. argues that the measures fall within the Illustrative List because the "measures require 'the purchase or use by an enterprise of products of domestic origin or from any domestic source' so as 'to obtain an advantage.'"[254] Thus, the measures fall within the Illustrative List and are considered investment measures that are inconsistent with Article 2 of the TRIMs Agreement.

Finally, the U.S. alleged that the measures are inconsistent with Part I.7.2 and I.7.3 of the Accession Protocol and Paragraph 203 of the Working Party Report.[255] Paragraph I.7.2 of the Accession Protocol provides that "China shall eliminate and shall not re-introduce or apply non-tariff measures that cannot be justified under the provisions of the WTO Agreement."[256] By introducing measures that are inconsistent with Article III:2, Article III:4, and Article III:5 of the

253 TRIMS Agreement, Annex, Illustrative List.

254 *First Written Submission* at 42.

255 *First Written Submission* at 44.

256 *Accession Protocol* at ¶ I.7.2.

GATT 1994, China has acted in a manner that is inconsistent with what was agreed to in paragraph I.7.3 of the Accession Protocol.[257]

Paragraph I.7.3 of China's Accession Protocol reiterates paragraph 203 of the Working Party Report.[258] As discussed above, these provisions require China, "upon accession, [to] comply with the TRIMs Agreement… eliminate and cease to enforce… local content … requirements made effective through laws, regulations or other measures."[259] The U.S. alleged that the measures violate Article 2 of TRIMs and "in light of the fact that the measures effectively maintain the local content requirement initially set forth in *China's Automotive Industry Policy"* of 2004, the measures are inconsistent with both paragraph 203 of the Working Party Report and Part I.7.3 of China's Accession Protocol.[260]

China has argued that the measures are not inconsistent with its commitments. First, the measures involve customs duties and those customs duties are consistent with Article II.[261] Second, if the Panel finds that the measures violate Article III and the TRIMs Agreement, China relies on Article XX(d), which allows for measures that are "necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement."[262]

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257 *First Written Submission* at 45.

258 *Accession Protocol* at ¶ I.7.3; *Working Party Report* at ¶ 203.

259 *Accession Protocol* at ¶ I.7.3.

260 *First Written Submission* at 45.

261 *China – Measures Affecting Imports of Automobile Parts, Rebuttal Submission of the United States of America*, WT/DS340 at ¶ 3 (22 June 2007).

262 *Id*.

As automobile parts and whole automobiles have different import tariffs, China argues that the measures are necessary to prevent the "circumvention" of China's tariff system by importers separating automobiles into split systems. China equates separate automobile parts entering China with the splitting of a kit (either an SKD or CKD), which contain all of the parts of an automobile and, in the tariff schedule, are treated as complete automobiles.[263] China believes that imported parts – "even if sourced from different places at different times – are conceptually the same as a kit. After all, in both cases, at some point, the parts will be used to make an automobile."[264]

The United States argues that the measure – "although purportedly adopted to prevent importers from splitting kits to circumvent duties on whole cars – is vastly broader than that."[265] Not only does the measure include kits broken into several boxes, it "sweeps together all imported parts from different suppliers, from different countries, purchased at different times, and even parts produced within China if such parts have insufficient local content."[266] The U.S. goes to lengths to show the difference between a kit and streams of parts used in manufacturing operations, concluding that China has no basis for comparing the streams of parts used by a manufacturing plant to the conduct of purported "circumvention" involved in splitting a kit before import."[267] The commercial reality is such that parts used by a manufacturing plant

263 *Id*.

264 *Id*. at ¶ 8.

265 *Id*. at ¶ 7.

266 *Id*..

267 *Id*. at ¶¶ 10-11.

cannot be put in kits and thus China's purported goal of stopping "circumvention" "in the form of splitting pre-organized kits – is in no way consistent with [the] actual scope and operation of China's measures."[268] Accordingly, the purpose of the measures is to "impose a local content requirement on all automobile manufacturers in China, and …encourage the growth of the domestic parts industry by discriminating against imported auto parts."[269]

China also relies on GRI 2(a), an interpretative rule of the Harmonized System. GRI 2(a) states that:

> Any reference in a heading to an article shall be taken to include a reference to that article incomplete or unfinished, provided that, as presented, the incomplete or unfinished article has the essential character of the complete or finished article. It shall also include a reference to that article complete or finished (or failing to be classified as complete or finished by virtue of this rule), presented unassembled or disassembled.[270]

The United States argues that China cannot rely on GRI 2(a) because the interpretative rule only relates to China's schedule of tariff commitments and is "not relevant to the consideration of China's obligations under GATT Article III, or to the question of whether China's additional charges on imported parts are to be considered either as 'ordinary customs duties' under Article II:1(b), or as internal charges under Article III:2."[271] As none of the dispositive issues in the dispute turn on issues of tariff classification, GRI 2(a) provides China

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268 *Id*. at ¶ 12.

269 *Id*.

270 *Id*. at ¶ 32.

271 *Id*. at ¶ 13.

with no defense. In Sum, the U.S. argues that it has "established breaches of Articles III:2, III:4, and III:5 of the GATT 1994, of the TRIMs Agreement, and of the SCM Agreement. China's only defense – that its classification of imported parts as whole vehicles is correct under the principles set out in GRI 2(a) – is not even relevant to analysis under those provisions of the WTO Agreement."[272]

The U.S. argues that GRI 2(a) is not applicable to China's Article II:1(a) defense because these are not "ordinary customs duties" but are rather internal charges and thus subject to obligations under Article III:2.[273] The U.S. points out that China has based its case entirely on "circumvention" and yet GRI 2(a) does not mention "circumvention."[274] Additionally, GRI 2(a) "uses the language 'as presented' and 'presented' indicating that customs authorities should classify the goods in the condition as presented to customs upon importation."[275] It seems implausible that "a customs authority should seek out all entries of diverse parts, by different importers, from different suppliers, at different times, and even of different national origin, and then proceed to collect them into some fictitious unassembled product, to then be classified as the assembled product."[276]

272 *Id*. at ¶ 26.

273 *Id*. at ¶ 27.

274 *Id*. at ¶ 33.

275 *Id*.

276 *Id*.

B. Certain Measures Granting Refunds, Reductions or Exemptions from Taxes and Other Payments

After receiving China's first "long-overdue" subsidies notification to the WTO Subsidies Committee in 2006, the U.S. pressed China to withdraw subsidies that appeared to be prohibited by the WTO.[277] After China was unwilling to commit to the immediate withdrawal of these subsidies, the U.S. initiated a challenge to these subsidies under the WTO's dispute settlement procedures.[278]

On February 7 2007 the United States filed with the Dispute Settlement Body a request for consultation with China over various subsidy programs.[279] In March 2007, the United States held consultations with China and learned that China had repealed one of the subsidy programs listed in the U.S. request for consultation and had recently adopted a new Enterprise Income Tax Law.[280] Although the changes to the Enterprise Income Tax Law included many improvements over the former law, the new law does not go into effect until January 1, 2008 and Article 57 of the new law allows established enterprises to receive preferential tax treatment for five additional years beginning from the date the law goes into effect.[281] The U.S. and China held consultations

277 *See National Trade Estimate 2007* at 105.

278 *China – Certain Measures Granting Refunds, Reductions or Exemptions from Taxes and Other Payments, Request for Consultation by the United States*, WT/DS358/1 (7 February 2007).

279 *Id*.

280 *China – Certain Measures Granting Refunds, Reductions or Exemptions from Taxes and Other Payments, Request for Further Consultations by the United States*, WT/DS358/1/Add.1 (2 May 2007).

281 *Enterprise Income Tax Law of the People's Republic of China*, Order No. 63 [2007] of the President of the People's Republic of China (16 March 2007).

again in June 2007, but, after those consultations did not resolve the dispute, the United States filed a request for the establishment of a panel on the following programs.[282]

> (1) *Circular of the State Administration of Taxation Concerning Transmitting the Interim Measure for the Administration of Tax Refunds to Enterprises with Foreign Investment for Their Domestic Equipment Purchases*, Order No. 171 GuoShiFa [1999] No. 171 (20 August 1999)[283] read in conjunction with the *Circular of the State Administration of Taxation and the National Development and Reform Commission of the People's Republic of China, on Printing and Issuing the Trial Measures for the Administration of Tax Rebate for the Purchase of Domestically-Produced Equipment in Foreign Investment Projects* GuoShuiFa [2006] No. 111 (24 July 2006).[284]

The purpose of the measure is to "encourage enterprises with foreign investment to use domestic equipment." Under Article 3 of Circular No. 171, enterprises with foreign-investment accounting for more than 25 percent of total investment are eligible to receive value-added-tax refunds on certain equipment purchased. For a company to get a VAT rebate, the company must have documents showing that it is in fact a foreign invested enterprise.[285] Article 4 provides that the equipment eligible for the VAT exemption must fall under the Encouraged and Restricted B categories listed in the *Notice of the State Council Concerning the Adjustment of Taxation*

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282 *China – Certain Measures Granting Refunds, Reductions or Exemptions from Taxes and Other Payments, Request for the Establishment of a Panel by the United States,* WT/DS358/13 (13 July 2007), attached as Exhibit 8.

283 Attached as Exhibit 9.

284 Attached as Exhibit 10.

285 Department of Commerce, International Trade Administration, *Coated Free Sheet Paper from the People's Republic of China: Preliminary Affirmative Countervailing Duty Determination*, 72 Fed. Reg. 17484 (April 9, 2007).

Policies for Imported Equipment (No. 37(1997)). Additionally, under Article 4, the measure applies only to unused "domestic equipment" purchased after September 1999. The Article defines domestic equipment as "those manufactured by the enterprises within the territory boundaries of the PRC."

Similarly, Circular No. 111 encourages the use of domestic equipment in foreign projects.[286] The measure gives local governments some responsibility in approving tax refunds to "encouraged foreign-funded projects" that purchase certain domestic equipment. Foreign funded projects of less than $30 million must receive a project confirmation letter and an attached list of approved equipment from local governments, while those projects greater than $30 million receive a confirmation letter and an equipment list from the National Development and Reform Commission.

The Department of Commerce examined Circular No. 171 in its preliminary determination in *Coated Free Sheet Paper from the PRC.* The Department found that the VAT rebate in this program did in fact confer a countervailable subsidy.[287] Although the Chinese Government claimed that the goal of the program was to "equalize the tax burden on the purchase of domestically produced and imported equipment" by foreign-invested enterprises, since under another program foreign enterprises are exempt from paying VAT on imported

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286 *Circular of the State Administration of Taxation and the National Development and Reform Commission of the People's Republic of China, on Printing and Issuing the Trial Measures for the Administration of Tax Rebate for the Purchase of Domestically-Produced Equipment in Foreign Investment Projects* GuoShuiFa [2006] No. 111 (24 July 2006).

287 Department of Commerce, International Trade Administration, *Coated Free Sheet Paper from the People's Republic of China: Preliminary Affirmative Countervailing Duty Determination*, 72 Fed. Reg. 17484, 17496 (April 9, 2007).

equipment, the Department found that the Chinese Government was unable to show that the programs were linked.[288] In its analysis, the Department determined that the VAT rebates were a financial contribution in the form of revenue foregone, providing a benefit to the recipients in the amount of the tax savings, and that the rebates were specific in that they were contingent upon use of domestic equipment and benefited a specific group.[289]

This program gives preferential treatment that is conditioned on an enterprise purchasing domestic goods over imported goods. Thus it appears to be inconsistent with Articles 3.1(b) and 3.2 of the SCM Agreement. As advantages are given to enterprises that purchase domestic equipment over imported equipment, the measures accord imported products treatment less favorable than that accorded "like" domestic products, which is inconsistent with Article III:4 of GATT 1994 and Article 2.1 and Annex 1, paragraph 1(a), of the TRIMs Agreement. Similarly, the measures are not consistent with China's obligations under paragraphs 7.2-7.3 and 10.3 of Part I of its Protocol of Accession and paragraph 1.2 of Part I of the Protocol, to the extent that it incorporates paragraph 203 of the Report of the Working Party.

(2) *Circular of the Ministry of Finance and the State Administration of Taxation Concerning the Issue of Tax Credit for Business Income Tax for Homemade Equipment Purchased by Enterprises with Foreign Investment and Foreign Enterprises*, CaiShuiZi [2000] No. 49 (14 January 2000)[290] read in conjunction with *Circular of the State Administration of Taxation on Printing and Distributing the Measures Concerning Business Income Tax Credit on the*

288 *Id.*

289 *Id.*

290 Attached as Exhibit 11.

> *Investment of Enterprises with Foreign Investment and Foreign Enterprises by Way of Purchasing Homemade Equipment*, GuoShuiFa [2000] No. 90 (18 May 2000)[291] Subsidies under this program will continue to be granted under the *Enterprise Income Tax Law of the People's Republic of China*, of the President of the People's Republic of China [2007] No. 63 (16 March 2007)[292], by virtue of Article 57 of that Law.

The Measure allows for foreign-owned enterprises to receive a tax credit for purchasing "homemade equipment." The Chinese government has claimed that the purpose of the program is to attract foreign investment.[293] Production equipment covered by the measure includes: machines, transportation vehicles, appliances and tools referred to in Circular 49 "and which are maintained as fixed assets for production or business purposes." Under Circular 49 the enterprise must fall under the Encouraged or Restricted B categories of the Catalog of Industrial Guidance for Foreign Investment, but must not be listed in the Catalog of Non-Duty Exemptible Articles of Importation.[294] The measure provides that 40 percent of the investment for "homemade equipment" purchases is refundable, but may not exceed the incremental increase in income tax from the previous year. The credit may be deducted over a maximum seven year period if taxes paid do not exceed the amount of the deduction. To receive the income tax credit, eligible enterprises must submit an application to local tax authorities within two months of purchasing the equipment.

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291 Attached as Exhibit 12.

292 Attached as Exhibit 13.

293 *Id*.; Program LVIII.

294 *Circular of the State Council Concerning the Adjustment in the Taxation Policy of Imported Equipment*, GuoFa [1997] No. 37 (29 December 1997).

In its preliminary determination in *Coated Free Sheet Paper from the PRC,* the Commerce Department determined that the income tax credits were a countervailable subsidy.[295] Furthermore the tax credits were found to be a financial contribution as revenue foregone by the local governments that provide a benefit to the recipients in the amount of the tax savings.[296] Finally, the tax credits were found to be "contingent upon use of domestic over imported goods."[297]

As the income tax credits give preferential treatment to enterprises on the condition that domestic machinery is purchased over foreign machinery, they appear to be inconsistent with Articles 3.1(b) and 3.2 of the SCM Agreement. As advantages are given to enterprises that purchase domestic equipment over imported equipment, the measures accord imported products treatment less favorable than that accorded "like" domestic products, which is inconsistent with Article III:4 of GATT 1994 and Article 2.1 and Annex 1, paragraph 1(a), of the TRIMs Agreement. Similarly, the measures are not consistent with China's obligations under paragraphs 7.2-7.3 and 10.3 of Part I of its Protocol of Accession and paragraph 1.2 of Part I of the Protocol, to the extent that it incorporates paragraph 203 of the Report of the Working Party.

(3) *Circular on Distribution of Interim Measures Concerning Reduction and Exemption of Enterprise Income Tax for Investment in Domestically Made Equipment for Technological Renovation*; CaiShui [1999] No. 290 (8

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295 Department of Commerce, International Trade Administration, *Coated Free Sheet Paper from the People's Republic of China: Preliminary Affirmative Countervailing Duty Determination*, 72 Fed. Reg. 17484, 17495 (April 9, 2007).

296 *Id*.

297 *Id*.

> December 1999). [298] Subsidies under this program will continue to be granted under the *Enterprise Income Tax Law of the People's Republic of China*, Order No. 63 [2007] of the President of the People's Republic of China (16 March 2007) by virtue of Article 57 of that Law.

The purpose of the program is to encourage and support investment in domestic technology and machinery. The measure provides for income tax refunds on domestic equipment purchased to upgrade equipment and technology. It is available to all enterprises with investment in technological transformation projects that conform to the state industrial policy. Under the measure 40 percent of the investment in domestic equipment may be offset in the year of investment from the increase in income tax from the previous year. The measure does not apply to foreign enterprises or foreign-invested enterprises. The Canadian Border Services Agency has found this income tax refund to be a prohibited subsidy for being contingent, in whole or part, on the use of domestic goods.[299]

This tax refund program conditions preferential tax treatment on the purchase of domestic equipment over foreign equipment, thus according imported products treatment less favorable than that accorded "like" domestic products. Thus, the program appears to be inconsistent with Articles 3.1(b) and 3.2 of the SCM Agreement, with Article III:4 of GATT 1994, and Article 2.1 and Annex 1, paragraph 1(a), of the TRIMs Agreement. Similarly, the measures are not

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298 Attached as Exhibit 14 {Chinese original and English summary}.

299 *Statement of Reasons Concerning the making of a final determination with respect to the dumping of Certain Copper Pipe Fittings Originating in or exported from the United States of America, the Republic of Korea and the People's Republic of China and the making of a final determination with respect to the subsidizing of Certain Copper Pipe Fittings Originating in or exported from the People's Republic of China*, February 2, 2007, *available at* http://www.cbsa-asfc.gc.ca/sima/anti-dumping/ad1358-fd-de-eng.html.

consistent with China's obligations under paragraphs 7.2-7.3 and 10.3 of Part I of its Protocol of Accession and paragraph 1.2 of Part I of the Protocol, to the extent that it incorporates paragraph 203 of the Report of the Working Party.

> (4) Articles 75(7) and 75(8) of the *Rules for Implementation of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises,* Order No. [1991] 85 Decree of the State Council (30 June 1991)[300]*;* read in conjunction with Articles 8 and 9 of the *Provisions of the State Council on the Encouragement of Foreign Investment,* Order No. [1986] 95 GuoFa (11 October 1986)[301]; and Articles 6 of the *Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises,* Order [1991] No. 45 of the President of the People's Republic of China (9 April 1991).[302] Subsidies under this program will continue to be granted under the *Enterprise Income Tax Law of the People's Republic of China*, Order No. [2007] 63 of the President of the People's Republic of China (16 March 2007) by virtue of Article 57 of that Law.

This measure gives preferential tax treatment to enterprises that are export-oriented or those that are in technological and economic development zones. Under Article 75(7) of Order No. 85 and Article 8 of Order No. 95, export-oriented enterprises that export 70 percent or more, according to value, of their output may, after the period of other exemptions or reductions has expired, pay a tax rate 50 percent lower than what is mandated under the tax law. Enterprises in economic and technological development zones are able to reduce their tax liability from 15 percent to 10 percent. Article 75(8) of Order No. 95 and Article 8 of Order No. 85 provides that

300 Attached as Exhibit 15.

301 Attached as Exhibit 16.

302 Attached as Exhibit 17.

foreign advanced technology enterprises that remain advance technology enterprises after other tax exemptions and reductions have expired, may, for an additional three years, pay at fifty percent of the enterprise income tax rate, as specified in the Income Tax Law.

Article 6 of the Income Tax Law states that the State shall "guide the orientation of foreign investment and encourage the establishment of enterprises with foreign investment which adopt advanced technology and equipment and export all or greater part of their products."[303]

As these tax preferences are conditioned on export performance they violate Articles 3.1(a) and 3.2 of the SCM Agreement, and consequently paragraph 10.3 of Part I of China's Protocol of Accession, and paragraph 1.2 of Part I of its Protocol, to the extent that it incorporates paragraph 167 of the Report of the Working Party.

> (5) Article 73(6) of the *Rules for Implementation of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises*, Decree [1991] No. 85 of the State Council (30 June 1991); read in conjunction with Articles 7 of the *Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises*, Order [1991] No. 45 of the President of the People's Republic of China (9 April 1991); and Section XIII of the *Catalogue for the Guidance of Foreign Investment Industries*, Order [2004] No. 24 of the State Development and Reform Commission, the Ministry of Commerce of the People's Republic of China (30 November 2004).[304] Subsidies under this program will continue to be granted under the *Enterprise Income Tax Law of the People's Republic of China*, Order No. [2007] 63 of the President of

303 Article 6, *Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises; Order No. 45*.

304 Attached as Exhibit 18.

the People's Republic of China (16 March 2007) by virtue of Article 57 of that Law.

This measure gives preferential tax treatment to certain foreign enterprises and enterprises with foreign investment that are established in Special Economic Zones.[305] The measure reduces the tax rate for such enterprises to the reduced income tax rate of fifteen percent.[306] Special Economic Zones include: coastal economic open zones, special economic zones, and economic and development zones in old urban districts of municipalities that are involved in projects encouraged by the State. Under Article XIII of the Catalogue, permitted projects are those "whose products are to be wholly exported directly."

As this tax benefit is conditioned on products being "wholly exported" and thus conditioned on export performance, it violates Articles 3.1(a) and 3.2 of the SCM Agreement, and consequently paragraph 10.3 of Part I of China's Protocol of Accession, and paragraph 1.2 of Part I of its Protocol, to the extent that it incorporates paragraph 167 of the Report of the Working Party.

(6) Article 81 of the *Rules for Implementation of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises* Order No. 85 [1991] Decree of the State Council (30 June 1991); read in conjunction with Articles 10 of the *Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises*, Order [1991] No. 45 of

305 Article 7, *Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises; Order No. 45*.

306 Article 73(6) of the *Rules for Implementation of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises*, Decree [1991] No. 85 of the State Council (30 June 1991).

> the President of the People's Republic of China (9 April 1991). Subsidies under this program will continue to be granted under the *Enterprise Income Tax Law of the People's Republic of China*, Order No. [2007] 63 of the President of the People's Republic of China (16 March 2007) by virtue of Article 57 of that Law.

The measure gives preferential treatment to encourage foreign investors to reinvest profits made from the enterprise to create more investment in enterprises that are export-oriented, technologically-advanced, or operating in certain special economic zones.[307] The measure reduces the income tax levied on such enterprises by forty percent of paid income tax on the amount that is reinvested for five years.[308] Under Article 81 of the Income Tax Rules for Implementation, reinvested enterprises must, within three years, have "achieved the standards with respect to export-oriented enterprises or have not continued to be confirmed as advanced technology enterprise" or they must repay sixty percent of the taxes refunded.

The measure also gives tax preferences to infrastructure projects in certain economic zones. Infrastructure projects in certain economic zones where the period of operation is fifteen years or more are exempt for the first five years that the enterprise is profit making and then pay at fifty percent of the applicable enterprise income tax rate from the sixth through the tenth year.

As the benefit of this subsidy is contingent on enterprises being export-oriented, it violates Articles 3.1(a) and 3.2 of the SCM Agreement, and consequently paragraph 10.3 of Part

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307 *Article 81 of the Rules for Implementation of the Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises*' Decree [1991] of the State Council (30 June 1991).

308 Article 10, *Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises; Order No. 45*.

I of China's Protocol of Accession, and paragraph 1.2 of Part I of its Protocol, to the extent that it incorporates paragraph 167 of the Report of the Working Party.

(7) Article 3 of the *Provisions of the State Council on the Encouragement of Foreign Investment.* GuoFa [1986] No. 95 (11 October 1986)

Article 3 provides that export enterprises and technologically-advanced enterprises "shall be exempt from payment to the State of all subsidies to staff and workers, except for the payment or allocation of funds for labor insurance, welfare expenses and housing subsidies for Chinese staff and workers in accordance with the provisions of the State."

As this benefit exempts enterprises from paying certain subsidies to workers, conditioned on the enterprise being an export enterprise or technologically advanced enterprise, it violates Article 3.1(a) of the SCM Agreement, Article 2 of the TRIMs Agreement, and paragraph 1 of Article XI of GATT 1994. The measure also appears not to comply with China's obligations under paragraphs 7.3 of Part I of its Accession Protocol, as well as paragraph 1.2 of Part I of its Accession Protocol, to the extent that it incorporates paragraph 203 of the Report of the Working Party.

(8) *Circular of the State Council Concerning the Adjustment in the Taxation Policy of Imported Equipment,* GuoFa [1997] No. 37 (29 December 1997) read in conjunction with Section XIII of the *Catalogue for the Guidance of Foreign Investment Industries,* Order [2004] No. 24 of the State Development and Reform Commission, the Ministry of Commerce of the People's Republic of China (30 November 2004).

The measure gives preferential tax treatment by exempting both foreign-invested enterprises and certain domestic enterprises from VAT and tariffs on imported equipments used in the development of investment projects encouraged by the State in the "Catalogue for the Guidance of the Foreign Investment Industries" and those that are funded by loans granted by foreign governments and international financial organizations. The purpose of the program is to encourage foreign investment in technical advancement and to introduce foreign advanced technology equipment that promotes the development of the economy. To be eligible, the foreign business investment project must transfer technology and be consistent with the category of encouragement and the restricted B category under the Catalogue of Industries Guidance for Foreign Business. The measure also allows for technologies and matching components and parts imported for the project to be exempt from tariffs and import-linked VAT. Under Article XIII of the Catalogue, encouraged foreign investments are "Permitted foreign invested projects whose products are to be wholly exported directly."[309]

As this benefit is conditioned on the project being export-oriented and transferring technology, it violates Article 3.1(a) of the SCM Agreement, Article 2 of the TRIMs Agreement, and paragraph 1 of Article XI of GATT 1994. The measure also appears not to comply with China's obligations under paragraphs 7.3 of Part I of its Accession Protocol, as well as paragraph 1.2 of Part I of its Accession Protocol, to the extent that it incorporates paragraph 203 of the Report of the Working Party.

[309] Section XIII of the *Catalogue for the Guidance of Foreign Investment Industries*, Order [2004] No. 24 of the State Development and Reform Commission, the Ministry of Commerce of the People's Republic of China (30 November 2004).

(9) Article 25, 28, and 31 of the *Enterprise Income Tax Law of the People's Republic of China*, Order [2007] No. 63 of the President of the People's Republic of China (16 March 2007); read in conjunction with Section XIII of the *Catalogue for the Guidance of Foreign Investment Industries*, Order [2004] No. 24 of the State Development and Reform Commission, the Ministry of Commerce of the People's Republic of China (30 November 2004)

As mentioned above, Section XIII of the Catalogue for the Guidance of Foreign Investment Industries lists, for encouraged foreign investment industries, "Permitted foreign invested projects whose products are to be wholly exported directly."[310] Article 25 of the Enterprise Income Tax Law states that the "important industries and projects whose development is supported and encouraged by the state shall enjoy the preferential treatments in enterprise income tax." Article 28 provides that enterprises with a meager profit pay a reduced rate of 20 percent and "important high-tech enterprises necessary to be supported by the state" have a reduced rate of 15 percent.[311] Article 31 gives startup investment enterprises that engage in "important startup investments necessary to be supported and encouraged by the state" a deduction of a certain proportion of the investment amount from taxable income.

As these programs give benefits conditioned on the projects being export oriented, they violate Article 3.1(a) of the SCM Agreement, Article 2 of the TRIMs Agreement, and paragraph 1 of the Article XI of GATT 1994. The measures also appears not to comply with China's

310 Section XIII of the *Catalogue for the Guidance of Foreign Investment Industries*, Order [2004] No. 24 of the State Development and Reform Commission, the Ministry of Commerce of the People's Republic of China (30 November 2004).

311 Article 28 of the *Enterprise Income Tax Law of the People's Republic of China*, Order [2007] No. 63 of the President of the People's Republic of China (16 March 2007).

obligations under paragraphs 7.3 of Part I of its Accession Protocol, as well as paragraph 1.2 of Part I of its Accession Protocol, to the extent that it incorporates paragraph 203 of the Report of the Working Party.

VI. FURTHER ACTION AGAINST CHINA AT THE WTO FOR POTENTIAL VIOLATIONS

A. Technology Transfer

As discussed above, many of China's trading partners have complained about continuing policies of mandatory technology transfer. When China acceded to the WTO, it agreed to (1) "eliminate and cease to enforce … performance requirements... made effective through laws, regulations, or other measures"; (2) "not enforce provisions of contracts imposing such requirements;" and (3) "ensure that … the right of importation or investment by national and sub-national authorities, is not conditioned on … performance requirements of any kind, such as…the transfer of technology":

> China shall, upon accession, comply with the TRIMs Agreement, without recourse to the provisions of Article 5 of the TRIMs Agreement. China shall eliminate and cease to enforce trade and foreign exchange balancing requirements, local content and export or performance requirements made effective through laws, regulations or other measures. Moreover, China will not enforce provisions of contracts imposing such requirements. Without prejudice to the relevant provisions of this Protocol, China shall ensure that the distribution of import licences, quotas, tariff rate quotas, or any other means of approval for importation, the right of importation or investment by national and sub national authorities, is not conditioned on: whether competing domestic suppliers of such products exist; or performance requirements of any kind, such as local content, offsets, the transfer of technology, export performance or the conduct of research and development in

China.[312]

In other words, China's Accession Protocol at paragraph 7.3 identifies the transfer of technology as a type of "performance requirement." According to paragraph 7.3, China agreed to eliminate all performance requirements made effective through laws, regulations, or other measures, and to not enforce performance requirements in contracts made under those laws, regulations, or other measures. To the extent that China does not eliminate or cease to enforce technology transfer requirements, China is in violation of its Accession Protocol and, thus, in violation of the WTO Agreement.

Paragraph 1 of Article XII of the Agreement Establishing the World Trade Organization provides that "Any State or separate customs territory ….may accede to this Agreement, on terms to be agreed between it and the WTO."[313] In the past, WTO panels and the Appellate Body have found these terms and commitments to be an "integral part" of the Agreement.[314] The WTO Secretariat has stated that a Member's accession protocol will "bind it to observe the rules contained in the Agreement establishing the WTO….[and] also bind the new Member in question to observe specified commitments."[315] The Secretariat continues:

These special commitments are either set out in the text of the

312 *Accession Protocol* at ¶ 5.

313 WTO Agreement Art. XII.

314 *See European Communities – Customs Classification of Frozen Boneless Chicken Cuts, Complaint by Brazil*, Report of the Panel, WT/DS269/R (30 May 2005); *Korea – Measures Affecting Government Procurement*, Report of the Panel, WT/DS163/R (1 May 2000); *European Communities – Customs Classification of Certain Computer Equipment*, Report of the Appellate Body, WT/DS62/AB/R (5 June 1998).

315 *Technical Note on the Accession Process, Note by the Secretariat, Revision*, WT/ACC/7/Rev.2, at 21 (1 November 2000).

> Protocol itself or, more frequently, in the relevant Working Party Report's commitment paragraphs (which are incorporated by reference in the Protocols). Both sets of rules are integral parts of the Protocol and have the same status and legal effect. They are enforceable through the Dispute Settlement Mechanism of the WTO. The entire package of Report, Protocol of Accession and Schedules of Concessions and Commitments in Goods and Services constitute the conditions under which the acceding government is permitted to join the WTO Agreement.[316]

Section 1.2 of China's Accession Protocol states that the "Protocol, which shall include the commitments referred to in paragraph 342 of the Working Party Report, shall be an integral part of the WTO Agreement."[317] However, China has backed away from specific commitments made to the Working Party and from commitments made in its Accession Protocol. As explained below, many of China's policies and actions are inconsistent with China's obligations under paragraph 7.3 of Part I of its Accession Protocol, as well as paragraph 1.2 of Part I of its Accession Protocol, to the extent that it incorporates paragraph 203 of the Report of the Working Party.[318]

1. China Continues to Require Technology Transfer Provisions in Contracts Contrary to Paragraph 7.3 of its Accession Protocol

China has not fulfilled its commitment to "eliminate and cease to enforce" all mandatory technology transfer provisions in its laws, regulations or other measures and "ensure" that

316 *Id.*

317 Paragraph 342 of the Working Party Report states that certain paragraphs of the Working Party Report containing specific commitments by China, including paragraph 203, "are incorporated in paragraph 1.2 of the Draft Protocol." *Working Party Report* at ¶ 342.

318 *Accession Protocol* Part I ¶¶ 1.2, 7.3; *Working Party Report* at ¶ 203.

investment approval is not conditioned on technology transfer. Article 43 of the Regulations for the Implementation of the Law on Sino-Foreign Equity Joint Ventures requires that "technology transfer agreements signed by a joint venture shall be submitted for approval to the examination and approval authority,"[319] such as the provincial departments of MOFCOM or the NDRC.[320] The Article limits technology transfer agreements to ten years and states that "after the expiry of a technology transfer agreement, the technology importing party shall have the right to use the technology continuously."[321] Similarly, the 2004 Automobile Policy requires that technology transfer agreements be filed when seeking approvals for new production plants.[322]

China has repeatedly stated that such provisions or policies, as with other provisions and policies discussed in this report, are only encouraged and "that it was legitimate for China or any other Member to have this kind of policy to encourage technology transfer if it was not a mandatory requirement."[323]

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319 Attached as Exhibit 4.

320 *Trade Policy Review: China, Report by the Secretariat,* WT/TPR/S161/Rev.1 (26 June 2006) at p. 201, ¶ 124.

321 Regulations for the Implementation of the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment (entered into force July 22, 2001).

322 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Additional Questions from the United States to China Concerning Trade-Related Investment Measures*, G/TRIMS/W/37 (23 September 2004) at ¶ 3. China's representative argued at the TRIMs Committee that the "reason why China required 'foreign technology transfer and contract on technical cooperation' was to prevent illegal assembling, to protect intellectual property and to ease up the procedures for product testing and accreditation, but not to force foreign parties to transfer their technologies. *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/708 (8 November 2004) at ¶ 21.

323 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/586 (12 November 2002) at ¶ 69.

China's WTO commitments, however, are not limited to its own imposition of mandatory technology transfer requirements but extend to the *enforcement* of such performance requirements contained in contracts between private parties. Thus, to the extent that China maintains regulations or other measures that recognize, impose requirements on, and permit the approval of technology transfer agreements, those measures are inconsistent with China's commitments under Paragraph 7.3.

Even assuming *arguendo* that China's WTO obligations extend only to the imposition of mandatory requirements, however, GATT and WTO panels have adopted a broad definition of what might constitute a government *requirement.*[324] For example, in *Canada -- FIRA*, the panel found that existing undertakings could be considered "requirements" since they "could be legally enforced," regardless of how the undertaking may have been arrived at "(voluntary submission, encouragement, negotiation, etc)."[325] In *ECC – Parts and Components*, the panel expanded "requirements" to include undertakings "which an enterprise voluntarily accepts in order to obtain an advantage from the government."[326] Although the word "requirement" "clearly implies government action involving a demand, request or the imposition of a condition…to situations involving actions by private parties, it is necessary to take into account that there is a

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[324] *See Canada – Administration of the Foreign Investment Review Act*, Report of the Panel, GATT Doc. No. L/5044 (25 July 1983)*; EEC – Regulation on Imports of Parts and Components*, Report by the Panel (adopted 16 May 1990); *Canada – Certain Measures Affecting the Automotive Industry*, Report of the Panel, WT/DS139/R, WT/DS142/R (11 February 2000).

[325] *Canada – Administration of the Foreign Investment Review Act*, Report of the Panel, GATT Doc. No. L/5044 (25 July 1983) at ¶ 5.4.

[326] *EEC – Regulation on Imports of Parts and Components*, Report by the Panel (adopted 16 May 1990) at ¶ 5.21.

broad variety of forms of government action that can be effective in influencing the conduct of private parties."[327]

As stated above, foreign investments must be approved by local authorities and these same authorities must also recommend investment projects for the approval of loans from Chinese banks.[328] To the extent that local authorities are given such high discretion in approving foreign investment in their region, "encouraged" laws and policies are easily made "requirements." U.S. businesses have consistently reported that the high level of discretion that local government officials have results in greater pressure on investors to transfer technology.[329] China's current policies of "encouragement," and high level of government involvement in investment decisions, combined with its past practices, make it difficult for China to "ensure" that investment decisions are not, in fact, based on performance requirements.

2. China Continues to Enforce Technology Transfer Provisions Made Effective Through Law, Regulations or Other Measures that are Contrary to Paragraph 7.3 of its Accession Protocol

As discussed before, with respect to existing contracts that contain technology transfer requirements, China has informed the TRIMs Committee that these contractual provisions would not be automatically void and would require a renegotiation. China has stated that the "contract

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327 *Canada – Certain Measures Affecting the Automotive Industry*, Report of the Panel, WT/DS139/R, WT/DS142/R (11 February 2000) at ¶ 10.107.

328 See *supra* p. 6.

329 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/586 (12 November 2002) at ¶ 59.

itself or some of its articles could not be altered or invalidated by a Chinese court or any other administrative body through a mandatory order." China's justification is that since these contracts have "been signed by the relevant parties in consideration of their own business interests, the parties involved should negotiate about the amendment of those contracts themselves on the basis of fairness, justice and equality."[330] Once a contract has been renegotiated and an agreement reached, the new contract can only go into effect after the approval of the "competent authority."[331] Judging from the number of complaints from U.S. businesses, it would appear that foreign businesses are required to renegotiate existing contracts and offer favorable terms to obtain government "approval" for continued access to the Chinese market.

In paragraph 7.3 of the Accession Protocol, however, China agreed not to enforce provisions of contracts imposing performance requirements. Thus, China's position, that the existence of technology transfer provisions in preexisting contracts are not automatically invalid but, instead, provide a valid basis for parties to renegotiate those provisions, would appear to be in direct contradiction with China's explicit undertaking in the Accession Protocol to "eliminate and cease to enforce trade and foreign exchange balancing requirements, local content and export

330 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/708 (8 November 2004) at ¶ 20.

331 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol of Accession of the People's Republic of China to the World Trade Organization, Report of the Chairman*, G/L/586 (12 November 2002) at p. 25.

or performance requirements made effective through laws, regulations or other measures."[332] The requirement that the revised contracts be approved by a "competent authority" requires government action and leaves open the possibility that, during renegotiations, businesses will "voluntarily accept [certain undertakings] in order to obtain an advantage from the government."[333]

3. Article 3.8 of the Dispute Settlement Understanding

China has likely violated its Protocol by failing to "eliminate and cease to enforce" technology transfer provisions and "ensure" that investment approval is not conditioned on technology transfer. As China's actions do not appear to violate a specific provision of the WTO Agreements, but instead impact an "integral" part of the Agreement that is "enforceable through the Dispute Settlement Mechanism", a case would likely be brought under Article 3.8 of the Dispute Settlement Understanding ("DSU"). Under Article 3.8, the failure of a member to carry out its obligations under a covered agreement is considered a *prima facia* case of nullification or impairment. Specifically, Article 3.8 of the DSU provides that:

> In cases where there is an infringement of the obligations assumed under a covered agreement, the action is considered *prima facie* to constitute a case of nullification or impairment. This means that there is normally a presumption that a breach of the rules has an adverse impact on other Members parties to that covered agreement, and in such cases, it shall be up to the Member against whom the complaint has been brought to rebut the charge.[334]

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332 *Accession Protocol* at ¶ 5.

333 *EEC – Regulation on Imports of Parts and Components*, Report by the Panel (adopted 16 May 1990) at ¶ 5.21.

334 Dispute Settlement Understanding Article 3.8.

Thus, Article 3.8 of the DSU "provides that there is a presumption that benefits are nullified or impaired – i.e., there is a presumption of "harm" – where a provision of the Agreement has been violated." [335] As demonstrated above, China has likely violated commitments made in its Accession Protocol and as such, has violated the WTO Agreement. Once the United States has made a *prima facia* case, it would be up to China to show that it has not violated its Accession commitments.[336]

B. Additional VAT Programs

1. China's *Circular about VAT Exemption Policy for Certain Farming Materials* (No. 113/2001), jointly issued by the Ministry of Finance and the State Administration of Taxation on July 20, 2001

In 2001, China began exempting phosphate fertilizers from VAT except for one type of fertilizer—diammonimum phosphate (DAP)—that was produced in and imported from the United States.[337] The U.S. has noted that this Circular "exempts all phosphate fertilizers except diammonium phosphate (DAP) from China's value-added tax (VAT)," but that "DAP, a product

335 *Argentina – Definitive Anti-Dumping Measures on Imports of Ceramic Floor Tiles from Italy*, Report of the Panel, WT/DS189/R (28 September 2001), at ¶ 6.105.

336 *See European Communities – Regime for the Importation, Sale and Distribution of Bananas*, Report of the Appellate Body, WT/DS27/AB/R (9 September 1997); *United States – Taxes on Petroleum and Certain Imported Substances*, Report of the Panel, BISD 34S/136 (adopted on 17 June 1987)*; Guatemala – Definitive Anti-Dumping Measures on Grey Portland Cement from Mexico*, Report of the Panel, WT/DS156/R (24 October 2000).

337 Exhibit 19 contains selected trade statistics, including fertilizer.

produced in the United States, competes with similar phosphate fertilizers produced in China, such as monoammonium phosphate (MAP)." [338]

China's differential tax policy discourages the use of foreign-produced DAP in favor of domestically-produced MAP, with which DAP competes.[339] The U.S. has "raised this issue with China on several occasions, both at the WTO and bilaterally."[340] The United States has asked China to explain why it applied different tax treatment to these products and how the differences in treatment were consistent with its national treatment obligations under Article III of the General Agreement on Tariffs and Trade 1994.[341] Specifically, China's differential tax policy potentially violates Article III:2 of GATT 1994.

a. Article III:2 Violation

Generally, Article III "seeks to prevent Members from applying internal taxes and regulations in a manner which affects the competitive relationship, in the marketplace, *between the domestic and imported products involved*, 'so as to afford protection to domestic production.'"[342] The Article obliges Members "to provide equality of competitive conditions for

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338 China's Transitional Review Mechanism, *Questions from the United States to China concerning Market Access*, G/MA/W/35 (20 August 2002) at Item 19.

339 China's Transitional Review Mechanism, *Questions from the United States to China concerning Market Access*, G/MA/W/35 (20 August 2002) at Item 19.

340 *Transitional Review Mechanism Pursuant to Paragraph 18 of the Protocol on the Accession of the People's Republic of China*, *Questions from the United States to China concerning Market Access*, G/MA/W/51 (13 October 2003) at Item 3.

341 China's Transitional Review Mechanism, *Questions from the United States to China concerning Market Access*, G/MA/W/35 (20 August 2002) at Item 19.

342 *European Communities – Measures Affecting Asbestos and Asbestos-Containing Products*, Report of the Appellate Body, WT/DS135/AB/R (12 March 2001).

imported products in relation to domestic products."[343] Article III:2 "provides for specific obligations regarding internal taxes and internal charges."[344] As there are two sentences in Article III:2, there are two distinct standards for finding a violation. The first sentence examines whether products of an exporting country are taxed "in excess of" the taxes on "like" domestic products while the second sentence examines "whether products of an exporting country are taxed similarly to domestic products which are 'directly competitive or substitutable.'"[345] As "like products" are a subset of products that are "directly competitive or substitutable product," a violation of the first sentence would also violate the second sentence.[346] Thus, "if the imported and domestic products are 'like products,' and if the taxes applied to the imported products are 'in excess of' those applied to the like domestic products, then the measure is inconsistent with Article III:2, first sentence" and would thus violate both the first and second sentence of Article III.[347]

i. Article III: First Sentence

Determining whether imported and domestic products are "like products" should "be done on a case-by-case basis, by examining relevant factors."[348] The factors used to determine

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343 *Japan - Taxes on Alcoholic Beverages*, Report of the Appellate Body, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R (4 October 1996) at 14.

344 *Id*. at 16.

345 *Korea – Taxes on Alcoholic Beverages*, Report of the Panel, WT/DS75/R (17 September 1998) at ¶ 10.35.

346 *Japan - Taxes on Alcoholic Beverages*, Report of the Appellate Body, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R (4 October 1996) at 22.

347 *Id*. at 17.

348 *Mexico – Tax Measures on Soft Drinks and Other Beverages*, Report of the Panel, WT/DS308/R (October 7, 2005) at ¶ 8.28.

whether a product is "similar" include "the product's end-uses in a given market; consumers' tastes and habits, which change from country to country; the product's properties, nature and quality."[349] Tariff classification may also be a relevant indicator of product similarity and has been used by several previous panels.[350] "Uniform classification in tariff nomenclatures based on the Harmonized System (the "HS") was recognized in GATT 1947 practice as providing a useful basis for confirming "likeness" in products.[351] Similarly, tariff bindings can provide significant guidance as to the identification of "like products" as they can be extremely precise with regard to product description.[352] In a recent panel report it was sufficient to find that the two products fell under the same four-digit HS number to suffice this part of the "like product" analysis."[353]

(a) Likeness of products; products' properties, nature and quality; products' end-uses

To analyze the two fertilizer products' likeness, properties, nature and quality, and end-uses, the following chart is provided. The information was obtained from a Chinese producer of phosphate located in Sichuan Province.[354]

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349 Report of the Working Party on *Border Tax Adjustments*, BISD 18s/19, at ¶ 18 (2 December 1970).

350 *Japan - Taxes on Alcoholic Beverages*, Report of the Appellate Body, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R (4 October 1996) at 21.

351 *Id*. at 22.

352 *Id*. at 22.

353 *Mexico – Tax Measures on Soft Drinks and Other Beverages*, Report of the Panel, WT/DS308/R (October 7, 2005) at ¶ 8.28.

354 http://www.ecvv.com/product/vp988443/China-Monoammonium-Phosphate-MAP.html.

Diammonium Phosphate (DAP)	Monommonium Phosphate (MAP)
Chemical formula: (NH4)2HPO4	**Chemical formula**: NH4H2PO4
Properties: White granular crystal, relative density is 1.619, melting point is 155 degree centigrade, soluble in water easily, insoluble in alcohol, turn into Monoammonium Phosphate by losing ammonium gradually when exposed in the air, pH value of 1% solution is 8.0.	**Properties:** White granular crystal; relative density is 1.803(19 degree centigrade), melting point is 190 degree centigrade, easily soluble in water, slightly soluble in alcohol, insoluble in acetone, pH value of 1% water solution is 4.5.
Technical Specification: Industrial grade: (1) Main content: 99.0% min. (2)P2O5: 53.0% min. (3)Nitrogen, as N: 20.8% min. (4)pH of 1% water solution: 7.8-8.2 (5)Water insoluble: 0.10% max. (6)Moisture: 0.15% max. Food grade: (1) Main content: 99.0% min. (2)P2O5: 53.0% min. (3)Nitrogen, as N: 20.8% min. (4)pH of 1% water solution: 7.8-8.2 (5)Water insoluble: 0.05% max. (6)Arsenic, as As: 0.0003% max. (7)Fluoride, as F: 0.002% max. (8)Heavy metal, as Pb: 0.001% max. (9)Moisture: 0.15% max.	**Technical Specification:** Industrial grade: (1) Main content: 99.0% min. (2)P2O5: 61.0% min. (3)Nitrogen, as N: 11.8% min. (4)pH of 1% water solution: 4.4-4.8 (5)Water insoluble: 0.10% max. (6)Moisture: 0.1% max. Food grade: (1) Main content: 99.0% min. (2)P2O5: 61.0% min. (3)Nitrogen, as N: 11.8% min. (4)pH of 1% water solution: 4.4-4.8 (5)Water insoluble: 0.05% max. (6)Arsenic, as As: 0.0003% max. (7)Fluoride, as F: 0.002% max. (8)Heavy metal, as Pb: 0.001% max. (9)Moisture: 0.1% max.
Uses: (1) As a fire-prevention agent for fabric, timber and paper. (2) For food grade, it is mainly used as a fermentation agent, nourishment, and so on. (3) Used as a high effective non-chloride N, P compound fertilizer in agriculture. (4) It contains totally 74% fertilizer elements (N+P2O5), used as a basic raw material for N, P and K compound fertilizer.	**Uses:** (1) As a fire-prevention agent for fabric, timber and paper, as well as a fire-prevention coating, and dry powder for fire extinguisher. (2) For food grade, it is mainly used as a fermentation agent, nourishment agent, and so on. (3) Used as a high effective non-chloride N, P compound fertilizer in agriculture. (4) It contains totally 73% fertilizer elements (N+P2O5), and may be used as a basic raw material for N, P and K compound fertilizer.

(b) Consumers' tastes and habits

While the facts available make it difficult to gauge what consumers' tastes and habits are, there are many studies on the internet that compare the differences between the two products. With respect to seeding, one farmer newsletter wrote:

> DAP or MAP? DAP is usually a little cheaper for the N & P it gives, but in no-till if you need to add a decent dose of P (eg >15P/ha), you start adding too much N with the seed. This is why it is better to use MAP based products in no-till. If you are only using 40-50kg DAP, then there are no problems with toxicity risks. MAP also handles better in moist conditions, something that is very important on the south coast.

(c) Tariff classification

Both DAP and MAP fall under the same 4-digit HS Heading,[355] but under separate six-digit HS subheadings. The 4-digit HS Heading containing MAP and DAP has eight 6-digit HS subheadings. Subheading, HS 31.05.30: Diammonium hydrogenorthophosphate (diammmonium phosphate), includes DAP and subheading HS 31.05.40: Ammonium dihydrogenorthophosphate (monoammonium phosphate) and mixtures thereof with diammmonium hydrogenorthophosphate (diammmonium phosphate)[356] includes mixtures of MAP and DAP. China has bound its tariffs at the six- and eight-digit level. Within the 4-digit HS Heading containing MAP and DAP, China has bound all eight 6-digit HS subheadings. China's bound rate for six of the eight subheadings,

355 The 4- Digit HTS Heading is: Mineral or Chemical Fertilizers Containing Two or Three of the Fertilizing Elements Nitrogen, Phosphorus and Potassium; Other Fertilizers; Goods of this Chapter in Tablets or Similar Forms or in Packages of a Gross Weight Not Exceeding 10kg.

356 Subheading HS 31.05.40 also includes "other mineral and chemical fertilizers containing the two fertilizing elements nitrogen and phosphorus."

including MAP, is 4%. For the other two subheadings, including DAP, China has higher bound rates, but agreed to permit access for these products under tariff rate quotas, with a within-quota tariff rate of 4%.[357] Essentially, China committed to allowing both products in at a bound 4% tariff, although DAP is subject to a tariff rate quota.

In response to U.S. questions, China has claimed that its differential treatment of DAP and MAP is not in violation of national treatment obligations because DAP and MAP are not identical or similar goods, are not substitutable products, and are not competitive products.[358] Specifically, "[i]n China, DAP was directly applied in manufacturing, while MAP was mainly used to produce compound or special fertilizers."[359] However, the indications of use from a Chinese website reviewed above would appear to contradict those claims.

The products appear to have similar chemical formulas, properties, technical specifications, and uses. There appear to be minor differences in properties, as DAP is a mixture of MAP and ammonium, but one of the properties for DAP is that it will "turn into Monoammonium Phosphate by losing ammonium gradually when exposed in the air." Both products also seem to have both industrial and agricultural specifications, which seems to contradict China's statement that, in China, DAP was used for manufacturing purposes while

357 Committee on Market Access, *Minutes of the Meeting Held on 12 June 2002*, G/MA/M/32 (11 September 2002) at ¶ 11.1.

358 Committee on Market Access, *Minutes of the Meeting Held on 20 October and 5 December 2003*, G/MA/M/35 (10 December 2003) at ¶ 7.13.

359 Committee on Market Access, *Minutes of the Meeting Held on 20 October and 5 December 2003*, G/MA/M/35 (10 December 2003) at ¶ 7.13.

MAP was used to produce fertilizers. While the tariff classifications for the two products are different at the six-digit level, that is not dispositive on the question of "like products."

The facts appear to indicate that, with respect to tariff schedule rates and the negotiated bound rates MAP and DAP are "like products." As many Members have taken commitments that apply across a broad range of products and across several different HS Headings, the Appellate Body warns that when a tariff binding includes a wide range of products, it is "not a reliable criterion for determining or confirming product likeness."[360] However, China has taken specific tariff commitments for these products at the six-digit level. A review of the tariff schedules and tariff bindings for five other Members - Australia, the European Union, Korea, South Africa, and the United States – shows that in all five countries the products are bound at the same rate and both products have the same MFN rate. Taking into account China's commitment for a within-quota tariff rate of 4% on DAP, China too has the same bound and MFN rates for both products. With respect to tariff classifications, it appears that China and five other countries treat these products similarly. In comparing the products' likeness, properties, nature and quality, end-uses, consumer preferences, and tariff classification, it appears that the products are "like products."

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[360] *Japan - Taxes on Alcoholic Beverages*, Report of the Appellate Body, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R (4 October 1996) at 22.

> "For example, Jamaica has bound tariffs on the majority of non-agricultural products at 50%. Trinidad and Tobago have bound tariffs on the majority of products falling within HS Chapters 25-97 at 50%. Peru has bound all non-agricultural products at 30%, and Costa Rica, El Salvador, Guatemala, Morocco, Paraguay, Uruguay and Venezuela have broad uniform bindings on non-agricultural products, with a few exceptions."

Id. at note 49.

The second part of a first sentence analysis looks to see whether the tax on foreign products is "in excess of" that on like domestic products. If the tax on imported products is found to be "in excess of" that on like domestic products, the tax would be inconsistent with Article III:2.[361] In evaluating whether taxes on imported products are "in excess of" those on like domestic products, the Appellate Body has found that "[e]ven the smallest amount of 'excess' is too much."[362] "The prohibition of discriminatory taxes in Article III:2, first sentence, is not conditional on a 'trade effects test' and nor is it qualified by a *de minimis* standard."[363] As discussed above, China's Circular exempts all phosphate fertilizers except diammonium phosphate from a 13% VAT. Thus DAP, a foreign-produced fertilizer is assessed a 13% VAT, while MAP, its Chinese-produced competitor, is not. The taxes on the foreign product are thus "in excess of" of the taxes assessed on the domestic product and will likely disrupt the competitive relationship between domestic and foreign products.[364] To the extent that the VAT on DAP is "in excess of" of the tax on MAP and, to the extent that MAP and DAP are "like products," the VAT measure appears to violate the first sentence of Article III:2 of GATT 1994.

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361 *Id*. at 22.

362 *Id*. at 23.

363 *United States – Measures Affecting Alcoholic and Malt Beverages*, BISD 39S/206 (adopted on 19 June 1992) at ¶ 5.6.

364 "A change in the competitive relationship contrary to [Article III:2] must consequently be regarded 'ipso facto' as a nullification or impairments of benefits accruing under the General Agreement. A demonstration that a measure inconsistent with Article III:2, first sentence, has no or insignificant effects would therefore in the view of the Panel not be a sufficient demonstration that the benefits accruing under that provision had not been nullified or impaired…."

United States – Measures Affecting Alcoholic and Malt Beverages, Report by the Panel, DS23/R (19 June 1992) at p. 71 ¶ 5.6, *citing United States – Taxes on Petroleum and Certain Imported Substances*, Report of the Panel, BISD 34S/136, (adopted on 17 June 1987) at pp. 158-59.

ii. Article III: Second Sentence

Determining whether the tax violates sentence two of Article III:2, requires an analysis of whether the imported and domestic products are "directly competitive or substitutable products." Three separate issues must be addressed in this analysis. These issues are whether: (1) the products are in competition with each other; (2) "not similarly taxed"; and (3) "the dissimilar taxation of the directly competitive or substitutable imported domestic product is 'applied… so as to afford protection to domestic production.'"[365] Panels have determined that domestic and imported products are directly competitive or substitutable products when they have similar physical characteristics, end-uses, channels of distribution, and prices.[366] In order to find that domestic products and imported products are "not similarly taxed," there must be a greater than *de minimis* tax burden on imported products than on "directly competitive or substitutable" domestic products.[367] If the difference in taxation is large, it may be enough to show that the taxation was applied "so as to afford protection," but other factors may be relevant, including an "objective analysis of the structure and application of the measure in question on domestic as compared to imported products."[368]

China claims that DAP and MAP are not competitive or substitutable, but the facts presented above appear to demonstrate that these products are in competition with each other.

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365 *Japan - Taxes on Alcoholic Beverages*, Report of the Appellate Body, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R (4 October 1996) at 24.

366 *Korea – Taxes on Alcoholic Beverages*, Report of the Panel, WT/DS75/R (17 September 1998) at ¶ 109.

367 *Japan - Taxes on Alcoholic Beverages*, Report of the Appellate Body, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R (4 October 1996) at 27.

368 *Id*. at 28-30.

Additionally, internet suppliers promote the products in a way that implies that they are "directly competitive or substitutable products." In fact, the products are such close competitors that one study presents a graph detailing "World DAP/MAP Production and Excess Capacity – 2006" and "US vs World DAP/MAP Exports," as if they were one and the same.[369] From these facts, it appears that the marketplace considers MAP and DAP to be "directly competitive or substitutable products" in both the United States and in China.

The differential in VAT assessed is enough to show that these two products are not similarly taxed. However, it may also be shown that the VAT rebate policy was applied in such a manner as to protect domestic products. As discussed above, the VAT exemption applies to all phosphate fertilizers, with the exception of DAP, which is primarily produced in and imported from the United States. The differential tax policy discourages the use of foreign-produced DAP in favor of domestically-produced MAP with which DAP competes. As such, the measure likely violates the second sentence of Article III:2 of GATT 1994 and, thus, violates China's WTO obligations.

Since the VAT policy was first put in place, the United States has repeatedly raised this issue and expressed its concern that China's differential VAT treatment of DAP and MAP is discriminatory and inconsistent with the principles of national treatment.[370] In return, China has

369 www.potashcorp.com/media/pdf/investor_relations/industry_overview/2007/POT_Overview07_Phosphate.pdf.

370 *See China's Transitional Review Mechanism, Questions from the United States to China concerning Market Access*, G/MA/W/58 (31 August 2004) at ¶ 6; China's Transitional Review Mechanism, *Questions from the United States to China concerning Market Access*, G/MA/W/71 (6 September 2005) at ¶ 13; China's

continued to maintain that its differential VAT treatment of DAP and MAP is justified and that it "had currently no intention to change the system."[371] The facts here, however, likely demonstrate that MAP and DAP are "like products," that the tax on DAP is "in excess of" that on MAP, and that the products are "directly competitive or substitutable products." As such, the VAT measure likely violates Article III:2 of GATT 1994.

b. Article XXIII

In the alternative, China's differential VAT tax policy nullifies or impairs benefits the U.S. expected under China's WTO Accession commitments, giving rise to a claim under Article XXIII of GATT 1994. Article XXIII provides:

> If any contracting party should consider that any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired or that the attainment of any objective of the Agreement is being impeded as the result of
>
> (a) the failure of another contracting party to carry out its obligations under this Agreement, or
>
> (b) the application by another contracting party of any measure, whether or not it conflicts with the provisions of this Agreement

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Transitional Review Mechanism, *Communication from the United States*, G/MA/W/78 (18 September 2006) at ¶ 6.

See also USTR, *2007 National Trade Estimate Report on Foreign Trade Barriers* at 85:

> In 2001, China began exempting all phosphate fertilizers except diammonium phosphate (DAP) from the VAT. DAP, a product that the United States exports to China, competes with other phosphate fertilizers produced in China, particularly monoammonium phosphate. Both the United States Government and U.S. producers have complained that China has employed its VAT policies to benefit domestic fertilizer production.

[371] Committee on Market Access, *Minutes of the Meeting Held on 4 October 2006*, G/MA/M/42 (14 November 2006) at ¶ 7.4.

In an early GATT dispute, the Working Party examined whether Australia's removal of a subsidy on sodium nitrate fertilizer, while maintaining a subsidy on ammonium sulphate fertilizer, violated Australia's obligations under the GATT and "nullified or impaired the tariff concessions granted by Australia to Chile on nitrate of soda."[372] The Working Party determined that an "impairment would exist if the action of the Australian Government which resulted in upsetting the competitive relationship between sodium nitrate and ammonium sulphate could not reasonably have been anticipated by the Chilean Government, taking into consideration all pertinent circumstances and the provisions of the General Agreement, at the time it negotiated for the duty-free binding on sodium nitrate."[373]

The Working Party found that, during negotiations, the Government of Chile had reason to assume that "the war-time fertilizer subsidy would not be removed from sodium nitrate before it was removed from ammonium sulphate" and thus suffered a nullification of impairment of a benefit accruing.[374] The Working Party stated that it was influenced by the following circumstances:

> (a) The two types of fertilizer were closely related; (b) Both had been subsidized and distributed through the same agency and sold at the same price; (c) Neither had been subsidized before the war, and the war-time system of subsidization and distribution had been introduced in respect of both at the same time and under the same war powers of the Australian Government; (d) This system was

372 *The Australian Subsidy on Ammonium Sulphate,* GATT/CP.4/39, (31 March 1950) at 1.

373 *The Australian Subsidy on Ammonium Sulphate,* GATT/CP.4/39, (31 March 1950) at 4.

374 *The Australian Subsidy on Ammonium Sulphate,* GATT/CP.4/39, (31 March 1950) at 4.

> still maintained in respect of both fertilizers at the time of the 1947 tariff negotiations.[375]

Similarly, China's differential VAT treatment would likely be considered a nullification or impairment of a benefit under Article XXIII. Before determining that Australia's actions violated its obligations under Article XXIII of the Agreement, the Working Party examined whether the two products were "like products."[376] The Working Party found that the two fertilizers were not "like products" because the items were listed as separate items under the Australian tariff code, had different tariff rates, both domestically and in third countries, and one of the items was bound while the other was not.[377] As discussed above, these factors are not applicable to MAP and DAP, and it is likely that the two products would be considered "like products," a more narrow and higher standard than "closely related," which is the standard under Article XXIII of GATT 1994.

During the accession process, China committed to certain obligations with respect to tariff rate quotas on fertilizers. Specifically, China committed to permit access under tariff rate quotas for DAP within a quota tariff rate of 4%.[378] The 4% binding would allow MAP and DAP, under the tariff rate quota, to enter China at the same rate. Although China committed to equal access, China appears to have "undermin[ed] the promised market access through tax policies

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375 *The Australian Subsidy on Ammonium Sulphate,* GATT/CP.4/39, (31 March 1950) at 4.

376 *The Australian Subsidy on Ammonium Sulphate,* GATT/CP.4/39, (31 March 1950) at 3.

377 *The Australian Subsidy on Ammonium Sulphate,* GATT/CP.4/39, (31 March 1950) at 3.

378 Committee on Market Access, *Minutes of the Meeting Held on 12 June 2002,* G/MA/M/32 (11 September 2002) at ¶ 11.1.

that discriminated between like and directly competitive fertilizer products."[379] During tariff negotiations for China's accession, the United States "had reason to assume" that any change in VAT policies for MAP would also be changed DAP, so as to protect the competitive relationship between the products. Thus, China's discriminatory policy likely nullifies or impairs a benefit accruing to the United States and would likely violate Article XXIII of GATT 1994.

2. Consumption Taxes on Various Products

China's consumption tax "applies to a range of consumer products, including spirits and alcoholic beverages, tobacco, cosmetics and skin and hair care preparations, jewellery, fireworks, rubber, motorcycles and automobiles."[380] In the first TRM, the United States noted its concern that China used different methods for calculating consumption taxes on domestic and imported products which resulted in higher taxes being imposed on imported products.[381] In particular, the United States noted that, under the 1993 *Provisional Regulations on Consumption Tax*, different tax bases are used to compute consumption taxes for domestic and imported products.[382] The

379 *Id.*

380 United States Trade Representative, *2002 Report to Congress on China's WTO Compliance* (December 11, 2002) at 22.

381 Exhibit 19 contains selected trade statistics, including certain consumer goods.

382 For domestic products, the tax base for domestic products is the sales amount (apparently the ex factory price). (*Provisional Regulations*, Article 5.) This amount is multiplied by the consumption tax rate to derive the consumption tax due. In contrast, for imported products, Article 9 sets the tax base as the "composite assessable value," which is defined as (dutiable value + customs duty), divided by (1 – consumption tax rate). The resulting amount is then multiplied by the consumption tax rate to derive the consumption tax due.

United States has asked China to explain how this different tax treatment is consistent with national treatment requirements under GATT 1994.[383] In the second TRM, China answered that it used different tax formulas for imports and domestic products in order to equalize their tax treatment. China stated that the reason for the difference in consumption taxes for imported goods and domestic goods was due to how the selling prices between foreign and domestic goods were determined.[384] China's practice of having different consumption taxes for foreign and domestic products is inconsistent with China's national treatment commitments and appears to be a violation of Article III:2 of GATT 1994.

China's Transitional Review Mechanism, *Questions from the United States to China concerning Market Access*, G/MA/W/35 (20 August 2002) at Item 20.

383 China's Transitional Review Mechanism, *Questions from the United States to China concerning Market Access*, G/MA/W/35 (20 August 2002) at Item 20.

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> In China, taxable value for the purpose of imposing consumption tax included a consumption tax factor, i.e.: taxable value = (cost + profit)/(1 - consumption tax rate). Such a calculation method applied to both imported goods and domestic goods. The consumption tax factor was put into the taxable value while calculating and levying consumption tax on either imported or domestic products. Due to such a method, the consumption tax factor was taken into account when the selling price of domestic products was being determined. Thus, since the taxable value of domestic products already included a consumption tax factor, the corresponding consumption tax was the taxable value multiplied by the tax rate. Since the import value of imported goods did not include a consumption tax factor, such a value was converted into a taxable value that contained a consumption tax factor. The consumption tax was then worked out based on the converted taxable value. Otherwise, the value of imported goods would not contain a consumption tax factor, while that of domestic goods would, which would lead to unfair treatment in relation to tax imposition on imported and domestic products.

Committee on Market Access, *Minutes of the Meeting Held on 20 October and 5 December 2003*, G/MA/M/35 (10 December 2003) at ¶ 7.14.

As discussed in the previous section, the purpose of Article III is to prevent Members from applying internal regulations and taxes that disrupt the competitive relationships between domestic and imported goods, so as to afford protection to domestic production. Again, the first sentence of Article III:2 examines whether product of an exporting country are taxed in excess of the taxes on the "like" domestic product, while the second sentence examines whether products of an exporting country are taxed similarly to domestic products which are "directly competitive or substitutable."[385] In following the like product analysis from above, it is likely that the consumption tax violates the first sentence of Article III:2. As the consumption tax applies to imported consumer goods "ranging from alcoholic beverages to cosmetics to automobiles,"[386] a large number of the imported consumer goods are likely to be considered "like products" with domestic consumer goods.

The next question is whether the tax on imported products is "in excess of" that on like domestic products. Again, even the smallest amount of excess is too much, and as discussed above, it need only disrupt the competitive relationships between the products.[387] However, in 2007, USTR commented that by using a "substantially different tax base to compute consumption taxes for domestic and imported products, the tax burden imposed on imported consumer goods … is higher than for competing domestic products."[388] To the extent that the

385 *Korea – Taxes on Alcoholic Beverages*, Report of the Panel, WT/DS75/R (17 September 1998).

386 *National Trade Estimate* 2007 at 93.

387 *Japan - Taxes on Alcoholic Beverages*, Report of the Appellate Body, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R (4 October 1996) at 27.

388 *National Trade Estimate* 2007 at 93.

consumption tax formula used on imported products creates a tax "in excess of" that on "like domestic products," and to the extent that China's consumption tax gives Chinese domestic products an advantage over imported products, the tax would violate Article III:2 of the GATT 1994.

PART 2:

TRADE-RELATED ASPECTS OF INTELLECTUAL PROPERTY RIGHTS (TRIPS)

I. INTRODUCTION

When China joined the World Trade Organization (WTO), it committed to providing effective protection for intellectual property rights (IPR).[389] However, more than five years later, China continues to be viewed as having unacceptably high levels of intellectual property theft and concerns remain that China, despite many changes to laws and regulations and attention at least at the central government level, still provides inadequate IPR enforcement.[390] China's trading partners continue to provide technical assistance and to regularly consult on the steps needed to reduce the level of intellectual property (IP) theft both within China and in products being exported from China. Concerns have been raised by the U.S. and others that China's current legal regime suffers from too few criminal prosecutions, that IP owners are unable to obtain effective enforcement because of low damage awards that neither compensate IP owners for past losses nor constitute a deterrent to future infringements, and that courts and other government entities typically do not destroy infringing goods or equipment used to make infringing goods.[391]

389 *See, e.g.*, *Accession of the People's Republic of China*, WT/L/432 (23 November 2001) at Annex 1A, ¶ VI(a).

390 For a detailed analysis of these issues and the global crisis facing intellectual property protection, see Terence P. Stewart et al., *The Crisis in Intellectual Property Protection and China's Role in that Crisis*, The Trade Lawyers Advisory Group LLC (May 2007) [hereinafter "*Crisis in IP Protection*"].

391 *See, e.g.*, *China – Measures Affecting the Protection and Enforcement of Intellectual Property Rights*, Request for Consultations by the United States, WT/DS362/1, IP/D/26, G/L/819 (16 April 2007), attached as Exhibit 20; *Transitional Review Under Section 18 of the Protocol on the Accession of the People's Republic of China*, Report of the General Council by the Chair, IP/C/43 (21 November 2006) at ¶¶ 60, 63.

The United States has spent enormous efforts working with China to get them to correct problems in their legal structure and their enforcement efforts. While bilateral cooperation remains an important component to achieving an acceptable IP environment in China, the scale of the problem and the continued unwillingness of China to address certain problems in an aggressive manner justify the United States and other trading partners pursuing their rights through WTO consultations and, if necessary, dispute panels. The United States recently initiated a case at the WTO to address prominent concerns with China's protection of copyrighted materials. In its request for consultations, the United States made specific allegations with respect to China's threshold requirements for criminal penalties and certain administrative procedures that allow for infringing goods to re-enter the channels of commerce.[392] The United States should similarly pursue consultations on China's compliance with its obligations under the TRIPS Agreement for other pressing enforcement-related problems, such as inadequate damage awards in civil disputes and the frequent failure of judicial authorities to order the destruction of infringing goods and equipment used to make these goods.

[392] *See China – Measures Affecting the Protection and Enforcement of Intellectual Property Rights*, Request for Consultations by the United States, WT/DS362/1, IP/D/26, G/L/819 (16 April 2007), attached as Exhibit 20.

II. CHINA'S WTO OBLIGATIONS WITH RESPECT TO INTELLECTUAL PROPERTY RIGHTS

A. China's Accession to the WTO

When China joined the WTO, it ultimately agreed to bring all of its laws and regulations into compliance with its obligations under the TRIPS Agreement.[393] This Agreement is broken up into several parts, with each section focusing on different commitments. The first part details the Agreement's General Provisions and Basic Principles, and lays out, *inter alia*, the nature and scope of a Member's obligations, the national treatment provision and the objectives of the Agreement.[394] These articles provide that a Member "shall give effect to the provisions of this Agreement," and that Members are allowed, but not obligated, to provide IP protection beyond what the Agreement requires.[395] In other words, the Agreement is intended to provide a minimum, but by no means a maximum, level of protection. With regard to the objectives of the Agreement, Article 7 states the following:

> The protection and enforcement of intellectual property rights should contribute to the promotion of technological innovation and to the transfer and dissemination of technology, to the mutual advantage of producers and users of technological knowledge and

393 *See Accession of the People's Republic of China*, WT/L/432 (23 November 2001) at Annex 1A, ¶ VI(a); *Report of the Working Party on the Accession of China*, WT/MIN(01)/3 (10 November 2001) at ¶ 305 [hereinafter "*Working Party Report*"].

394 *See* Agreement on Trade-Related Aspects of Intellectual Property Rights, April 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, Articles 1, 3 and 7, The Legal Texts: The Results Of The Uruguay Round Of Multilateral Trade Negotiations 320 (1999), 1869 U.N.T.S. 299, 33 I.L.M. 1197 (1994) [hereinafter "TRIPS Agreement"].

395 *See* TRIPS Agreement, Article 1.1.

> in a manner conducive to social and economic welfare, and to a balance of rights and obligations.[396]

The second part of the TRIPS Agreement provides the Standards Concerning the Availability, Scope and Use of Intellectual Property Rights, and details the terms of compliance for a Member's intellectual property laws covering areas such as copyright, trademark, patent, and geographical indicators.[397]

The third part details a Member's obligations with regard to Enforcement of Intellectual Property Rights.[398] The first provision of this part states that:

> Members shall ensure that enforcement procedures as specified in this Part are available under their law so as to permit effective action against any act of infringement of intellectual property rights covered by this Agreement, including expeditious remedies to prevent infringements and remedies which constitute a deterrent to further infringements. These procedures shall be applied in such a manner as to avoid the creation of barriers to legitimate trade and to provide for safeguards against their abuse.[399]

In addition to this general obligation to provide an effective system of intellectual property rights protection that deters future infringements, Part III of the TRIPS Agreement also provides guidelines for civil and administrative procedures and remedies, provisional measures, border measures for Customs authorities, and criminal procedures.[400]

396 TRIPS Agreement, Article 7.
397 *See* TRIPS Agreement, Articles 9-40.
398 *See* TRIPS Agreement, Articles 41-61. The entire TRIPS Agreement is broken up into a total of seven parts with the remaining four parts consisting of: Acquisition and Maintenance of Intellectual Property Rights and Related *Inter-Partes* Procedures; Dispute Prevention and Settlement; Transitional Arrangements; and Institutional Arrangements; Final Provisions. *See* TRIPS Agreement, Parts IV-VII.
399 TRIPS Agreement, Article 41.1.
400 TRIPS Agreement, Articles 42-61.

Accordingly, when China acceded to the WTO, it had to ensure both that its laws were technically in compliance with the obligations stated in the TRIPS Agreement and also that its IPR regime provided effective protection to both foreign and domestic rights holders. This entailed making revisions to it existing laws regarding copyrights, patents and trademarks, as well as revisions to relevant implementing regulations and ensuring that its administrative, criminal and civil systems were prepared to effectively protect and enforce such rights.[401]

In addition to these commitments regarding intellectual property protection, China also addressed concerns of Members of the WTO regarding China's ability to provide adequate remedies and effectively enforce intellectual property rights. Given China's high rates of counterfeiting and piracy, Members wanted assurances that China would "vigorously" apply enforcement legislation.[402] The table below summarizes major concerns Members had regarding China's enforcement measures at the time of its accession.

401 *See generally Working Party Report* at ¶¶ 259-284 (detailing specific commitments China made with respect to its intellectual property laws).

402 *See id.* at ¶ 288.

MEMBER CONCERNS REGARDING CHINA'S ENFORCEMENT MEASURES	
Heavy Reliance on Administrative Procedures	China's heavy reliance on administrative actions, which only amounted to low fines and the loss of infringing goods.[403] These inadequate sanctions, along with high criminal thresholds, made it difficult to effectively enforce IP rights in China.[404] The Members wanted to see more administrative cases referred to criminal actions, particularly those involving repeat offenders and willful infringers.[405]
Civil Judicial Procedures	The difficulty for right holders to pursue judicial relief because of the system's structure of basing filing fees on the amount of damages requested, calculating damages according to the infringer's profits, and requiring evidence of actual sales. This combination generally resulted in damage awards that did not adequately compensate the injured right holder.[406]
Criminal Procedures	Monetary thresholds required for a criminal action were not often met and, therefore, the criminal procedures, as applied, were not effectively addressing IPR infringements.[407]
Provisional Measures	Chinese laws did not provide judicial authorities with strong provisional measures to stop the flow of infringing goods and to preserve the evidence of an alleged infringement.[408]
Special Border Measures	China's existing border regulations were not consistent with the border measures obligations contained in TRIPS Agreement articles 51 through 60.[409] These included: the suspension by the customs authorities of the release in free circulation of infringing goods, rules of evidence for initiating a suspension of release, and the right to destroy or stop the re-exportation of infringing goods.[410]

403 *See id.* at ¶ 297.
404 *See id.*
405 *See id*.
406 *See id.* at ¶ 289.
407 *See Working Party Report* at ¶ 304.
408 *See id.* at ¶¶ 293-296.
409 *See id.* at ¶¶ 300-301.
410 *See id.* at ¶¶ 300-301.

B. Chinese IPR Laws Post-WTO Accession

Since joining the WTO, China has taken great steps to strengthen its IPR regime.[411] The Government has implemented Annual Action Plans to address many concerns, including: legislative reform; law enforcement; training and education; international cooperation; promoting business self discipline; and services to right holders.[412] However, despite these efforts and China's contentions at the time of its accession that it would implement rules and regulations to adequately protect IP rights, many of the same concerns persist.[413]

In the years following accession, Members continued to express their concerns regarding China's enforcement mechanisms.[414] In its 2006 Trade Policy Review of China, the WTO Secretariat reported that "[i]t appears that enforcement remains weak and infringement of intellectual property rights widespread."[415] In 2007, the USTR expounded on China's enforcement problems by stating that "IPR enforcement is hampered by a lack of coordination among Chinese government ministries and agencies, a lack of training, the allocation of

411 For a full discussion on China's efforts, see *Crisis in IP Protection*, at Section III.

412 *China's Action Plan on IPR Protection 2006*, People's Daily Online, April 30, 2006.

413 For a review of enforcement concerns regarding China's IPR system, see *Crisis in IP Protection.*

414 *See, e.g.*, *Transitional Review Under Section 18 on the Protocol on the Accession of the People's Republic of China*, Report to the General Council by the Chair, IP/C/31 (10 December 2003) at ¶¶ 57-58, 65; *Transitional Review Under Section 18 on the Protocol on the Accession of the People's Republic of China*, Report to the General Council by the Chair, IP/C/34 (9 December 2004) at ¶¶ 81, 83, 88; *Request for Information Pursuant to Article 63.3 of the TRIPS Agreement*, Communication from the United States, IP/C/W/461 (14 November 2005).

415 *Trade Policy Review: China*, Report by the Secretariat, WT/TPR/S161 (28 February 2006) at ¶ 313.

resources, a lack of transparency in the enforcement process and its outcomes, and local protectionism and corruption."[416]

Inadequate deterrence within China's administrative, civil, and criminal systems remains one of the biggest problems with China's intellectual property system.[417] High thresholds for criminal prosecution continue to constrain China's enforcement authorities, while inadequate civil damages and "toothless" administrative penalties provide little deterrence against infringement.[418] Additionally, infringing goods remain in the market due to the reluctance of courts to grant remedies allowing preliminary injunctions and the destruction of infringing goods.[419] The lack of enforcement of intellectual property rights in China is illustrated in high levels of piracy and counterfeiting and an increase in China's share of infringing goods at the U.S. border.[420]

III. CHINA'S TRADING PARTNERS UTILIZE WTO PROVISIONS TO SEEK ADDITIONAL PROGRESS IN CHINA'S INTELLECTUAL PROPERTY REGIME

Despite China's efforts and acknowledged progress in bringing its intellectual property laws and regulations into compliance with its WTO obligations, its global trading partners

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416 *2007 National Trade Estimate Report on Foreign Trade Barriers*, United States Trade Representative, at 110 [hereinafter "*NTE 2007*"].

417 *See Trade Policy Review: China,* Report by the Secretariat, WT/TPR/S161 (28 February 2006) at ¶303; *Transitional Review Under Section 18 of the Protocol on the Accession of the People's Republic of China,* Report of the General Council by the Chair, IP/C/43 (21 November 2006) at ¶ 63.

418 *NTE 2007* at 112.

419 *See Transitional Review Under Section 18 of the Protocol on the Accession of the People's Republic of China,* Report of the General Council by the Chair, IP/C/43 (21 November 2006) at ¶ 63; *Transitional Review Under Section 18 of the Protocol on the Accession of the People's Republic of China*, Communication from the United States, IP/C/W/453 (5 October 2005) at ¶ 17.

420 *See NTE 2007* at 112; *see also 2007 Special 301 Report*, United States Trade Representative, at 18 (noting that U.S. industry reports that 85 to 93 percent of all copyrighted material sold in China is pirated).

remain dissatisfied. The United States, as well as other countries, has attempted to elicit further changes in China's intellectual property regime by using various mechanisms outlined in the WTO agreements. First, the United States made a request in November 2005 for additional information and clarifications regarding certain of China's IPR enforcement mechanisms, pursuant to TRIPS Article 63.3.[421] The United States failed to receive an adequate response from China with regard to this request and as the counterfeiting and piracy problem continued to balloon, the United States submitted a request for consultations with China in April 2007, thus initiating the first step in a formal WTO dispute settlement process.[422]

A. United States Requests Information Pursuant to TRIPS Article 63.3

The TRIPS Agreement contains its own provisions for Dispute Prevention and Settlement, located in Part V, with Article 63 devoted to Transparency and Article 64 devoted to Dispute Settlement. Paragraph 1 of Article 63 requires Members to publish or make publicly available all laws, regulations, judicial interpretations, and administrative rulings relating to the subject matter of the Agreement, *i.e.*, intellectual property laws, regulations, and enforcement procedures.[423] Article 63.3 provides that a Member "shall be prepared to supply," in writing, any of the information listed in paragraph 1, upon request by another Member. Additionally, where a Member feels that its IP rights may be affected by a specific judicial decision, administrative

421 *See Request for Information Pursuant to Article 63.3 of the TRIPS Agreement*, Communication from the United States, IP/C/W/461 (14 November 2005).

422 *See China – Measures Affecting the Protection and Enforcement of Intellectual Property Rights*, Request for Consultations by the United States, WT/DS362/1, IP/D/26, G/L/819 (16 April 2007) [hereinafter "*China – Measures Affecting IPR*"], attached as Exhibit 20.

423 *See* TRIPS Agreement, Article 63.1.

ruling or bilateral agreement dealing with intellectual property, that Member may also request access to, or information regarding, those decisions or agreements.[424] On October 25, 2005, the United States presented the Delegation of China with such a request. This was followed by similar requests from Japan and Switzerland.[425]

In its request, the United States asked for further clarification and additional information relating to specific cases of IP enforcement that China had referred to between 2001 and 2004.[426] The United States stated that the goal of this request was both to "encourage the sharing of such information" and to "gain a better understanding of such key features of IPR cases in China as the legal basis on which they have been decided and the remedies actually imposed on infringers."[427] The United States hoped to gain specific information regarding China's remedies for IPR infringements in order determine why China's enforcement system was not working and what could be done to fix it.[428] Accordingly, the United States requested clarification in the following six categories: (1) specific legal basis for its findings of IPR infringement; (2) specific amounts and nature of remedies, provisional measures, and information relating to matters

424 *Id.*, Article 63.3.

425 *See Request for Information Pursuant to Article 63.3 of the TRIPS Agreement*, Communication from Japan, IP/C/W/463, 14 November 2005; *Request for Information Pursuant to Article 63.3 of the TRIPS Agreement*, Communication from Switzerland, IP/C/W/462 (11 November 2005).

426 *See Request for Information Pursuant to Article 63.3 of the TRIPS Agreement*, Communication from the United States, IP/C/W/461 (14 November 2005). The United States identified these cases as ones which China had referred to in previous publications where China had provided statistical data relating to its enforcement of IP rights through administrative, criminal and civil remedies. As an example, the United States referred to a publication by the State Council Information Office, entitled "New Progress in China's Protection of Intellectual Property Rights," dated April 25, 2005, where China referenced administrative cases of copyright infringement, administrative cases of trademark infringement and counterfeiting, and civil and criminal cases of first instance related to IPR infringement. *Id.* at fn.1.

427 *Request for Information Pursuant to Article 63.3 of the TRIPS Agreement*, Communication from the United States, IP/C/W/461 (14 November 2005).

428 *U.S. Seeks Data on Chinese Protection of Intellectual Property*, USINFO.STATE.GOV, October 26, 2005, *available at* http://usinfo.state.gov/ei/Archive/2005/Oct/26-168537.html.

involving repeat infringers; (3) identify location of action, year of commencement and resolution, and competent authority responsible for handling the referenced cases; (4) transfer of cases to criminal authorities, including number of cases transferred and amount of illegal profits involved; (5) identify cases involving foreign nationals and whether those nationals are of WTO Member countries or non-Member countries; and (6) identify the products and operations involved in the various infringement cases.[429]

At the time, the United States Trade Representative, Rob Portman, stated that the "United States is deeply concerned by the violations of intellectual property rights in China…If China believes that it is doing enough to protect intellectual property rights, then it should view this process as a chance to prove its case."[430]

China responded by questioning the legal basis for the United States' requests, noting specifically the China did not have a common law judicial system and therefore did not have "judicial decisions and administrative rulings of general application," as the United States had requested and within the meaning of TRIPS Agreement Article 63.3.[431] China also stated that the United States had not properly referred to a "specific case," as required by Article 63.3 and requested clarification from the United States on this point. Finally, while China made a point of emphasizing its compliance with Article 63 and its willingness to cooperate with other WTO

429 *Request for Information Pursuant to Article 63.3 of the TRIPS Agreement*, Communication from the United States, IP/C/W/461 (14 November 2005).

430 *USTR Pursues WTO Process to Probe IPR Enforcement in China*, Press Release, Office of the United States Trade Representative, October 26, 2005.

431 *See Response to a Request for Information Pursuant to Article 63.3 of the TRIPS Agreement*, Communication from China, IP/C/W/465 (23 January 2006) at ¶ 4.

Members, it also noted a Member certainly had a right to request information pursuant to Article 63.3, but it found no corresponding obligation for a Member to reply to such request.[432]

The United States responded by providing further clarification as to how the rights of its citizens were affected by China's cases for which it sought further information and explained its bases for believing its requests fell within the scope of Article 63.3. In this reply to China, the United States stated its belief that "our Governments can and should work to enhance mutual understanding of the true significance of these cases in light of the requirements of Part III [Enforcement] of the TRIPS Agreement."[433] However, despite expressed desires on both sides for cooperation and transparency, this particular means of information-gathering never produced the information the United States wanted and was unable to provide any further clarity on the effectiveness of China's enforcement measures.

B. U.S. Requests Formal Consultations With China Through WTO to Address Intellectual Property Laws and Protection

More than five years after China joined the WTO the United States was still dissatisfied with the high levels of IPR infringements in China and the perceived lack of effective enforcement efforts. In order to address some of the specific concerns regarding China's IP

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432 *See Response to a Request for Information Pursuant to Article 63.3 of the TRIPS Agreement*, Communication from China, IP/C/W/465 (23 January 2006) at ¶¶ 2, 8, 9. China responded similarly to requests from Japan and Switzerland. *See Response to a Request for Information Pursuant to Article 63.3 of the TRIPS Agreement*, Communication from China, IP/C/W/466 (23 January 2006); *Response to a Request for Information Pursuant to Article 63.3 of the TRIPS Agreement*, Communication from China, IP/C/W/467 (23 January 2006).

433 *Follow-Up Request for Information Pursuant to Article 63.3 of the TRIPS Agreement*, Communication of the United States, Addendum, IP/C/W/461/Add.1 (24 January 2006) at ¶ 6.

system, the United States took the first step in formal dispute resolution proceedings through the WTO and filed a request for consultations with respect to certain of China's IP laws and regulations relating to copyrights and trademarks.[434] This request addressed four major concerns: (1) China's thresholds for criminal procedures and penalties; (2) the disposal of infringing goods that were confiscated by Customs authorities; (3) gaps in copyright and enforcement protection for foreign works that have not yet been authorized for distribution or publication in China; and (4) the scope of criminal procedures and penalties for those who engage in unauthorized reproduction or distribution of copyrighted works.[435]

The first issue relates to China's threshold requirements for criminal prosecution, which has been a hotly contested point in China's laws in recent years.[436] China's criminal law contains vague phrases to define when certain acts of counterfeiting and piracy subject infringers to criminal sanctions. For instance, one who commits the act of infringement shall be subject to criminal penalties "if the circumstances are serious," and shall be exposed to more extensive penalties "if the circumstances are especially serious."[437] In a similarly vague fashion, the law provides that those who sell counterfeit goods shall be subject to criminal penalties "if the

434 *See China – Measures Affecting IPR*, attached as Exhibit 20.

435 *Id*.

436 *See Crisis in IP Protection*, at 101-109 (discussing China's criminal enforcement system and problems posed by the threshold requirements); *see also supra* Part 2, Section II.A (reviewing the *Report of the Working Party on the Accession of China*, which noted WTO Members' concerns over China's criminal thresholds and the problems they raised in terms of enforcing of IP rights).

437 *Criminal Law of the People's Republic of China*, Adopted at the Second Session of the Fifth National People's Congress on July 1, 1979, Revised at the Fifth Session of the Eighth National People's Congress on March 14, 1997, Article 213 [hereinafter "*Criminal Law of China*"], excerpts attached as Exhibit 21. *See China – Measures Affecting IPR.*

amount of sales is relatively large," and the penalties will be more severe "if the amount of sales is huge."[438]

China has previously attempted to address these ambiguous terms by issuing two Judicial Interpretations that provide more specific information as to what constitutes "serious" or "relatively large." The Supreme People's Court and the Supreme People's Procuratorate promulgated the first in December 2004 and, upon continued pressure from the international community, the second in April 2007, just a few days prior to the United States' filing of its request for consultations.[439] Pursuant to these interpretations, with regard to trademark infringement, the "circumstances are serious," and thus criminal penalties apply, when the infringer's illegal business volume (appraised according to the value of the goods at the prices at which they are sold) exceeds RMB 50,000 ($6,100) or the income from such goods is more than RMB 30,000 ($3,700).[440] Additionally, one is criminally liable if he knowingly sells more than RMB 50,000 ($6,100) worth of goods with infringing trademarks.[441] Similarly, an infringer is

438 *Criminal Law of China*, Article 214. *See China – Measures Affecting IPR.*

439 *See Judicial Interpretations by the Supreme People's Court and the Supreme People's Procuratorate on Several Issues of Concrete Application of the Laws in Handling Criminal Cases of Infringing Intellectual Property*, December 22, 2004 [hereinafter "*Judicial Interpretation I*"], attached as Exhibit 22; *Judicial Interpretations by the Supreme People's Court and the Supreme People's Procuratorate on Several Issues of Concrete Application of the Laws in Handling Criminal Cases of Infringing Intellectual Property II*, April 5, 2007 [hereinafter "*Judicial Interpretation II*"], attached as Exhibit 23.

440 *See Judicial Interpretation I*, at Article 1. This interpretation further defines "especially serious" circumstances as when the illegal business volume is more than RMB 250,000 ($30,500) or the illegal gains are more than RMB 150,000 ($18,300). *Id.* For a more detailed discussion regarding the First and Second Judicial Interpretations, see *Crisis in IP Protection*, at 104-109.

441 *See Judicial Interpretation I*, at Article 2.

criminally liable for copyright infringements when, for profit-making purposes, he reproduces and/or distributes at least 500 units.[442]

The United States challenged these provisions on two points, arguing that they were inconsistent with TRIPS Agreement Articles 41 and 61. As stated earlier, Article 41 contains the general enforcement requirement that Members must implement measures to ensure effective action against infringements and provide remedies that will deter future infringements.[443] Article 61 pertains specifically to criminal procedures and states that "Members shall provide for criminal procedures and penalties to be applied at least in cases of willful trademark counterfeiting or copyright piracy on a commercial scale."[444] The United States argued that determining the price thresholds for illegal business volume according to the price at which the infringing product is sold, as opposed to the value of the corresponding legitimate item, provides the infringer the opportunity to sell many low-priced counterfeit items without being subject to criminal liability. Similarly, the mere existence of quantitative thresholds essentially provides a "safe harbor" for infringers and equates to an absence of criminal liability for commercial scale infringement, which is inconsistent with the enforcement requirements of TRIPS Agreement Articles 41 and 61.[445]

The second issue addressed in the request for consultation pertains to Customs authorities' disposal of infringing goods. Article 46 of the TRIPS Agreement states that

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442 *See Judicial Interpretation II*, at Articles 1, 2. This interpretation further defines "other serious circumstances" as when the amount of infringing products is 2,500 units or more. *Id.* at Article 1.

443 *See supra* Part 2, Section II.A; *see also* TRIPS Agreement, Article 41.1.

444 TRIPS Agreement, Article 61.

445 *See China – Measures Affecting IPR.*

authorities shall be allowed to order disposal of infringing goods outside the channels of commerce, without compensation, or order that the goods be destroyed. Specifically with respect to goods containing a counterfeit trademark, the Article also states that "the simple removal of the trademark unlawfully affixed shall not be sufficient, other than in exceptional cases, to permit release of the goods into the channels of commerce."[446] Article 59 provides that the provisions in Article 46 directly apply to Customs authorities.[447] The United States alleged that China's Customs regulations are inconsistent with these provisions of the TRIPS Agreement because they provide a hierarchy for disposal of infringing goods that allows for the goods to re-enter the stream of commerce.[448]

China's Customs procedures are detailed in its Regulations and the Implementing Measures.[449] Pursuant to Article 27 of the Regulations and Article 30 of the Implementing Measures, the first option for disposal of infringing goods is to either give them to a charity where they can be used for the public welfare, or the right holder may purchase the infringing goods if it wishes to have them.[450] If neither of these options is viable, the authorities shall remove the infringing mark and auction the goods off, with the proceeds going to the state

446 TRIPS Agreement, Article 46.

447 *See* TRIPS Agreement, Article 59.

448 *See China – Measures Affecting IPR.*

449 *See Regulations of the People's Republic of China on Customs Protection of Intellectual Property Rights* (adopted at the 30th Ordinary Meeting of the State Council on 26 November 2003, published by the State Council on 2 December 2003, and effective from 1 March 2004) [hereinafter "*Customs Regulations for IPR*"], attached as Exhibit 24; *Measures of the General Administration of Customs of the People's Republic of China for the Implementation of the Regulation of the People's Republic of China on the Customs Protection of Intellectual Property Rights* (adopted at the executive meeting of the General Administration of Customs on April 22nd, 2004, and entered into force as of July 1st, 2004) [hereinafter "*Customs Implementing Regulations for IPR*"], attached as Exhibit 25.

450 *See Customs Regulations for IPR*, at Article 27; *Customs Implementing Regulations for IPR*, at Article 30.1.

treasury.[451] If the first and second options do not apply, meaning that the goods cannot be used for public welfare, the right holder does not want to purchase them, and the infringing mark cannot be removed, only then will the goods be destroyed.[452] The fact that these goods are allowed back into the stream of commerce, via an auction, after the mere removal of the infringing mark is inconsistent with China's TRIPS obligations contained in Articles 46 and 59.

The United States also challenged China's copyright law, together with its administrative procedures regarding censorship or other approval for foreign copyrighted works, such as written materials, sound recordings and performances.[453] The United States based this challenge on two main points. First, Article 4 of China's Copyright Law states that "works the publication or distribution of which is prohibited by law shall not be protected by this Law."[454] Accordingly, to the extent that foreign copyright holders are denied protection and/or a means to enforce their rights if their work has not been authorized for publication or distribution, the United States argued that China's laws are inconsistent both TRIPS Agreement Article 9.1, which incorporates minimum standards of copyright protection as detailed in the Articles 1 through 21 of the Berne

451 *See Customs Regulations for IPR*, at Article 27; *Customs Implementing Regulations for IPR*, at Article 30.2.

452 *See Customs Regulations for IPR*, at Article 27; *Customs Implementing Regulations for IPR*, at Article 30.3

453 *See China – Measures Affecting IPR* (citing administrative regulations such as the Administrative regulations on Audiovisual Products, the Administrative Regulation on Publishing, the Measures for the Administration of Import of Audio and Video Products, the Procedures for Examination and Approval for Publishing Finished Electronic Publication Items Licensed by a Foreign Copyright Owner, and the Procedures for Recording of Imported Publications).

454 *Copyright Law of the People's Republic of China* (Adopted at the Fifteenth Session of the Standing Committee of the Seventh National People's Congress on 7 September 1990, and revised in accordance with the Decision on the Amendment of the Copyright Law of the People's Republic of China adopted at the 24th Session of the Standing Committee of the Ninth National People's Congress on 27 October 2001) [hereinafter "*Copyright Law of China*"], Article 4, attached as Exhibit 26.

Convention, and TRIPS Agreement Article 41.1 by failing to provide certain copyright holders with the opportunity to enforce their rights.[455]

Additionally, the United States emphasized that Article 5(1) of the Berne Convention provides that foreign authors shall be granted the same protections as domestic authors, and Article 5(2) states that a right holder shall be able to exercise their rights without being "subject to any formality."[456] Therefore, the United States argued that China's laws requiring foreign right holders to successfully complete a review before being approved for distribution or publication constituted a "formality" that was inconsistent with TRIPS Agreement Article 9.1.[457] Additionally, to the extent that China's pre-distribution and pre-authorization review procedures for Chinese nationals resulted in copyright protection and enforcement being available earlier than it was for foreign copyright holders, or if such procedures otherwise granted domestic right holders with more favorable protection or enforcement, this was inconsistent with the national treatment provision in TRIPS Agreement Article 3.1.[458]

Finally, the United States took issue with the fact that China's law apparently did not provide criminal penalties for the unauthorized reproduction of copyrighted works, unless that reproduction was accompanied by unauthorized distribution.[459] Article 217 of China's Criminal

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455 *See China – Measures Affecting IPR*; TRIPS Agreement, Articles 9.1, 41.1.

456 Berne Convention for the Protection of Literary and Artistic Works (1979), Article 5, *available at* www.wipo.int/treaties/en/ip/berne/trtdocs_wo001.html. *See China – Measures Affecting IPR.*

457 *See China – Measures Affecting IPR.*

458 *See id.; see also* TRIPS Agreement, Article 3.1 (stating that "each Member shall accord to the nationals of other Members treatment no less favourable than that it accords to its own nationals with regard to the protection of intellectual property, subject to the exceptions already provided in" the major international intellectual property treaties).

459 *See China – Measures Affecting IPR.*

Law provides circumstances under which criminal penalties will apply for copyright infringement, stating that such penalties shall apply, *inter alia*, for "reproducing and distributing a written work, musical work, motion picture…" and for "reproducing and distributing an audio or video recording produced by another person without permission of the producer."[460] The United States argued that, to the extent that China's law did not provide for criminal penalties when one willfully infringed a copyright on a commercial scale through unauthorized reproduction, but without distribution, and *vice versa*, the law appeared to be inconsistent with China's obligations contained in TRIPS Agreement Articles 41.1 and 61.[461] Again, Article 41 provides the general enforcement obligations while Article 61 provides that Members must at least provide criminal procedures and penalties in cases of willful infringement on a commercial scale. For its part, China attempted to clarify this language in its most recent Judicial Interpretation, promulgated just days before the United States filed its request for consultations at the WTO. In that Interpretation, Article 2 states that "for purposes of Article 217 of the Criminal Code, the term 'reproduction and distribution' means reproduction and/or distribution."[462] It reiterates this clarification by further stating that "if anyone illegally publishes, reproduces and/or distributes another person's work and such copyright infringement constitutes a crime, that person shall be convicted and punished for the crime of copyright infringement."[463]

460 *Criminal Law of China*, Article 217.
461 *See China – Measures Affecting IPR.*
462 *Judicial Interpretation II*, Article 2.
463 *Id.*

The two delegations met for formal consultations in early June but failed to reach a resolution on these issues.[464] Accordingly, the United States has moved the matter forward to formal dispute settlement proceedings by requesting the establishment of a panel.[465]

IV. OTHER PROBLEMS WITH CHINA'S INTELLECTUAL PROPERTY LAWS AND REGULATIONS: THE CASE FOR ADDITIONAL WTO CHALLENGES

As discussed in the previous section, the United States' case pending at the WTO addresses some of the persistent concerns regarding China's enforcement mechanisms with respect to IPR infringements, focusing mainly on China's administrative procedures and criminal penalties. Some of the main points the United States raised in its request for consultations are concerns that existed at the time of China's accession, namely the monetary thresholds that must be met to trigger criminal penalties and the administrative disposal of infringing goods by Customs authorities.[466] Two similarly persistent concerns that the United States did not address in its first request for consultations are the fact that China continues to award very low damages

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464 *See* William New, *US, China Fail to Resolve Differences in Consultations on WTO IP Cases*, Intellectual Property Watch, June 11, 2007. Over the course of the proceedings, China has repeatedly stated its belief that its laws are fully in compliance with its TRIPS obligations and requested its trading partners be patient as it continues to work on its intellectual property regime. *See China to Actively Respond to Trade Cases*, Chinadaily.com, May 25, 2007, *available at* www.chinadaily.com.cn/bizchina/200705/25/content_880525.htm; William New, *US, China Fail to Resolve Differences in Consultations on WTO IP Cases*, Intellectual Property Watch, June 11, 2007. Chinese officials have also stated that the U.S. does not understand China's legal system, nor does it understand "basic concepts of IPR protection," and further stated that the U.S. is misusing the WTO dispute settlement mechanism in an attempt to force China to apply measures beyond those required by the TRIPS Agreement. *See id.*

465 *See China – Measures Affecting the Protection and Enforcement of Intellectual Property Rights*, Request for the Establishment of a Panel by the United States, WT/DS362/7 (21 August 2007), attached as Exhibit 27; *see generally* Understanding on Rules and Procedures Governing the Settlement of Disputes, April 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, Article 6.1, The Legal Texts: The Results Of The Uruguay Round Of Multilateral Trade Negotiations 354 (1999), 1869 U.N.T.S. 401, 33 I.L.M. 1226 (1994) [hereinafter "Dispute Settlement Understanding"].

466 *See Working Party Report*, paras. 297, 301-301; *see also supra* Part 2, Section II.A. (discussing Members' concerns at the time of China's accession).

in civil IPR disputes and that courts order destruction of infringing goods and tools only on rare occasions.[467]

This section explores China's civil enforcement system for IP rights, by focusing on the issues of low damages and infrequent destruction of infringing goods and equipment used to make infringing goods. While the laws and regulations governing China's civil enforcement system appear, on their face, to be technically compliant with the minimum standards of protection outlined in the TRIPS Agreement, the application of such laws has failed to achieve the necessary objectives of deterrence and compensation. In 2007, right holders typically expressed concerns not about the laws or regulations but about the inadequate enforcement and results that do not fully reflect harm to the right holder.[468]

Having an effective civil system for enforcement of rights is critical for rights holders. Companies work with the Chinese Government to help administrative authorities identify fake trademarks and other infringing goods, but the civil system should provide right holders the opportunity to recover damages lost from the infringement and to take the implements of

[467] This issue of civil judgments ordering destruction of infringing goods is based on TRIPS Article 46, whereas the United States based its disposal argument on Customs regulations that instruct goods to be released back into channels of commerce through auctions if the infringing marks can be removed, which is inconsistent with the Special Requirements Related to Border Measures contained in TRIPS Article 59.

[468] *See, e.g.*, National Association of Manufacturers, *Submission in Response to Request by USTR for Public Comment with Respect to 2007 National Trade Report on Foreign Trade Barriers*, November 1, 2006 (emphasizing the need for increased enforcement of China's laws relating to IPR protection); Motion Picture Association, *Submission in Response to Request by USTR for Public Comment with Respect to 2007 National Trade Report on Foreign Trade Barriers*, November 8, 2006 (emphasizing the need for increased enforcement of China's IP laws); *Intellectual Property Protection as Economic Policy: Will China Ever Enforce its IP Laws?*, Statement of Professor Daniel C.K. Chow, Congressional-Executive Commission on China: Counterfeiting in China, May 16, 2005 (explaining that China's laws are now considered by most to be in compliance with the standards set out in the TRIPS Agreement, but that enforcement of these laws is inadequate and does not establish sufficient deterrence to IP theft), *available at* www.cecc.gov/pages/roundtables/051605/Chow.php.

infringement out of use through destruction. Civil actions should also provide China an important means of deterring future infringements.

By comparing China's remedies to those of the United States and other countries, certain aspects of China's system are noticeably different. Together, low damage awards and the infrequent destruction of infringing goods and the equipment used to produce such goods create a system that generally does not provide adequate compensation to right holders for infringements and does not objectively create an effective deterrent against future infringements; such lack of effective enforcement is inconsistent with TRIPS Article 41.

A. Key Enforcement Provisions in TRIPS Agreement: General Obligations and Civil Procedures

As previously reviewed, enforcement provisions in the TRIPS Agreement contain certain general obligations, as well as more specific obligations with respect to, *inter alia*, civil procedures and remedies. The following tables provides a summary of the key requirements contained in TRIPS Articles 41-48.

GENERAL OBLIGATIONS	
Article 41.1	Members shall provide enforcement procedures that will permit effective action against infringement of intellectual property rights, including expeditious remedies to prevent infringements and remedies which constitute a deterrent to future infringements.
Article 41.2	Enforcement procedures shall be fair and equitable; they shall not be unnecessarily complicated or costly, or entail unreasonable time-limits or unwarranted delays.

GENERAL OBLIGATIONS	
Article 41.3	Decisions on the merits of the case shall be in writing, reasoned, and available to the parties of the proceedings.
Article 41.4	Parties shall have the opportunity for judicial review of final administrative decisions and legal aspects of initial judicial decisions.

CIVIL AND ADMINISTRATIVE PROCEDURES AND REMEDIES	
Article 42	*Fair and Equitable Procedures* – Members shall provide civil judicial procedures concerning enforcement of intellectual property rights. Defendants shall receive timely written notice with sufficient details, including the basis of the claims. All parties shall be allowed independent legal counsel and duly entitled to substantiate their claims and present all relevant evidence.
Article 43	*Evidence* – When a party presents reasonably available evidence to support its claim that evidence relevant to its substantiation of its claims lies in control of the opposing party, the judicial authorities shall have authority to compel the opposing party to produce such evidence.
Article 44	*Injunctions* – Judicial authorities shall have authority to order a party to desist from an infringement.
Article 45.1	*Damages* – Judicial authorities shall have authority to order the infringer to pay the right holder damages adequate to compensate for injury caused by infringement.
Article 45.2	*Damages* – Judicial authorities shall also have authority to order the infringer to pay the right holder's expenses and appropriate fees.
Article 46	*Other Remedies* – In order to create an effective deterrent to infringement, the judicial authorities shall have the authority to order that infringing goods be disposed of outside the channels of commerce or destroyed. They shall also have the authority to order the materials and implements which are predominantly used in the creation of the infringing goods be disposed of outside the channels of commerce so as to minimize risks of future infringements. With respect to counterfeit trademark goods, the simple removal of the unlawful trademark is not sufficient to permit the release of

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	goods back into the channels of commerce.
Article 47	*Right of Information* – Judicial authorities shall have the authority to order the infringer to identify third parties involved in infringing activities.
Article 48	*Indemnification of the Defendant* – Judicial authorities shall have the authority to order a party at whose request measures were taken to provide adequate compensation to a party who was injured by being wrongfully enjoined or restrained.

When a panel or the Appellate Body is analyzing whether a Member's laws and regulations are consistent with its WTO obligations, the dispute settlement procedures are designed to "preserve the rights and obligations" detailed in the agreements, and to "clarify the existing provisions of those agreements in accordance with customary rules of interpretation of public international law."[469] These customary rules are generally taken from the *Vienna Convention on the Law of Treaties (Vienna Convention)*, which states that "a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose."[470]

When implementing these customary rules of interpretation, panels usually start by reviewing the dictionary definitions of the relevant words in order to identify the ordinary

469 Dispute Settlement Understanding, Annex 2, Article 3.2.

470 *See, e.g.*, *European Communities – Customs Classification of Frozen Boneless Chicken Cuts*, Report of the Panel, WT/DS269/R (30 May 2005) at ¶¶ 7.88-7.89 [hereinafter "*EC – Chicken Cuts*, Panel Report"] (quoting the *Vienna Convention on the Law of Treaties*, Article 31.1); *United States – Final Dumping Determination on Softwood Lumber from Canada*, Report of the Panel, WT/DS264/R (13 April 2004) at ¶ 7.3 (citing the *Vienna Convention on the Law of Treaties*, Article 31.1).

meaning.[471] The analysis progresses by considering the key terms within the relevant context. The *Vienna Convention* again provides guidance by explaining that the context may include the text of the treaty, including the preamble and any annexes, as well as relevant negotiating documents or other agreements made by the parties in connection with the conclusion of the treaty.[472] This context analysis is generally performed by starting first with the immediate context in which the relevant terms are found and then broadens from there, looking next to other substantive provisions of the treaty, including the preamble, and then on to other covered agreements if the meaning behind the relevant terms is still unclear.[473] The goal of this progression is to determine whether the other provisions of the treaty may provide insight into the intended meaning of the relevant terms, as a general goal of treaty interpretation is to ascertain the meaning which was intended when the parties agreed to the provisions.[474]

Pursuant to this framework, when analyzing the enforcement provisions of TRIPS and evaluating a Member's compliance with the terms, one should start with the ordinary definition of the relevant words, then look to the immediate context contained in the provision. However, this provision should be considered not in isolation, but rather in conjunction with the other enforcement provisions in Part III of the TRIPS Agreement that might present additional relevant

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471 *See, e.g., United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, Report of the Appellate Body, WT/DS285/AB/R (7 April 2005) at ¶ 164 [hereinafter "*US – Gambling*, AB Report"]; *European Communities – Customs Classification of Frozen Boneless Chicken Cuts*, Report of the Appellate Body, WT/DS269/AB/R, WT/DS286/AB/R (12 September 2005) at ¶ 175 [hereinafter "*EC – Chicken Cuts*, AB Report"] (noting that the dictionary is often a useful place to start but the definitions they provide are "not necessarily dispositive" and the ordinary meaning of a term must be "ascertained according to the particular circumstances of each case").

472 *See US – Gambling*, AB Report, at ¶ 171 (referring to *Vienna Convention*, Article 31.2).

473 *See, e.g., US – Gambling*, AB Report, at ¶¶ 178-179; *EC – Chicken Cuts*, AB Report, at ¶ 193.

474 *See EC – Chicken Cuts*, AB Report, at ¶ 175.

context.[475] This analysis must be performed while keeping in mind the object and purpose of the agreement, which, according to the preamble, is to "promote effective and adequate protection."[476]

An important aspect to such enforcement analysis will be the General Obligations contained in Article 41. The first subparagraph of this provision requires that Members provide enforcement measures that "permit effective action against any act of infringement."[477] Such enforcement measures need to include "expeditious remedies to prevent infringements and remedies which constitute a deterrent to further infringements."[478] A key phrase in this provision is *effective* action, yet the agreement does not provide a definition. The dictionary provides the ordinary meaning of the word "effective" as follows:

> 1. Concerned with or having the function of accomplishing or executing.
> 2. Powerful in effect; effectual; efficient, efficacious. Making a strong impression; striking, vivid.
> 3. That is concerned in the production of an event or condition; have the power of acting on objects.
> 4. Fit for work or (esp. military) service.
> 5. Having an effect or result. Actually usable or brought to bear; equivalent in its effect.[479]

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475 *See, e.g.*, *Canada – Term of Patent Protection*, Report of the Appellate Body, WT/DS170/AB/R (18 September 2000).

476 TRIPS Agreement, Preamble. The preamble is one of the sources the WTO panel or Appellate Body often look to for context to try and understand the intended meaning behind the terms of the provisions. *See, e.g.*, *Canada – Term of Patent Protection*, Report of the Appellate Body, WT/DS170/AB/R (18 September 2000) at ¶ 59; *India – Patent Protection for Pharmaceutical and Agricultural Chemical Products*, Report of the Appellate Body, WT/DS50/AB/R (19 December 1997) at ¶ 57 (referring to the preamble as confirmation that the panel had accurately interpreted a provision of the TRIPS Agreement).

477 TRIPS Agreement, Article 41.1.

478 *Id.*

479 *Shorter Oxford English Dictionary*, Clarendon Press (5th Ed. 2002) at 794.

Read in the context of this provision, it would seem that a general obligation for a Member's enforcement measures is that they actually accomplish this aim of allowing right holders to take action against any act of infringement. Accordingly, in determining whether a Member has met its TRIPS enforcement obligations, it may not be enough that the Member has put in place the requisite laws, but rather the laws must actually be enforced[480] and serve the purpose of enabling or executing action against infringement.

It is also relevant to note, as a preliminary matter, that challenges at the WTO are designed to address "situations in which a Member considers that any benefits accruing to it directly or indirectly under the covered agreements are being impaired by measures taken by another Member."[481] Accordingly, challenges must address a "measure at issue."[482] The Appellate Body has established that, in principle, "any act or omission attributable to a WTO Member can be a measure of that Member for purposes of dispute settlement proceedings."[483] In addition to such acts as laws and regulations, this term has been interpreted to include acts or instruments that set forth "rules or norms" of general application and prospective application.[484] Pursuant to this definition, if a Member's laws or regulations appear to be consistent with its

480 *See* World Trade Organization, *Intellectual Property: Protection and Enforcement*, Understanding the WTO: The Agreements, *at* www.wto.org/english/thewto_e/whatis_e/tif_e/agrm7_e.htm (accessed May 29, 2007).

481 Dispute Settlement Understanding, Article 3.3.

482 *See id.*, Article 6.2.

483 *United States – Sunset Review of Anti-Dumping Duties on Corrosion-Resistant Carbon Steel Flat Products from Japan*, Report of the Appellate Body, WT/DS244/AB/R (15 December 2003) at ¶ 81 [hereinafter "*US – CORE Sunset Review*, Report of the Appellate Body"]. *See, e.g.*, *United States – Measures Relating to Zeroing and Sunset Reviews*, Final Report of the Panel, WT/DS322/R (20 September 2006) at ¶ 7.37 (referring to analysis in *US – CORE Sunset Review*, Report of the Appellate Body); *United States – Measures Relating to Zeroing in Sunset Reviews*, Report of the Appellate Body, WT/DS322/AB/R (9 January 2007) at ¶ 88 (upholding the panel's reasoning with regard to measures at issue).

484 *See United States – Measures Relating to Zeroing and Sunset Reviews*, Report of the Appellate Body, WT/DS322/AB/R (9 January 2007) at ¶ 88; *US – CORE Sunset Review*, Report of the Appellate Body, at ¶ 81.

WTO obligations on their face, but are applied in a systematic manner that equates to a general rule or norm of application, those procedures could be challenged as such as measures that are impairing the benefits of other Members.[485]

B. Low Damage Awards in Civil IPR Disputes

A common and significant complaint regarding China's judicial system with respect to IPR cases is that damage awards are often very low.[486] This fact has multiple TRIPS implications, with the first being that low damages are not likely to have a deterrent effect, as required by TRIPS Article 41.1. Additionally, these low damages often do not adequately compensate the right holder for the injury it suffered, which is inconsistent with TRIPS Article 45.1. Finally, the TRIPS Agreement requires that civil judicial procedures provide right holders with a means to enforce their rights.[487] Enforcement of a right seemingly encompasses compensation when that right is infringed, so when a right holder receives little to no compensation upon a finding of infringement, it would appear that the relevant procedures are not providing the right holder with a means to effectively enforce its right.

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485 *See US – CORE Sunset Review*, Report of the Appellate Body, at ¶ 82 (stating that the objective of the dispute settlement system of trying to provide security and predictability in trade would be "frustrated if instruments setting out rules or norms inconsistent with a Member's obligations could not be brought before the panel"); *see also United States – Measures Relating to Zeroing and Sunset Reviews*, Report of the Appellate Body, WT/DS322/AB/R (9 January 2007) at ¶ 88; *United States – Measures Relating to Zeroing and Sunset Reviews*, Final Report of the Panel, WT/DS322/R (20 September 2006) at ¶ 7.37.

486 *See, e.g.*, Eric Langer, *China Today: Intellectual Property Protection in China: Does it Warrant Worry?*, BioPharm International, May 1, 2007; *Copyright Enforcement Under the TRIPS Agreement*, International Intellectual Property Alliance, October 2004, at 5.

487 *See* TRIPS Agreement, Article 42.

1. Low Damages Do Not Act as a Deterrent to Future Infringements

As a general obligation, TRIPS requires Members to maintain enforcement provisions that will provide for "effective action" against IRP infringements, including "remedies which constitute a deterrent to further infringements."[488] In terms of deterrence, monetary damages are an obvious means of imposing a judgment that could likely keep someone from choosing to pursue infringement again in the future. Accordingly, when damage awards are routinely low, it would make sense that the level of deterrence provided by that system would also be low.

Article 45.1 of the Civil and Administrative Procedures and Remedies provided for in the TRIPS Agreement requires judicial authorities to "have the authority to order the infringer to pay the right holder damages adequate to compensate for the injury the right holder has suffered because of the infringement...." China's laws are technically in compliance with this provision, as the Patent, Trademark and Copyright laws all have similar provisions with respect to civil damages, providing that the amount of damages shall be based on the losses suffered by the right holder, or, when losses are difficult to determine, the profits earned by the infringer.[489] While none of the laws provide a limit on damages, the Trademark and Copyright laws do provide a statutory alternative, stating that when damages cannot be determined based on other means, the

488 TRIPS Agreement, Article 41.1.

489 *See Patent Law of the People's Republic of China*, Adopted at the 17th Session of the Standing Committee of the Ninth National People's Congress on August 25, 2000, Article 60 [hereinafter "*Patent Law of China*"], attached as Exhibit 28; *Trademark Law of the People's Republic of China*, Amended for the Second Time according to the Decision on Amending the Trademark Law of the People's Republic of China of the 24th Session of the Standing Committee of the Ninth National People's Congress on October 27, 2001, Article 56 [hereinafter "*Trademark Law of China*"], attached as Exhibit 29; *Copyright Law of China*, Article 48, attached as Exhibit 26.

court can determine the amount of damages but it cannot exceed RMB 500,000 ($65,000).[490] The laws demonstrate that Chinese judicial authorities have the authority to award significant damages, but the reality is that damages are typically small, severely hindering the deterrent aspect of China's civil enforcement measures.

In a review of 36 civil cases where Chinese courts determined valid IPR infringement had occurred, 23 cases resulted in damage awards of less than $10,000, and more than half of those cases actually resulted in damages of less than $5,000.[491] In two of those cases, the court actually denied any damages at all and simply ordered the defendants to cease infringement.[492] Of the remaining 13 cases, eight cases resulted in damage awards between $10,000 and $30,000, and four cases resulted in damages between $30,000 and $70,000. In the last remaining case, the court awarded damages of around $1 million.[493]

490 *See Trademark Law of China*, Article 56; *Copyright Law of China*, Article 48.

491 English case summaries obtained through InterLingua Legal Publishing in their monthly reports entitled *China Intellectual Property Report* (November 2006 – March 2007). A chart summarizing the relief requested and the relief received in these cases is attached as Exhibit 30.

492 *See* Ao Mei Sofa (Shenzen), Ltd. v. Beijing AYSR Furniture, Ltd., *China Intellectual Property Report*, InterLingua Legal Publishing (January 2007) at 2; Mr. Gao Lin, Tianjin Jeigao Technology Trade Limited v. Beijing Shunhua Real Estate Development Limited, *China Intellectual Property Report*, InterLingua Legal Publishing (November 2006) at 5. In Gao Lin, the court relied on Article 63 of China's Patent Law which provides that a person who sells a patented product is not responsible for economic losses if they obtained the product through legitimate channels of distribution and did not know of the infringement. In Ao Mei Sofa, the court found that the defendant had infringed on the plaintiff's design patent by exhibiting a sofa with an identical design at an international furniture exhibition. However, because the court found that the defendant had only promoted the product as there was no confirmation that any sales were made following the exhibition, the court concluded that the plaintiff had therefore failed to provide evidence of economic losses.

493 *See* Fujian Yipinde Tea Limited v. Pinpinde Tea Chain Limited, Mr. Cai Gangde, Fujian Shanhe Tea Limited, *China Intellectual Property Report*, InterLingua Legal Publishing (November 2006) at 23. In this case, the plaintiffs provided evidence that the defendants' profit off selling large amounts of trademark-infringing tea was over RMB 20.5 million and had requested RMB 10 million in damages, yet the court awarded RMB 8 million.

In a separate case, *Beijing Panorama Stock Photo v. Beijing Jiutouniao Food Management Ltd*, the plaintiff sued over copyright infringement when its photo was used in an advertisement without permission.[494] Upon finding that the defendant had infringed the plaintiff's copyright, the trial court originally granted the requested damages in the amount of RMB 12,000 ($1,500). On appeal, the court reaffirmed the finding of infringement, but found that the plaintiff had failed to provide evidence regarding the actual amount of economic damages suffered and decided to base the amount of damages on the actual cost of the photo, which was found to be RMB 2,000 ($260).[495] While this case raises the issue of evidentiary burdens a plaintiff must overcome in civil disputes, a point which is addressed in more detail *infra*, it also demonstrates a damage award that is inadequate.[496] The amount awarded in this case is not likely to cover the costs incurred in the trial, particularly since this case went through an appeal, let alone inflict any sort of financial hardship that might act as a deterrent to future infringements.

In a recent case, Nike, the American shoe manufacturer, sued three Chinese companies for infringement of Nike's trademarked Air Jordan logo. Nike employees had found the counterfeit shoes being sold in Chinese stores for the equivalent of about $13, whereas the authentic shoes can easily cost over $100.[497] Upon discovering the shoes, Nike informed the stores of the infringing goods and requested that they stop selling them. A few weeks later, Nike

494 *See China Intellectual Property Report*, InterLingua Legal Publishing (February 2007) at 11-12.
495 *See id.*
496 *See infra* Section IV.C for a discussion on China's evidentiary procedures that inhibit enforcement of intellectual property rights.
497 *See Nike Wins Counterfeiting Lawsuit Against Chinese Shoemakers*, The Canadian Press, August 21, 2007.

noted that the stores were still selling the illegal shoes and commenced judicial proceedings shortly thereafter in the Shanghai 2nd Intermediate People's Court.[498] The court determined Nike's trademark had been infringed upon and awarded RMB 350,000 ($46,000), which was significantly lower than the requested amount of RMB 1 million ($131,000).[499]

By comparison, the United States IP system permits recovery of full damages, even if that amount is very large. For example, ten of the largest awards in patent infringement cases in 2006 ranged from $34 million to $307 million.[500] The largest patent award ever handed down came in February 2007 against Microsoft in the amount of $1.52 billion.[501] However, this case is also making its way through appeals and the judgment has currently been set aside.[502] On a more general scale, the average award in a patent dispute in 2005 was $5.3 million, with the median award amount at $6 million.[503] These numbers were rather different from 2004, where the average award was $31.7 million, but the median award was $2.8 million.[504]

The U.S. system is based on principles of equity, with the goal of making the right holder whole upon a finding of infringement.[505] However, this system also provides for punitive

498 *See* Cao Li, *Shoemakers Told to Pay Nike Compensation*, China Daily, August 21, 2007; *Nike Wins Counterfeiting Lawsuit Against Chinese Shoemakers*, The Canadian Press, August 21, 2007.

499 *See id.*

500 Noric Dilanchian, *Patent Infringement Damages Skyrocket*, Dilanchian Lawyers and Consultants, January 5, 2007, *available at* www.dilanchian.com.au/content/view/177/36.

501 *See* Bloomberg News, *Microsoft Asks Court to Nullify Patent Verdict*, San Jose Mercury News, *available at* www.mercurynews.com/ci_6476950?source=rss.

502 *See id.*

503 *See 2007 Patent and Trademark Damages Study*, PricewaterhouseCoopers LLP, 2007, at 13, *available at* www.pwc.com/extweb/pwcpublications.nsf/docid/cb9df7557a7e45088525729500564c55.

504 *Id.*

505 *See, e.g.*, United States Trademark Law, 15 U.S.C. § 1117(a) (stating that damages are awarded "subject to the principles of equity"); eBay Inc. v. Mercexchange LLC, 126 S. Ct. 1837 (U.S. 2006) (explaining that

damages, should the circumstances warrant such an award. Courts are instructed to consider the circumstances surrounding the infringement and are allowed to award up to three times the amount of actual damages incurred by the right holder.[506] For instance, in the Nike example above, a court in the United States most likely would have increased the amount of damages it awarded due to the fact that the defendants had been made aware of the infringing shoes and yet continued to sell them.[507]

Australian IP law has similar provisions that allow the courts to increase the amount of damages beyond actual profits or damages to compensate for such situations as flagrant infringements or benefits accrued to the infringer.[508] One of the specific circumstances enumerated in Australian law that could justify an increased award of damages is "the need to deter similar infringements,"[509] which implies that a larger amount of damages will have a higher degree of deterrence and *vice versa*.

In Japan, between the years of 1990 and 1994, the average patent award remained constant at approximately $422,000, which has been described as "an amount which may not

automatic injunctive relief in patent infringement cases does not coincide with the "long tradition of equity practice" on which the patent system is based).

506 *See* United States Patent Law, 35 U.S.C. § 284 (providing that regardless of whether a judge or a jury determines the amount of damages "adequate to compensate for the infringement," the court has the authority to increase the damages to up to three times the assessed amount); United States Trademark Law, 15 U.S.C. § 1117(a) (stating that the court has the discretion, upon consideration of the circumstances of the case, to enter a judgment exceeding the actual amount of damages, but this should remain less than three times such amount). The U.S. Trademark Law also instructs that damages should be three times the amount of actual profits or damages in cases of willful infringement in connection with a sale or distribution of goods or services. 15 U.S.C. § 1117(b).

507 *See, e.g.*, Bott v. Four Star Corp., 807 F.2d 1567 (Fed. Cir. 1986) (discussing acts of bad faith on the part of the infringer that justify increased damage awards).

508 *See* Australian Patent Act 1990, Sec. 122(1A); Australian Copyright Act 1968, Sec. 115(4).

509 Australian Patent Act 1990, Sec. 122(1A)(b); Australian Copyright Act 1968, Sec. 115(4)(b)(ia).

necessarily be sufficient for the protection of IP rights."[510] In response to concerns regarding low damage awards, Japan's Patent Office performed a study in 1997 that resulted in revisions to the way in which Japanese courts determined damages.[511] Courts have now broadly interpreted a provision in Japan's patent law that provides for damages to be based on lost profits according to the "working capability" of the patentee as including not only the current capabilities relating to the patent but also potential capabilities.[512] Accordingly, Japan has experienced significant increases in the amount of damages awarded for infringements, with a case in 2002 awarding damages of approximately $63.5 million.[513]

Notably, the United States, Australia and Japan all ranked in the top ten countries for favorable IP environments, according to a business survey in 2007, and a review of their laws clearly shows that deterrence is a significant factor in determining damage awards for IPR infringement.[514] As stated at the beginning of this section, the vast majority of Chinese IP decisions that have been reviewed provide very limited damages, most below $10,000 and few above $100,000, amounts that are unlikely to prevent recurrent infringement and act as a deterrent to others.

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510 Noriko Higashizawa and Kunihiro Sumida, *Japan: IP Litigation*, *in* IP Value 2004, Globe White Page, at 394, *available at* www.buildingipvalue.com/n_ap/393_396.htm.

511 *See* Larry Coury, *C'est What? Saisie! A Comparison of Patent Infringement Remedies Among the G7 Economic Nations*, 13 Fordham Intell. Prop. Media & Ent. L.J. 1101, 1143-1145 (2002-2003).

512 *See id.* at 1144-1145; *see also* Japanese Patent Law, Article 102.

513 *See* Coury, *C'est What? Saisie! A Comparison of Patent Infringement Remedies Among the G7 Economic Nations*, at 1145; *see also* Noriko Higashizawa and Kunihiro Sumida, *Japan: IP Litigation*, *in* IP Value 2004, Globe White Page, at 394, *available at* www.buildingipvalue.com/n_ap/393_396.htm.

514 *See Global Survey on Counterfeiting and Piracy*, International Chamber of Commerce, January 29, 2007, at 9. This same survey, which was conducting by questioning 48 different companies, found China to have the least favorable IP environment. *See id.* at 10.

As noted, Chinese courts have, on occasion, awarded substantial judgments against Chinese companies.[515] This demonstrates that judicial authorities have the authority to compensate the right holder for the infringement and provide remedies that truly act as a deterrent, as is required by TRIPS. The failure of the Chinese courts to fashion remedies which in fact compensate IP holders for harm from infringement and that fail to deter further infringements would appear to be a violation of China's obligations under TRIPS Agreement Articles 41.1 and 45.1.[516]

In evaluating whether China's low damage awards amounts to WTO-inconsistent behavior, there are two provisions to consider. First, there is a procedural requirement in Article 45.1 that requires Members to provide judicial authorities with the authority to adequately

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515 *See, e.g.*, *Yamaha Corporation Wins Compensation in Trademark Infringement Case*, NTD Patent & Trademark Agency Ltd., June 25, 2007, *available at* http://english.ipr.gov.cn/ipr/en/info/Article.jsp?a_no=88512&col_no=127&dir=200706.

516 There is some indication that Chinese courts are becoming more inclined to award significant damages, though at the moment, these still seem to be rare cases as opposed to a general trend. On June 5, 2007, the Supreme Court issued a final judgment in a trademark infringement case and ordered the defendants to pay the plaintiff, Japan's Yamaha Corporation, damages in the amount of RMB 8.3 million ($1.1 million). *See Yamaha Corporation Wins Compensation in Trademark Infringement Case*, NTD Patent & Trademark Agency Ltd., June 25, 2007, *available at* http://english.ipr.gov.cn/ipr/en/info/Article.jsp?a_no=88512&col_no=127&dir=200706. This is reportedly one of the largest awards in a trademark infringement case in China. Rouse & Co. International, *Supreme Court Closes Final Chapter in Yamaha – Huatian Saga*, China Intellectual Property Express Issue 289, July 2, 2007, *available at* www.iprights.com/cms/templates/chinaipx.aspx?articleid=3626&zoneid=4. With respect to patents, a landmark decision was handed down in June 2006 by the Zhengzhou Intermediate People's Court. The court awarded damages in the amount of RMB 29.8 million ($3.7 million), which was the largest amount of damages ever awarded in an IPR infringement matter. *See* Cedric Lam and Janet Wong, *China & Hong Kong: Recent Developments in Intellectual Property*, Dorsey & Whitney LLP, *in* IP Value 2007, Globe White Page, at 263, *available at* www.buildingipvalue.com/07AP/p.262-265%20china,%20hong%20kong.pdf. Following this judgment, the case was appealed and the patent found to be invalid. The case is still on appeal at the HeNan High Court. *See* Rouse & Co. International, *Patent Re-examination Board Finds Patent Invalid After Court Has Made Large Damages Award in Patent Infringement Proceedings*, China Patent Express Issue 132, February 6, 2007.

compensate for injury that results from IPR infringement.[517] Second, this provision must also be considered within the context of the Agreement and read in conjunction with the general obligations of Article 41. Under this structure, it is not enough that judicial authorities have the ability to award damages, but rather those damages must also be in compliance with Article 41.1, which requires that enforcement procedures include remedies that will act as a deterrent to future infringements.

Given that the term 'deterrent' is not defined in the agreement, a WTO panel would likely rely on the general rules of treaty interpretation, as discussed above, by first considering the ordinary meaning of the term 'deterrence' and then looking to the other terms and provisions for context in trying to determine whether the damages generally provided for by China's judicial system constitute a "deterrent."[518] The dictionary states that deterrence is "the action of deterring or preventing by fear," with 'deter' defined as: "(1) restrain or discourage (*from* acting or proceeding) by fear, doubt, dislike of effort or trouble, or consideration of consequences; (2) inhibit, prevent."[519] The panel would then look to the surrounding terms in the provision for context and in this case, the relevant phrase is "remedies that act as a deterrent to future infringements."[520] Pursuant to this definition, it seems clear that the average awards of the size China routinely grants are not likely to evoke fear or prevent an infringer from engaging in such behavior again. Rather such damage awards would likely be viewed simply as a cost of doing

517 TRIPS Agreement, Article 45.1.
518 *See, e.g.*, *EC – Chicken Cuts*, Panel Report, at ¶ 7.89.
519 *Shorter Oxford English Dictionary*, Clarendon Press (5th Ed. 2002) at 658, 660.
520 TRIPS Agreement, Article 41.1.

business by the infringers, a frequent complaint of right holders with the legal system in China.[521]

While this alone may satisfy a panel that a violation of Article 41.1 exists, it could also go further with its analysis. The customary rules of treaty interpretation additionally provide for consideration of "any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation."[522] The phrase "subsequent practice" has been previously been interpreted to mean "a 'concordant, common or consistent' sequence of acts or pronouncements which is sufficient to establish a discernible pattern."[523] Accordingly, if it is possible to show that other Members[524] have interpreted the same provisions of the TRIPS Agreement in a common way, it supports the contention that an outlier is acting inconsistently with its obligations.

As stated above, there is plenty of evidence showing that other Member countries, who are perceived internationally as having positive IPR enforcement environments, award damages

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521 *See, e.g., 2006 Special 301 Report*, United States Trade Representative, April 28, 2006, at 18 (stating that low administrative fines are insignificant and simply viewed by infringers as an ordinary business cost).

522 *European Communities – Customs Classification of Frozen Boneless Chicken Cuts*, Report of the Appellate Body, WT/DS269/AB/R, WT/DS286/AB/R, at ¶ 255-259 [hereinafter "*EC – Chicken Cuts*, AB Report"] (referring to Article 31.3(b) of the *Vienna Convention on the Law of Treaties*).

523 *EC – Chicken Cuts*, AB Report, at ¶ 256 (quoting the definition provided by Appellate Body in *Japan – Taxes on Alcoholic Beverages*, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R (4 October 1996) at 13). This definition has been further clarified to mean that two elements need to be established; first that there is a "common, consistent, discernible pattern of facts or pronouncements," and second, that "those acts or pronouncements must imply agreement on the interpretation of the relevant provisions." *Id.* at ¶ 257 (citing *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, Report of the Appellate Body, WT/DS285/AB/R (7 April 2005) at ¶ 192).

524 When interpreting subsequent practice, the Appellate Body has held that a finding of common and concordant practice does not require that "each and every party must have engaged in a particular practice," but has also expressed the view relying on the practice of one member is generally insufficient. *See EC – Chicken Cuts*, AB Report, at ¶ 259.

much higher than those of China and some have even adopted statutory provisions that specifically address the correlation between higher damages and deterrence. This demonstrates a common interpretation as to a means of achieving deterrence and further supports the contention that China, as the outlier, is applying its laws in such a way that is inconsistent with the general obligation of providing remedies that will deter further infringements.

Additionally, as explained above, the general obligations contained in Article 41.1 suggest that in order for a Member to be in compliance with its TRIPS obligations, the laws not only need to exist, but they must be effective in accomplishing the desired action.[525] In this case, the authority provided in Article 45.1 is intended to be applied so as to adequately compensate the right holder for the injury it suffered due to the infringement.[526] The evidence presented showing a lack of adequate compensation, despite the fact that the authority to provide such compensation exists, demonstrates that China is not in compliance with its obligations contained in Article 45.1.

2. Effective Enforcement of Intellectual Property Rights Requires Adequate Compensation When Those Rights Are Infringed

Article 42 of the TRIPS Agreement provides the requirement for fair and equitable civil enforcement procedures. Specifically, it states:

> Members shall make available to right holders civil judicial procedures concerning the enforcement of any intellectual property right covered by this Agreement. Defendants shall have the right

525 *See supra* Part 2, Section IV.A.
526 TRIPS Agreement, Article 45.1.

> to written notice which is timely and contains sufficient detail, including the basis of the claims. Parties shall be allowed to be represented by independent legal counsel, and procedures shall not impose overly burdensome requirements concerning mandatory personal appearances. All parties to such procedures shall be duly entitled to substantiate their claims and to present all relevant evidence. The procedure shall provide a means to identify and protect confidential information, unless this would be contrary to existing constitutional requirements.[527]

The WTO Appellate Body (AB) has considered this provision of TRIPS in a previous dispute between the European Union and the United States.[528] In that dispute, the AB interpreted Article 42 to mean that right holders are entitled to have access to "civil judicial procedures that are effective in bringing about the enforcement of their rights covered by the Agreement."[529] Consistent with standard WTO analysis, this interpretation appears to incorporate the general obligations contained in Article 41.1, which require that Members provide enforcement procedures that will "permit effective action against any act of infringement of intellectual property rights covered by this Agreement."[530] Although WTO reports do not set legal precedent, the Appellate Body is often looked to for guidance when interpreting certain provisions of the WTO Agreements and, thus, this insight into TRIPS Article 42 is relevant.

As discussed in the previous section, China routinely awards damages that are quite low. In addition to ordering low damages, the awards are often hard to enforce, meaning that even when a court awards damages to a right holder, actually receiving the money is an entirely

527 TRIPS Agreement, Article 42.

528 *See United States – Section 211 Omnibus Appropriations Act of 1998*, Report of the Panel, WT/DS176/R (6 August 2001).

529 *United States – Section 211 Omnibus Appropriations Act of 1998*, Report of the Appellate Body, WT/DS176/AB/R (2 January 2002) at ¶ 215 (emphasis added).

530 TRIPS Agreement, Article 41.1.

separate obstacle. With respect to civil judicial decisions, an estimated 40 to 60 percent are actually carried out, and the number drops significantly when enforcement requires the involvement of officials in a different jurisdiction, to only about 10 percent.[531]

In the context of Article 42, and in light of the AB's interpretation, this is troublesome because adequate compensation for injury is seemingly an essential component to effective enforcement of one's rights. This contention is supported by the fact that TRIPS specifically requires judicial authorities to have the authority to provide a right holder with adequate compensation for the injury it suffered as a result of infringement.[532] As noted above, judges deciding IP cases in China do have this authority, yet they often award damages that do not seem to be adequate compensation for the injury. This situation would appear to be inconsistent with China's TRIPS obligations: if China's civil enforcement procedures are applied in such a way as to essentially frustrate effective enforcement of a right by failing to adequately compensate for injury, this is inconsistent with TRIPS Articles 42 and 41.1.

Inadequate compensation has an additional implication that supports the contention that China's civil enforcement system does not truly provide all right holders with a realistic avenue to enforce their rights, and thus is not fully in compliance with its TRIPS obligations. Potential plaintiffs have to consider these low damage awards when considering whether to pursue a case for infringement. The costs associated with a case are extensive, particularly for foreign right holders who likely incur additional costs in bringing a case in a foreign jurisdiction. Accordingly,

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531 *See* Gary Clyde Hufbauer, Yee Wong, Ketki Sheth, *US-China Trade Disputes: Rising Tide, Rising Stakes*, Institute for International Economics, August 2006, at 41.

532 *See* TRIPS Agreement, Article 45.1.

right holders often feel that pursuing a claim in China is not worth the time and resources it would require, given that there is a significant chance that they will not recover damages that will cover the harm done and the awarding of costs are inadequate to cover the actual cost of pursuing the proceedings.[533]

For instance, a report on the pharmaceutical industry noted that "the lack of meaningful damages for patent infringement," combined with difficulties in enforcing judgments, "has discouraged many foreign companies from pursuing patent infringement actions in China."[534] Additionally, in 2006 it was reported that the Motion Picture Association (MPA) had brought ten civil suits in China to try and address high levels of piracy. Of those ten cases, the MPA received six settlements that reached a total of only $94,000, an amount which did "not begin to cover the costs associated with bringing the cases to court and hardly serves as a deterrent to counterfeiters."[535] Similarly, the International Federation of the Phonographic Industry (IFPI) has filed hundreds of infringement cases in China and estimates that the average cost per case is

533 *See, e.g., Transitional Review Under Section 18 of the Protocol on the Accession of the People's Republic of China*, Report to the General Council by the Chair, IP/C/43 (21 November 2006) at ¶ 72 (highlighting Canada's concerns regarding China's enforcement mechanisms and stating that Canadians were not bringing cases in China because there were high costs and only a small chance of success); Maria Trombly, *Chinese Legal System Hinders IP Protection Efforts*, CIO Insight, October 24, 2005 (discussing the difficulties in bringing a civil case for IPR infringement in China and stating that only exceptionally large companies, such as Johnson & Johnson or Proctor & Gamble, are able to overcome the procedural and financial obstacles to pursue successful cases).

534 Eric Langer, *China Today: Intellectual Property Protection in China: Does it Warrant Worry?*, BioPharm International, May 1, 2007.

535 The Developing U.S.-China Relationship: Analysis of China's Weak Intellectual Property Rights Protection and Enforcement, Testimony of Dr. Neil C. Livingstone Before the U.S.-China Economic and Security Commission, June 8, 2006.

$13,000, while the recovery generally only covers one percent of those costs, with damages averaging $130 per suit.[536]

Given this financial reality, compensation for injury provides little motivation for bringing a case in China. Rather, when right holders choose to pursue civil remedies they do so with the goal of ceasing the infringement and taking a symbolic stance against the infringers.[537] For instance, the 3M Company, based in Minnesota, brought a case for patent infringement after it discovered that counterfeit versions of a popular series of respirator masks were being made in China.[538] After months of preparation, the company went to court and prevailed, winning damages in the amount of $31,000.[539] 3M knew that the costs would probably outweigh the financial recovery, but chose to pursue this case to send a message to the infringers that they planned on defending their brand integrity.[540]

3M is a large corporation who had the resources to pursue this action, despite knowing that it would incur significant financial costs in the process. However, not all right holders are in a similar position and pursing a civil case in China is often viewed as a non-viable option for dealing with infringement. As explained at the beginning of this section, the relevant TRIPS

536 *See* Bruce Einhorn and Xiang Ji, *Deaf to Music Piracy*, BuisnessWeek, September 10, 2007.

537 *See generally No Trade in Fakes Supply Chain Tool Kit*, U.S. Chamber of Commerce Coalition Against Counterfeiting and Piracy, 2006 at 7 (providing a case summary on Ford Motor Company's experiences fighting counterfeiting and piracy and stating that the company has found that it is generally hard to bring cases in foreign countries against IP infringements because monetary recoveries do not cover the costs of bringing the cases, yet Ford continues to pursue counterfeiters to protect the integrity of its brand).

538 *See* Lisa Lerer, *The Mask Avengers*, IP Law & Business, December 2006, *available at* www.ipww.com/display .php/file=/texts/1206/china.

539 *See id.*

540 *See id.*

provisions, when read together, make it clear that right holders are entitled to enforce their rights and to have access to a judicial system that will allow them to pursue such enforcement.[541] To the extent that China's civil procedures, and its generally inadequate compensation for IPR infringements, essentially inhibit certain right holders from pursuing enforcement of their rights, this is inconsistent with China's WTO enforcement obligations under TRIPS Articles 41.1 and 42.

C. China's Evidentiary Requirements May Be Applied in a Way That is Overly Burdensome and Limits the Right Holder's Ability to Effectively Enforce Their Rights

As discussed in the preceding sections, consistently low damage awards have significant implications with regard to effectively enforcing IP rights and providing a system that will deter future infringements. In reviewing information on Chinese cases, it is often noted that a granting of higher damages is not awarded due to lack of sufficient evidence. This section focuses on China's civil procedures with respect to evidence and questions whether they are being applied in a manner that is inhibiting effective enforcement of IPR.

As previously discussed, TRIPS Article 42 provides the requirement of fair and equitable civil enforcement procedures, which includes the requirement that all parties to the procedures "shall be duly entitled to substantiate their claims and to present all relevant evidence." Article 43 contains specific provisions relating to evidence in civil and administrative proceedings, with Article 43.1 providing the following:

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541 *See* TRIPS Agreement, Articles 41.1 and 42; *see also United States – Section 211 Omnibus Appropriations Act of 1998*, Report of the Appellate Body, WT/DS176/AB/R (2 January 2002) at ¶ 215.

> The judicial authorities shall have the authority, where a party has presented reasonably available evidence sufficient to support its claims and has specified evidence relevant to substantiation of its claims which lies in the control of the opposing party, to order that this evidence be produced by the opposing party, subject in appropriate cases to conditions which ensure the protection of confidential information.[542]

Again, this provision needs to be read in conjunction with the general obligation of Article 41.1 that this authority should not just exist but it should "permit effective action against any act of infringement of intellectual property rights…."[543]

Finally, TRIPS Article 41.2 provides that the enforcement procedures "shall not be unnecessarily complicated or costly, or entail unreasonable time-limits or unwarranted delays."[544] Read together, these provisions appear to require that Members provide enforcement procedures that allow a right holder to present all relevant evidence, that entrust judicial authorities with the power to facilitate the gathering of such relevant evidence that may lie in the hands of the opposing party, and that are provided in an effective manner that is not unreasonably complicated or costly.

It is often reported that China's evidentiary requirements in civil procedures are both burdensome and complicated, with one author even reporting that the evidence collection process for an IPR infringement case in China "can reduce even the calmest foreign lawyer to

542 TRIPS Agreement, Article 43.1.
543 *See supra* Part 2, Section IV.A.
544 TRIPS Agreement, Article 41.2.

tears."[545] One aspect of China's civil procedure laws that tends to present problems in bringing a successful case of IPR infringement is that each party is responsible for proving the facts of their case.[546] Additionally, China's rules do not provide parties with the opportunity to directly request information from the opposing side, as the U.S. discovery procedures allow.[547] Instead, China's laws provide that when a party is unable to obtain evidence due to "objective reasons," the party may request that the court investigate and collect the requisite evidence.[548] Further, the court has the authority to "obtain evidence from the relevant units or individuals, and such units or individuals may not refuse to provide evidence."[549] However, it has been reported that Chinese courts rarely invoke these provisions, making it difficult for plaintiffs to substantiate claims, particularly with respect to damages.[550] The available information regarding routinely

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545 *See* Lisa Lerer, *Gathering Storm*, IP Law & Business, December 2005, *available at* www.ipww.com/display.php/file=/texts/1205/netac1205; *see also* Maria Trombly, *Chinese Legal System Hinders IP Protection Efforts*, CIO Insight, October 24, 2005 (noting that courts often do not compel disclosure from opposing sides and that the evidence required to substantiate a claim is much more detailed than in the United States); J. Benfamin Bai, Helen Cheng, and Peter J. Wang, *Patent Litigation in Chinese Courts*, IP Frontline, November 16, 2006, *available at* www.ipfrontline.com/depts/article.asp?id=10608&deptid=6.

546 *See Civil Procedure Law of the People's Republic of China*, Adopted by the Fourth Session of the Seventh National People's Congress on April 9, 1991, promulgated by Order No. 44 of the President of the People's Republic of China, and effective on the date of its promulgation, Article 64 [hereinafter "*Civil Procedure Law of China*"], attached as Exhibit 31; *Some Provisions of the Supreme People's Court on Evidence in Civil Procedures*, Passed at the 1201st meeting of the Judicial Committee of the Supreme People's Court on December 6, 2001 and promulgated for implementation as of April 1, 2002 [hereinafter "*Provisions on Evidence in Civil Procedures*"], attached as Exhibit 32.

547 *See, e.g.*, United States Federal Rules of Civil Procedures, 28 U.S.C. 26 (2007) (providing for such discovery methods as oral depositions, written interrogatories and document production). China's evidentiary rules do appear to allow for an "exchange of evidence" upon application by a party, but they do not provide for an opportunity to request specific information that may be essential to your case. *See Provisions on Evidence in Civil Procedures*, Article 37.

548 *See Civil Procedure Law of China*, Article 64; *see also Provisions on Evidence in Civil Procedures*, Article 16 (stating that the court will initiate such investigation of evidence upon an application by the party).

549 *Civil Procedure Law of China*, Article 65.

550 *See, e.g.*, Lisa Lerer, *The Mask Avengers*, IP Law & Business, December 2006, *available at* www.ipww.com/display.php/file=/texts/1206/china (stating that it is nearly impossible to obtain evidence from the opposing side in Chinese civil litigation cases); *see also 2007 Special 301 Report*, United States Trade Representative,

low damages also supports the contention that judges do not utilize this authority to request information from the defendants that might help establish compensatory damages.

This system makes it particularly difficult for plaintiffs to establish damages, which are ideally based on lost profits or the infringer's sales of the illegal goods.[551] Imagine the difficulties of proving your opposing party's sales revenues without having access to their records. Given this evidentiary burden, it is not surprising that insufficient evidence is often cited as the court's justification for awarding low damages.[552]

Another major obstacle relates to China's requirement that if a piece of evidence was created outside the territory of China, it must be notarized and then authenticated by relevant government authorities in order for a court to accept it.[553] This can be an incredibly costly and time-consuming process, particularly for foreign parties who will likely have to have all of their

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at 19 (noting that the United States has been pressing China to implement discovery procedures with compulsory measures for evidence protection).

551 *See, e.g.*, *Patent Law of China*, Article 60 (providing that the amount of damages shall be assessed on the either the patentee's losses or the infringer's profits).

552 *See, e.g.*, Beijing Panorama Stock Photo v. Beijing Jiutouniao Food Management Ltd, *China Intellectual Property Report*, InterLingua Legal Publishing (February 2007) at 11-12 (providing significantly lower damages than requested because the plaintiff "failed to provide evidence regarding the actual amount of economic losses suffered"); Ms. Zhang Xiaoyan v. China Central Television, *China Intellectual Property Report*, InterLingua Legal Publishing (February 2007) at 12-13 (denying plaintiff's request for damages and awarding a significantly lower amount "due to lack of supporting evidence"); Ao Mei Sofa (Shenzhen), Ltd. v. Beijing AYSR Furniture, Ltd., *China Intellectual Property Report*, InterLingua Legal Publishing (January 2007) at 2 (refusing plaintiff's request for damages because "it could not be confirmed whether sales were made" of the infringing good). *See generally* J. Benjamin Bai, Helen Cheng, and Peter J. Wang, *Patent Litigation in Chinese Courts*, IP Frontline, November 16, 2006, *available at* www.ipfrontline.com/depts/article.asp?id=10608&deptid=6 (explaining that evidence preservation is essential to proving damages in the Chinese civil system and stating that, "in practice, the assessment of damages is often a difficult and complicated process, which explains why damages awards in China are often very low by U.S. standards…However, there is no statutory limit on the amount of damages that can be awarded, and some Chinese judges have stated that they would award high damages if presented with admissible evidence to support them.").

553 *See Provisions on Evidence in Civil Procedures*, Article 11.

evidence notarized and authenticated if they wish to even attempt civil enforcement of their IP rights in China. By comparison, the U.S. rules of evidence do not appear to differentiate between foreign and domestic evidence.[554] Rather, there is a general rule that authentication "as a condition precedent to admissibility is satisfied by evidence sufficient to support a finding that the matter in question is what its proponent claims."[555]

Consider the realities of China's rules. CBS Broadcasting attempted to have a third party's eye-shaped trademark registration canceled in China by claiming it was a popular and well-known mark belonging to CBS.[556] The court refused to cancel the trademark at least in part because CBS had failed to get a supporting document notarized to prove its legitimacy.[557] And when 3M Company of St. Paul, Minnesota decided to pursue its trademark infringement case in China, the evidentiary requirements proved to be daunting. 3M had to supply the court with tremendous documentation just to file its complaint. As most of the documentation was of foreign origin, it had to be notarized and much of it had to be authenticated at a Chinese consulate, which in this case was located in Chicago. After months of preparation, 3M's lawyers presented the court with a stack of materials that was about four feet high.[558]

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554 *See* United States Federal Rules of Evidence, 28 U.S.C. §§ 901-902. Certain foreign public documents must contain relevant certification as to the genuineness of the document, but related domestic public documents must also contain certifications, so the requirements are consistent. *See* 28 U.S.C. § 902.

555 United States Federal Rules of Evidence, 28 U.S.C. § 901(a).

556 *See* CBS Broadcasting Inc., U.S.A. v. Trademark Review and Adjudication Board of the PRC Administrative Department for Industry and Commerce, *China Intellectual Property Report*, InterLingua Legal Publishing, December 2006, at 17.

557 *See id.*

558 *See* Lisa Lerer, *The Mask Avengers*, IP Law and Business, December 2006, *available at* www.ipww.com/display.php/file=/texts/1206/china. Foreign companies also face the additional obligation of having to translate all materials into Chinese. *See Provisions on Evidence in Civil Procedures*, Article 12.

Moreover, 3M Company reported that proving infringement was not difficult, but proving that the defendants had sold the illegal goods was "nearly impossible" given that there was no access to financial records.[559] 3M eventually filed a request, and paid a standard fee of RMB 22,500 ($2,900), to have the court inspect the defendant's factory. This allowed for the discovery of serial numbers on infringing products that corresponded to similar numbers used on the infringing goods. While this satisfied the court's desire to see a chain of sale linking the defendant to the infringing products found in the market, "proving anything beyond that basic link, like the magnitude of [the defendant's] infringing activity, was impossible without records of sales volumes, profit margins, or operating income."[560]

These examples highlight the extreme difficulties plaintiffs face pursuant to China's evidentiary requirements in civil cases. These evidentiary requirements often result either in extremely low damage awards or actually deterring plaintiffs from bringing cases because the evidentiary requirements are simply insurmountable. Given that the TRIPS Agreement requires judicial authorities to have the authority to aid in obtaining evidence, it is striking that insufficient evidence is often a reason cited for the law damage awards. Moreover, it is hard to reconcile a system that requires a plaintiff to submit a four foot stack of notarized and authenticated documentation in order to bring a case with the requirements that parties are

559 Lisa Lerer, *The Mask Avengers*, IP Law and Business, December 2006, *available at* www.ipww.com/display.php/file=/texts/1206/china.

560 *Id.*

entitled to present all relevant evidence related to their claims but that such procedures not be unnecessarily complicated or costly.[561]

With respect to the impact of these evidentiary requirements on damage awards in general, numerous provisions in the TRIPS Agreement are relevant to establishing whether China's enforcement is consistent with its WTO obligations. First, Article 45.1 establishes the importance of adequately compensating for injury as a result of infringement by requiring judicial authorities in civil proceedings to be able to award such damages.[562] These judicial procedures must also allow parties to substantiate claims and present all relevant evidence,[563] but such procedures cannot be unnecessarily complicated or costly.[564] These provisions must also be construed within the context of the general obligation to enact enforcement measures that permit effective protection and enforcement of IP rights.[565]

As discussed above, adequate compensation is a seemingly inherent component to effectively enforcing one's rights, yet the civil procedures China has enacted make it virtually impossible to present the relevant evidence necessary to substantiate a claim for damages that could be construed as adequate compensation. This appears to be inconsistent with China's obligations under TRIPS Articles 41.1 and 42.

Additionally, to the extent that these evidentiary burdens are so great that they essentially limit foreign right holders' ability to bring a case, because they know they will incur substantial

561 *See* TRIPS Agreement, Articles 41.2 and 42.
562 *See id.*, Article 451.
563 *See* TRIPS Agreement, Article 42.
564 *See* TRIPS Agreement, Article 41.2.
565 *See* TRIPS Agreement, Article 41.1 and Preamble.

costs in satisfying the evidentiary requirements and still most likely will not be able to provide evidence to substantiate significant damages, it brings into question whether China's procedures are also inconsistent with Article 41.2, by being "unnecessarily complicated or costly."

Similar to the previous discussion on deterrence, the TRIPS Agreement, on its face, does not provide a definition for this crucial phrase. Accordingly, looking at the ordinary meaning of the word "unnecessarily" provides that enforcement procedures should not be "excessively" complicated or costly.[566] The term "complicated" is defined as "intricate, involved, confused, complex."[567] This idea that procedures cannot be excessively involved or costly coincides with the general obligation that right holders shall be entitled to enforce their rights, something they presumably would not be able to do if the methods for such enforcement were complicated and costly. The fact that right holders feel restricted in bringing cases because they know they will likely not be able to present sufficient evidence to establish damages adequate to even cover the cost of the proceedings, makes the aforementioned concern a reality. China's evidentiary procedures for civil enforcement of IP rights are unnecessarily complicated or costly because they effectively limit a right holder's ability to enforce its rights. To this extent, China's laws and regulations are also inconsistent with Article 41.2.

Finally, while it appears that China's laws are technically in compliance with the obligation in Article 43.1 to provide judicial authorities with the authority to order the opposing side to present relevant evidence, as has been stated before, it is not enough to simply provide

566 *Shorter Oxford English Dictionary*, Clarendon Press (5th Ed. 2002) at 3455 (stating the definition of unnecessary is "not necessary or requisite, needless; redundant; more than is necessary, excessive").

567 *Shorter Oxford English Dictionary*, Clarendon Press (5th Ed. 2002) at 469.

such authority. Read in light of the general obligations contained in Article 41.1, judicial authorities must actually use the authority so as to "permit effective action against any act of infringement of intellectual property rights…."[568] To the extent that Chinese judges do not use the provided authority to obtain evidence in the defendant's control that would be essential to awarding damages that may actually act as a deterrent to future infringements, China is not acting consistently with its obligations in Article 43.1.

D. Destruction of Infringing Goods and Materials

The issue of destruction, or lack thereof, is another persistent concern voiced by Members since the time of China's accession.[569] In addition to substantial financial damages, destruction of infringing goods, and the tools used to produce those goods, is an enforcement remedy that, on its face, has a clear deterrent effect: by destroying the infringing goods and tools it will be difficult, if not impossible, for the infringer to continue its illegal activity. The TRIPS Agreement addresses this fact in Article 46, providing other civil remedies (in addition to damages and injunctions discussed in Articles 44 and 45), which states:

> In order to create an effective deterrent to infringement, the judicial authorities shall have the authority to order that goods that they have found to be infringing be, without compensation of any sort, disposed of outside the channels of commerce in such a manner as to avoid any harm caused to the right holder, or, unless this would be contrary to existing constitutional requirements, destroyed. The judicial authorities shall also have the authority to order that materials and implements the predominant use of which has been in the creation of the infringing goods be, without compensation of any sort, disposed of outside the channels of

568 *See supra* Part 2, Section IV.A.
569 *See Working Party Report* at ¶¶ 300-301.

> commerce in such a manner as to minimize the risks of further infringements.[570]

The provision does provide for some judicial discretion by instructing the authorities to consider such destruction requests in light of the circumstances of the case in order to maintain "proportionality between the seriousness of the infringement and the remedies ordered."[571] Moreover, the provision states that "in regard to counterfeit trademark goods, the simple removal of the trademark unlawfully affixed shall not be sufficient, other than in exceptional cases, to permit release of the goods into the channels of commerce."[572]

China's trademark and copyright laws specifically grant administrative authorities with the ability to confiscate and destroy infringing goods,[573] and China's courts are granted the authority to confiscate such illegal goods in the civil code. Pursuant to Article 188 of China's civil law, "if the rights of authorship (copyrights), patent rights, rights to exclusive use of trademarks, rights of discovery, rights of invention…of citizens or legal persons are infringed upon by such means as plagiarism, alteration or imitation, they shall have the right to demand that the infringement be stopped, its ill effects be eliminated and the damages be compensated

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570 TRIPS Agreement, Article 46. (emphasis added)

571 *Id.*

572 *Id.*

573 *Trademark Law of China*, Article 53, attached as Exhibit 29; *Copyright Law of China*, Article 47, attached as Exhibit 26. Interestingly, the provision in China's copyright law relating to destruction contains the same vague language that the United States is currently contesting with respect to China's thresholds for criminal penalties. The copyright law states that "where circumstances are serious" the authorities may confiscate materials and tools used for producing the infringing goods. *See Copyright Law of China*, Article 47. Given that the TRIPS Agreement only requires that such authority exist, it is not likely the same language used in this context would be considered inconsistent with China's WTO obligations.

for."[574] Article 134 then provides the "main methods of bearing civil liability," which includes: ceasing infringements; removing obstacles; eliminating dangers; returning property; restoring property to its original condition; repairing, reworking or replacement; compensation for losses; eliminating ill effects and rehabilitating reputation. The article further states that these measures to impose civil liability "may be applied exclusively or concurrently. When hearing civil cases, a people's court, in addition to applying the above stipulations, may serve admonitions, order the offender to sign a pledge of repentance, and confiscate the property used in carrying out illegal activities and the illegal income obtained therefrom."[575]

While these provisions do not appear to explicitly authorize destruction of infringing goods and production materials in civil IPR cases, the courts have, on occasion, ordered such destruction, signaling that the authority does exist.[576] However, in a review of the same 36 cases discussed above, right holders requested destruction of the infringing products and/or tools in ten instances, yet such request was only granted once.[577] In that case, the owner actually requested destruction of the molds and tools used to make infringing plastic insulation material, rather than the infringing product itself, and the court ordered destruction of the goods, but not the molds and tools.[578] In three of those ten cases the right holder also requested destruction of the tools

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574 *General Principles of the Civil Law of the People's Republic of China,* Adopted at the Fourth Session of the Sixth National People's Congress, and promulgated by Order No. 37 of the President of the People's Republic of China on April 12, 1986, and effective as of January 1, 1987 [hereinafter "*China's Civil Law*"], Article 118, attached as Exhibit 33.

575 *China's Civil Law*, Article 134. (emphasis added)

576 *See* Miss Zhang Lianqin v. Ping Luo Construction, Ltd., *China Intellectual Property Report,* InterLingqua Legal Publishing, February 2007, at 6 (ordering destruction of infringing goods in a patent dispute).

577 *See* Case Summary Chart, attached as Exhibit 30.

578 *See* Miss Zhang Lianqin v. Ping Luo Construction, Ltd., *China Intellectual Property Report,* InterLingqua Legal Publishing, February 2007, at 6.

and molds used in producing the infringing products, yet these requests were not granted.[579] Chinese courts are much more inclined to grant requests for injunctions and order defendants to cease the infringing acts, but by not destroying the tools of infringement, the tools become available to the same party or to others, thereby permitting future infringement by the same or different individuals.[580]

It is difficult to understand the reasoning behind the judges' decisions with respect to destruction, and while the TRIPS Agreement does seem to allow for some discretion in deciding when destruction is a proper remedy, the TRIPS Agreement also emphasizes the deterrent effect such a remedy can have.[581]

By comparison, the civil enforcement system in the United States has an established history of destroying infringing goods and tools. Section 1118 of the trademark law is entitled "Destruction of infringing articles" and provides that when the courts determine that a violation exists, they may order all products bearing infringing marks and "all plates, molds, matrices, and other means of making the same," to be turned over for destruction.[582] Similarly, section 503 of the copyright law provides that as part of the final order, "the court may order the destruction or

579 *See* Bridgestone Limited, Japan v. Aeolus Tyre Limited et al., *China Intellectual Property Report*, InterLingqua Legal Publishing, November 2006, at 1; Zunhua Li Yuan Food v. Beijing Fu Yi Nong Chestnut, Ltd., *China Intellectual Property Report*, InterLingqua Legal Publishing, December 2006, at 2; Miss Zhang Lianqin v. Ping Luo Construction, Ltd., *China Intellectual Property Report*, InterLingqua Legal Publishing, February 2007, at 6.

580 *See, e.g.*, Bridgestone Limited, Japan v. Aeolus Tyre Limited et al, *China Intellectual Property Report*, InterLingqua Legal Publishing, November 2006, at 1 (denying Bridgestone's request to have the infringing tires and molds destroyed but ordering the defendants to stop manufacturing and selling the infringing goods); Zunhua Li Yuan Food, Ltd. v. Beijing Fu Yi Nong Chestnut et al., *China Intellectual Property Report*, InterLingqua Legal Publishing, December 2006, at 2 (denying plaintiff's request for destruction of all infringing products and molds but ordering the defendants to immediately cease the patent infringement).

581 *See* TRIPS Agreement, Article 46.

582 United States Trademark Law, 35 U.S.C. § 1118 (2007).

other reasonable disposition of all copies or phonorecords found to have been made or used in violation of the copyright owner's exclusive rights, and of all plates, molds, matrices, masters, tapes, film negatives, or other articles by means of which such copies or phonorecords may be reproduced."[583] Importantly, these laws do not simply exist, but they are actually enforced, with destruction being a common result in intellectual property disputes.[584] Additionally, these laws not only provide for destruction, but courts have affirmed that the right holder may be allowed to verify such destruction, so as to ensure that the infringing articles are really eliminated.[585]

While the patent statute does not contain a similar provision regarding destruction, courts have used their inherent powers to enforce judgments as a means of justifying such orders.[586] It is also common in the United States to obtain a seizure order prior to trial to both stop the harm of the infringement and to contain the infringing products and tools so that they may be destroyed upon a positive finding of infringement and the resolution of the case.[587]

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583 United States Copyright Law, 17 U.S.C. § 503(b) (2007).

584 *See, e.g.*, Christopher Phelps & Associates v. Galloway, 477 F.3d 128, 131 (4th Cir. 2007) (ordering the case to be remanded and suggesting destruction of copyright-infringing architectural plans); Capital Records, Inc. v. Mattingly, 461 F.Supp.2d 846,851-852 (S.D.Ill 2006) (granting permanent injunction against defendant and ordering defendant to destroy all copies of infringing music that were illegally downloaded onto a computer as well as the destruction of all copies that may have been transferred to any other physical medium or device); Health Industries Inc. v. European Health Spas, 489 F.Supp. 860, 869 (D.S.D. 1980) (ordering defendant to turn over all printed materials with the infringing trademark to the plaintiff for destruction); Amana Society v. Gemeinde Brau, 417 F.Supp. 310, 312 (providing that defendants must deliver all materials containing the infringing trademark to the plaintiffs for destruction).

585 *See, e.g.*, Knitwaves, Inc. v. Lollytogs Ltd., 71 F.3d 996, 1009 (2nd Cir. 1995) (reversing the lower court's finding of trademark infringement but affirming that an order of verification of destruction is allowed under both the trademark law and the copyright law).

586 *See* Lion Mfg. Corporation v. Chicago Flexible Shaft Co. et al., 106 F.2d 930, 934 (7th Cir. 1939) (addressing a dispute over whether the court had legal authority to order destruction of patent-infringing goods and concluding "that the court is vested with such authority by reason of its inherent power to enforce its judgments and decrees").

587 *See* United States Trademark Law, 15 U.S.C. § 1116(d); United States Copyright Law, 17 U.S.C. §§ 502, 503; *see also* First Technology Safety Systems, Inc. v. Depinet, 11 F.3d 641, 649 (6th Cir. 1993) (stating that

This system is in stark contrast to that of China, where destruction requests are frequently denied and it would appear that molds and tools used in making the infringing goods are usually left in the control of the infringer. While the TRIPS Agreement only requires authorities to have the power to order destruction, meaning that China would only be in obvious violation of its WTO obligations if its laws explicitly stated that the authorities could not destroy such goods and materials, if this power is rarely invoked and the patterns of infringement continue, China would appear to be violating its obligations to provide effective IP rights enforcement.

Pursuant to the customary rules of treaty interpretation, the provisions in TRIPS regarding civil procedures must be read in conjunction with the general enforcement obligations contained in Article 41.[588] Specifically, the requirement for authorities to be allowed to order destruction is addressed under Article 46, with the subheading "Other remedies."[589] This reference to remedies thus incorporates the general obligation in Article 41.1 that Members implement enforcement procedures that include remedies "which constitute a deterrent to further infringements." Accordingly, judicial authorities should not only have the authority to destroy infringing goods and tools, but this remedy should be applied in a manner so as to deter future infringements.

As discussed above with respect to damages, the word deterrence is not defined by the terms of the Agreement. However, the ordinary meaning of the word "deterrence" is "the action

it is "well established that 'the primary purpose of impoundment is to maintain the feasibility of the eventual destruction of items found at trial to violate the copyrights laws by safeguarding them during the pendency of the action.' Midway Mfg. Co. v. Omni Video Games Inc., 668 F.2d 70, 72 (1st Cir. 1981)").

588 *See* Dispute Settlement Understanding, Article 3.2; *see also EC – Chicken Cuts*, Panel Report, at ¶ 7.89.

589 *See* TRIPS Agreement, Article 46.

of deterring or preventing by fear."[590] The meaning of the word "deter" is further defined as: "(1) restrain or discourage (*from* acting or proceeding) by fear, doubt, dislike of effort or trouble, or consideration of consequences; (2) inhibit, prevent."[591] Pursuant to these definitions, the civil remedy of ordering destruction of infringing goods and tools would need to be applied so as to prevent or inhibit future infringements. Given that destruction of infringing goods seemingly prevents the possibility of future infringements by way of sale or other commerce, and destruction of infringing tools and molds seemingly prevents the possibility of future infringements by way of production, the deterrent aspect of this remedy is clear. However, because China rarely applies this remedy, it has no immediate deterrent impact because the infringing goods and tools are left in the control of the infringer.

Moreover, the ordinary meaning of the word "deterrence," and the phrase "deterrent to further infringement" encompasses a prospective view. As stated above, "deter" means to "restrain or discourage (*from* acting or proceeding) by fear,…or consideration of consequences."[592] By reading this general obligation with respect to remedies in conjunction with the civil procedures outlined in the TRIPS Agreement, it follows that in order for a Member's enforcement measures to be in compliance with its TRIPS obligations, the remedies it provides for in civil disputes should effectively deter future infringements of IP rights by making people fear the consequences of such infringing action.

590 *Shorter Oxford English Dictionary*, Clarendon Press (5th Ed. 2002) at 660.
591 *Id.* at 658.
592 *Id.* at 658.

While it is hard to gather concrete facts on levels of piracy and counterfeiting, the facts available show little to no decrease in illegal activity in recent years, further demonstrating that China's remedies lack deterrent effect. For instance, the International Intellectual Property Alliance reports that piracy levels concerning records and movies have remained constant in China over the last three years, at 85 percent.[593] Additionally, piracy levels of motion pictures in China increased between 2002 and 2004, from 91 percent to 95 percent, but then showed a slight decline in 2005 to 93 percent.[594] The lack of significant decline in these numbers is not surprising, given that (1) infringers in China are generally left with the tools to continue infringing behavior, meaning there is no loss of capital, and (2) the damages awarded in IP disputes are generally quite low. Rather, these numbers illustrate that the remedies provided by China's civil system has been ineffective in generating a significant amount of risk or fear to deter infringers and in preventing additional infringements. An environment in which infringement of IP rights continues even after civil actions and where courts are not ordering the destruction of equipment used in the manufacture of IP-infringing goods would appear to constitute a violation TRIPS Article 41.1.

With the extraordinary level of IP problems in China, it is not surprising that China's trading partners are pursuing information on activities by China to increase enforcement effectiveness. For example, in October 2006, through the WTO, the United States requested

593 *2007 Special 301 Report, People's Republic of China*, Comments to USTR from the International Intellectual Property Alliance, February 12, 2007, at 96.

594 *Id.*

information from China on its destruction activities.[595] Specifically, the U.S. requested information "with regard to the procedures regarding destruction of goods and materials used in producing counterfeit, pirated and other infringing goods pursuant to civil, criminal or administrative enforcement, for patent, trademark and copyright infringement."[596] The U.S. wanted to know, *inter alia*, whether goods or materials were destroyed or auctioned off after being seized or confiscated, and how they were restricted, if at all, from re-entering the channels of commerce. The U.S. also asked for statistics relating to "the destruction of goods and materials used to produce infringing goods in civil, criminal and administrative cases in 2005 and the first six months of 2006."[597]

China's response only addressed administrative seizures of trademark-infringing goods:

> With regard to the procedures for the destruction of goods and materials used in producing counterfeit, pirated and other infringing goods, [the Chinese representative] said that according to Article 53 of the Trademark Law the objects to be detained or confiscated were the infringing products and instruments specifically used for the manufacturing of infringing products and did not include products and materials not involved in infringing activities. All infringing goods that had been confiscated were being destroyed and not put up for auction. In 2005, the AICs had seized and destroyed more than 18,400 pieces of infringing goods, amounting to 7000 metric tonnes.[598]

595 *See Transitional Review Mechanism of China*, Communication from the United States, IP/C/W/482 (6 October 2006).

596 *Transitional Review Mechanism of China*, Communication from the United States, IP/C/W/482 (6 October 2006) at ¶ 6.

597 *Transitional Review Mechanism of China*, Communication from the United States, IP/C/W/482 (6 October 2006) at ¶ 6.

598 *Transitional Review Under Section 18 of the Protocol on the Accession of the People's Republic of China*, Report to the General Council by the Chair, IP/C/43 (21 November 2006) at ¶ 39.

While China is destroying certain IPR-infringing products, there is little information suggesting that the implements for producing infringing goods are being destroyed or otherwise being taken out of commercial use. With the problems of IP enforcement being so great in China, the United States can and should look at protecting its rights and benefits under the relevant WTO Agreements by utilizing the WTO dispute settlement system and filing additional requests for consultations.

CHINA'S LAWS, REGULATIONS AND PRACTICES IN THE AREAS OF TECHNOLOGY TRANSFER, TRADE-RELATED INVESTMENT MEASURES, SUBSIDIES AND INTELLECTUAL PROPERTY PROTECTION WHICH RAISE WTO COMPLIANCE CONCERNS

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