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# The Third-Shift Problem in china: The First Step is Admitting You Have a Problem

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## THE THIRD-SHIFT PROBLEM IN CHINA: THE FIRST STEP IS ADMITTING YOU HAVE A PROBLEM

*China's intellectual property laws remain paper tigers.*<sup>1</sup>

Aisha Farraj

Death by Apple iPhone seems almost impossible yet on July, 11, 2013, it became the harsh reality for a twenty-three-year-old flight attendant from China's Xinjiang region.<sup>2</sup> Ma Ailun, a flight attendant for China Southern Airlines, was electrocuted after answering a call on her iPhone while it was charging.<sup>3</sup> An investigation into Ma's death revealed that Ma was not using an official Apple iPhone charger, but rather a counterfeit third-party charger.<sup>4</sup> In response to Ma's death, Apple initiated a "USB Power Adapter Takeback Program" where customers could turn in third-party chargers at any Apple Retail Store or Apple Authorized Provider and purchase an official Apple charger for the discounted price of ten dollars.<sup>5</sup> While the program was initially aimed at American and Chinese Apple consumers, Apple eventually extended the program to a number of other countries, including Canada and the United Kingdom.<sup>6</sup> Ma's untimely death and the events surrounding it were the headline for news outlets across the globe and would become an even bigger story when a similar incident was reported less than a week later.

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<sup>1</sup> "Paper tiger,"( 纸老虎 in simplified Chinese) is a Chinese metaphor that refers to a particular subject appearing strong, but in reality is weak or powerless. For more information on the history of the metaphor see Henry Yuhuai He, *Dictionary of the Political Thought of the People's Republic of China* 649 (2001).

<sup>2</sup> *Electrocution Death Blamed on Charging iPhone*, CBCNews (Jul. 15, 2013), <http://www.cbc.ca/news/technology/electrocution-death-blamed-on-charging-iphone-1.1313114>.

<sup>3</sup> For the purposes of this Article, Chinese names are written with the family name first.

<sup>4</sup> Sean Levinson, *Woman Shocked To Death By Fake iPhone Charger Causes Apple To Reduce Charger Price*, Elite Daily (July 6, 2013), <http://elitedaily.com/news/technology/woman-shocked-to-death-by-fake-iphone-charger-causes-apple-to-reduce-charger-price/>. For discussion of what constitutes a counterfeit, see *infra* note 14-15.

<sup>5</sup> *Id.*

<sup>6</sup> Filip Truta, *Apple Updated USB Power Adapter Takeback Program*. Softpedia (August 13, 2013), <http://news.softpedia.com/news/Apple-Updates-USB-Power-Adapter-Takeback-Program-375119.shtml>. For full details of Apple's program, see *USB Power Adapter Takeback Program*, APPLE (August 6, 2013), <http://www.apple.com/support/usbadapter-takeback/>.

The second incident involved thirty-year-old Wu Jian Tong of Beijing who got electrocuted while plugging his iPhone into the wall to charge.<sup>7</sup> Wu was rushed to the hospital, with reports listing his last status as still being comatose ten days following the incident.<sup>8</sup> As in Ma's case, Wu was also using a counterfeit charger.

Ma and Wu are some of the latest victims of dangerous counterfeit products in the People's Republic of China (China or PRC). In 2004 there was a major outbreak of counterfeit baby formula that cost the lives of at least fifty Chinese babies and caused the malnutrition of more than 100 of other Chinese babies.<sup>9</sup> Cases of actual harm is not limited to within China as evidenced by a recent seizure by United States Customs. In February 2013, five people and five New York-based companies were accused of importing hazardous and counterfeit toys from China to sell in the United States.<sup>10</sup> The counterfeit toys were seized from shipping containers entering the United States from China on thirty-three separate occasions.<sup>11</sup> Seventeen of those seizures contained counterfeit toys with "excessive lead content and phthalate levels, small parts that presented choking and ingestion hazards, and easily accessible battery compartments."<sup>12</sup> These cases demonstrate the danger that counterfeiting poses to both United States and Chinese citizens alike.<sup>13</sup>

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<sup>7</sup> Philip Elmer-DeWitt, *Another Day, Another Round of iPhone Electrocution Headlines*, CNN Money (July 19, 2013), <http://tech.fortune.cnn.com/2013/07/19/apple-iphone-electrocution-charger/>.

<sup>8</sup> *Id.*

<sup>9</sup> For details of the outbreak, see Jonathan Watts, *Chinese Baby Milk Blamed for 50 Deaths*, The Guardian (Apr. 20, 2004), <http://www.theguardian.com/world/2004/apr/21/china.jonathanwatts>.

<sup>10</sup> Kristina Sgueglia, *5 Accused of Importing Counterfeit, Hazardous Toys*, CNN (Feb. 7, 2013), <http://www.cnn.com/2013/02/06/us/hazardous-toys/>.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> Although counterfeiting continues to be a global problem, this Article will focus on counterfeiting as it relates to the United States and China. The economic impact of intellectual property theft on American business is estimated to be approximately \$250 billion annually. see Laura C. Nastase, *Made in China: How Chinese Counterfeits are Creating a National Security Nightmare for the United States*, 19 Fordham Intell. Prop. Media & Ent. L.J. 143, 146 (2008). (citing Carlos M. Gutierrez, U.S. Sec'y of Commerce,

When discussing counterfeits there are three major categories that have emerged.<sup>14</sup> The first category is just plainly referred to as a “counterfeit.”<sup>15</sup> A counterfeit is a product that bears a trademark that its maker is unauthorized to use.<sup>16</sup> For example, a watchmaker from Texas who makes a watch and then puts the trademark Rolex on the back of it would have made a counterfeit. The second type of counterfeit is called a “knockoff.” Knockoffs are products that look like a branded product but do not actually bear an unauthorized trademark.<sup>17</sup> Typically, a consumer will know they are purchasing a knockoff because of the “product’s low price relative to the authentic good, the lack of

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Remarks at AdvaMed Annual Conference in Washington, D.C. (Oct. 2, 2007), *available at* [http://www.commerce.gov/NewsRoom/SecretarySpeeches/PROD01\\_004164](http://www.commerce.gov/NewsRoom/SecretarySpeeches/PROD01_004164).

<sup>14</sup> This Article discusses the three main types of counterfeit products that have emerged in the literature relating to counterfeits. For a different variation of these counterfeit categories, see Barry Berman, *Strategies to Detect and Reduce Counterfeiting Activity*, Business Horizons, May-June 2008, at 191.

<sup>15</sup> When discussing counterfeit products it is important to keep in mind that any one counterfeit product can infringe a number of different intellectual property rights. Consequently, there are three dominant categories of intellectual property rights that are typically infringed domestically and globally. See World Customs Organization, *Customs and IPR Report 2011 14* (2012), *available at* [http://www.wcoomd.org/en/media/newsroom/2012/july/~/\\_media/B5259E0497CA4FDF8CD64EB88F5D6CE7.ashx](http://www.wcoomd.org/en/media/newsroom/2012/july/~/_media/B5259E0497CA4FDF8CD64EB88F5D6CE7.ashx). Trademark infringement leads all other intellectual property rights, accounting for 91% of global counterfeiting cases. *Id.* As such, this Article will focus discussion on counterfeiting involving trademark infringement in China. A trademark is a “word, phrase, symbol or design, or a combination of words, phrases, symbols or designs, that identifies and distinguishes the source of the goods of one party from those of others.” United States Patent and Trade Office (USPTO), *Trademark, Copyright or Patent?*, [http://www.uspto.gov/trademarks/basics/trade\\_defin.jsp](http://www.uspto.gov/trademarks/basics/trade_defin.jsp) (last visited on Mar. 13, 2014). The typical definition of trademark infringement is the “use by another of the same or a similar mark that violates the prior trademark rights of another in the jurisdiction where such use occurs.” Int’l Trademark Ass’n, Global Trademark Resources, *Trademark Infringement*, <http://www.inta.org/TrademarkBasics/FactSheets/Pages/TrademarkInfringement.aspx> (last visited on Mar. 19, 2014). However it should be noted that the legal definition of what constitutes trademark infringement varies in every country. Patents and Copyrights are the two other intellectual property rights that are most commonly infringed both domestically and globally. For more information on patent infringement in China see Timothy J. Malloy, Christopher V. Carani & Yufeng Ma, McAndrews Held & Malloy, *What Every U.S. Corporation Should Know About China’s Patent Protection & Enforcement*, [http://www.mcandrews-ip.com/files/article/china\\_patent\\_protection.pdf](http://www.mcandrews-ip.com/files/article/china_patent_protection.pdf) (last visited Apr. 1, 2014). For more information on copyright infringement in China see Natalie P. Stoianoff, *The Influence of the WTO Over China’s Intellectual Property Regime*, 34 Sydney L. Rev. 65, (2012). For more general information on the enforcement of intellectual property rights in China see Jianqiang Nie, *The Enforcement of Intellectual Property Rights in China* (2006).

<sup>16</sup> Roger Parloff, *Not Exactly Counterfeit*, FORTUNE (April 26, 2006).

[http://money.cnn.com/magazines/fortune/fortune\\_archive/2006/05/01/8375455/](http://money.cnn.com/magazines/fortune/fortune_archive/2006/05/01/8375455/).

<sup>17</sup> Parloff, *supra* note 16. The term “knockoff” has also been used to encompass counterfeits that bear an unauthorized trademark. *Id.*

traditional packaging, and/or the unusual distribution channel.”<sup>18</sup> For purposes of clarity, “knockoffs” as referred to in this context does not include products that simply copy the design or style of another product.<sup>19</sup> Although knockoffs in the counterfeit context may not contain an infringing trademark, it may infringe another intellectual property right, such as copyright or patent. The third type of counterfeit is a “third-shift” counterfeit.<sup>20</sup> A third-shift counterfeit is “an unauthorized product made by an authorized contractor.”<sup>21</sup> As such, third-shift counterfeits are often referred to as “not exactly counterfeit” or a “third-shift good.”<sup>22</sup> Although all three categories of counterfeits pose problems for both the United States and China, this Article will focus on third-shift counterfeiting because it is essentially counterfeiting being done “right under the noses” of companies. As such, third-shift counterfeiting should be one of the first targets in reducing counterfeiting.

This Article examines third-shift counterfeiting in China and the attention that it has received from both the United States and China. In particular, the Article looks at United States companies that have outsourced the production of products to China. Part I of this article will analyze the current state of counterfeiting as it relates generally to the United States and China. Part II of the Article will explain the various dynamics of third-shift counterfeiting. More specifically, this section will look at a case involving New Balance sneakers where the problem of third-shift counterfeiting was exemplified.<sup>23</sup> Part

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<sup>18</sup> Berman, *supra* note 14.

<sup>19</sup> See *People v. Rosenthal*, No. 51738(U), 2003 WL 23962174, at 1 (N.Y. Crim. Ct. Mar. 4, 2003) (while discussing New York law, noted that “while it is perfectly legal to sell merchandise that copies the design and style of a product often referred to as ‘knock-offs’ it is against the law to sell goods that bear a counterfeit trademark”).

<sup>20</sup> The “third-shift” is also referred to as the “midnight shift,” or the “ghost shift.” Parloff, *supra* note 14. This Article will refer to this type of counterfeiting as “third shift.” The resulting products of this type of counterfeiting will be referred to as both “third-shift counterfeits” and “third-shift products.”

<sup>21</sup> Parloff, *supra* note 14.

<sup>22</sup> Parloff, *supra* note 14.

<sup>23</sup> See *infra* note 65.

III of the Article explains why the United States and China *can* and need to make better efforts to help combat third-shift counterfeiting. Part IV of the Article discusses the pitfalls of solutions that have already been attempted to battle third-shift counterfeiting. Finally, Part V proposes the possible solution of a China implemented, and U.S. supported, whistleblower program to help incentivize the reporting of third-shift counterfeiting in China.

## **I. THE CURRENT STATE OF COUNTERFEITING BETWEEN THE UNITED STATES AND CHINA**

China remains the primary source economy for counterfeit and pirated goods that enter the United States.<sup>24</sup> U.S. Customs and Border Protection reports that China represents seventy-two percent of all intellectual property rights (IPR) seizures.<sup>25</sup> This represents an increase of 12.5 percent increase from Fiscal Year 2011 to Fiscal Year 2012. Moreover, seizures of counterfeit goods from China and Hong Kong totaled an astonishing \$1.1 billion, a 10.4 percent increase from 2011.<sup>26</sup> Additionally, China remains on the United States Trade Representative (USTR) Priority Watch List for 2013.<sup>27</sup> China's government reports that in 2011 Chinese Customs seized approximately ten billion infringing goods valued at approximately RMB 50 billion or \$790 million.<sup>28</sup> Of these Chinese seizures, ninety-four percent of the infringing goods involved trademark

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<sup>24</sup> U.S. Customs and Border Protection, Office of Int'l Trade, *Intellectual Property Rights: Fiscal Year 2012 Seizure Statistics* 11 (2012), available at [http://www.cbp.gov/sites/default/files/documents/FY2012%20IPR%20Seizure%20Statistics\\_0.pdf](http://www.cbp.gov/sites/default/files/documents/FY2012%20IPR%20Seizure%20Statistics_0.pdf).

<sup>25</sup> *Id.* This statistic is based off of the manufacturer's suggested retail price (MSRP) of the seizures.

<sup>26</sup> *Id.* This statistic is based off of MSRP.

<sup>27</sup> United States Trade Representative (USTR), 2013 Special 301 Report 31 (2013). The USTR analyzes the IPR protection and enforcement of the ninety-five trading partners of the United States. The USTR then uses that information to compile a list of countries that are of most concern in regards to IPR protection and enforcement.

<sup>28</sup> Letter from the Int'l AntiCounterfeiting Coal., Inc. to Stanford McCoy, Assistant U.S. Trade Representative for Intellectual Property and Innovation, (Feb. 8, 2013) available at [http://www.iacc.org/assets/2013\\_iacc\\_special\\_301\\_final\\_.pdf](http://www.iacc.org/assets/2013_iacc_special_301_final_.pdf) [hereinafter IACC letter].

violations.<sup>29</sup> In addition, China's Administration for Industry and Commerce (AIC) reports that in 2011 the AIC handled 79,021 trademark violation cases, of which 68,836 were trademark infringement cases.<sup>30</sup> Of these trademark infringement cases, 17,022 were foreign related, with the AIC collecting and eliminating 11,8022 million illegal trademark labels.<sup>31</sup>

These figures show that counterfeiting in China continues to be rampant. Many would assume that better intellectual property rights laws would help stop the counterfeiting in China; however, it is not China's IPR laws that is the problem, it is the enforcement of those laws. China's trademark laws are actually quite comprehensive as written down. For example, Article 52 of the Trademark Law of the PRC lays out what constitutes infringement of the exclusive right to use a registered trademark.<sup>32</sup> In order for these intellectual property laws to have teeth China has to make better efforts to enforce them. Although China has made some strides in retroactively targeting counterfeiting (i.e. seizures of counterfeit products), China has not made a valiant effort to proactively

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<sup>29</sup> *Id.*

<sup>30</sup> Bd. of State Admin. for Indus. and Commerce (AIC), People's Republic of China, Annual Development Report on China's Trademark Strategy 2011 at 19 (2011).

<sup>31</sup> *Id.* The language of the AIC report indicates that the number of illegal trademark labels collected and eliminated was an astounding 118,022,000,000—that is over 100 billion!

<sup>32</sup> Trademark Law of the People's Republic of China art. 52 (promulgated by the Standing Comm. Nat'l People's Cong., effective October 27, 2001),

[http://www.saic.gov.cn/sbjenglish/flfg1\\_1/flfg/201012/t20101227\\_103092.html](http://www.saic.gov.cn/sbjenglish/flfg1_1/flfg/201012/t20101227_103092.html) (China). Article 52 states:

Any of the following acts shall be an infringement of the exclusive right to use a registered trademark:

- (1) to use a trademark that is identical with or similar to a registered trademark in respect of the identical or similar goods without the authorization from the trademark registrant;
- (2) to sell goods that he knows bear a counterfeited registered trademark;
- (3) to counterfeit, or to make, without authorization, representations of a registered trademark of another person, or to sell such representations of a registered trademark as were counterfeited, or made without authorization;
- (4) to replace, without the consent of the trademark registrant, its or his registered trademark and market again the goods bearing the replaced trademark; or
- (5) to cause, in other respects, prejudice to the exclusive right of another person to use a registered trademark.

Trademark Law art. 52

minimize counterfeiting (i.e. closing down factories that produce counterfeits). The next section will describe how enforcement of intellectual property rights usually plays out in China, using trademark rights as the example.

### Enforcing Trademark Rights in China

In order to bring a claim for trademark infringement in China the trademark must be registered.<sup>33</sup> If a trademark is registered, there are three main mechanisms for enforcement. The first and most common mechanism for enforcement is administrative action.<sup>34</sup> “Those who take the administrative route are almost exclusively Chinese.”<sup>35</sup> Throughout the provinces and in some cities, are the local Chinese government agencies that operate as a “quasi-judicial authority.”<sup>36</sup> These agencies that deal with infringement include the Intellectual Property Offices (IPOs), the AICs, the Copyright Office, and the Quality and Technical Supervision Bureaus (QTSBs) (local divisions of the Administration for Quality Supervision Inspection and Quarantine).<sup>37</sup> The AIC is most likely to handle a complaint of trademark infringement. If the agency is satisfied with a

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<sup>33</sup> See Trademark Law of the People’s Republic of China art. 51 (promulgated by the Standing Comm. Nat’l People’s Cong., effective October 27, 2001), [http://www.saic.gov.cn/sbjenglish/flfg1\\_1/flfg/201012/t20101227\\_103092.html](http://www.saic.gov.cn/sbjenglish/flfg1_1/flfg/201012/t20101227_103092.html) (China). Article 51 states that “the exclusive right to use a registered trademark is limited to the trademark which has been approved for registration and to the goods in respect of which the use of the trademark has been approved.” *Id.*

<sup>34</sup> Alan Cox & Kristina Sepety, *Intellectual Property Rights Protection in China: Litigation, Economic Damages, and Case Strategies*, in *Economic Approaches to Intellectual Property: Policy, Litigation and Management* 11.401, 11.402 (Gregory K. Leonard and Lauren J. Stiroh eds., 2005) available at [http://nera.myowg.com/extImage/PUB\\_IPR\\_Protection\\_China\\_IP1138.pdf](http://nera.myowg.com/extImage/PUB_IPR_Protection_China_IP1138.pdf).

<sup>35</sup> Thomas I. Ross, *Enforcing Intellectual Property Rights in China*, *China Business Review* (Oct. 1, 2012), <http://www.chinabusinessreview.com/enforcing-intellectual-property-rights-in-china/> [hereinafter Ross].

<sup>36</sup> Ross, *supra* note 35.

<sup>37</sup> China Intellectual Property Rights in Small and Medium Enterprises Helpdesk, *Enforcement of Intellectual Property Rights in China* 1, 1 (2013), [http://www.china-iprhelpdesk.eu/docs/publications/EN\\_Enforcement\\_Aug-2013.pdf](http://www.china-iprhelpdesk.eu/docs/publications/EN_Enforcement_Aug-2013.pdf) [hereinafter China IPR SME Helpdesk]. China IPR SME Helpdesk is a project funded by the European Commission’s Directorate-General for Enterprise and Industry under the Competitiveness and Innovation Framework Programme (CIP). China IPR SME Helpdesk objective is to assist small and medium sized European Union enterprises protect and enforce their IPR in or relating to China. *Id.* Currently, China IPR SME Helpdesk has eight offices in China.



trademark owner's complaint they will investigate.<sup>38</sup> Next, if the administrative agency does find trademark infringement, it has the authority to take actions against the infringing company.<sup>39</sup> The primary powers the agencies collectively have are the following: 1) raid an infringing company's premises and seize and destroy infringing product 2) grant an injunction to make an infringing company desist and 3) fine an infringing company for the infringement.<sup>40</sup> However, a U.S. company is usually at a disadvantage because these agencies are localized. "Many counterfeiters have successfully bribed or otherwise coopted local officials into allowing them to continue to operate."<sup>41</sup> Additionally, since counterfeiters sometimes account for the largest employers in some Chinese cities, the local agency may be reluctant to shutdown factories.<sup>42</sup> Another downside of taking the administrative route is that agency officials do not have the authority to award monetary damages.<sup>43</sup> A last disadvantage of administrative action is that there is no established appeal procedure.<sup>44</sup> Thus, if a trademark owner is dissatisfied with the agency's decision, it has to take case to court, which leads to the second enforcement mechanism.<sup>45</sup>

The second enforcement mechanism is judicial enforcement. Through civil litigation a trademark owner can seek injunctions, damages, and/or the surrendering and

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<sup>38</sup> Ross, *supra* note 35.

<sup>39</sup> China IPR SME Helpdesk, *supra* note 37, at 2.

<sup>40</sup> *Id.*

<sup>41</sup> Mark Turnage, *A Mind-Blowing Number of Counterfeit Goods Come from China*, Business Insider (Jun. 25, 2013, 10:28 AM), <http://www.businessinsider.com/most-counterfeit-goods-are-from-china-2013-6>.

<sup>42</sup> *Id.*

<sup>43</sup> Ross, *supra* note 35. Although an administrative agency cannot award compensation to an IPR holder, it can impose costs on the infringer for its acts of infringement. Kristina Sepetys and Alan Cox, *Intellectual Property Rights Protection in China: Trends in Litigation and Economic Damages*, NERA Economic Consulting 4 (2009), available at

[http://www.nera.com/extImage/PUB\\_IPR\\_Protection\\_China\\_0109\\_final.pdf](http://www.nera.com/extImage/PUB_IPR_Protection_China_0109_final.pdf) [hereinafter Sepetys & Cox, NERA]. It should be noted that information regarding administrative actions is not typically made public, making it difficult to assess their effectiveness. *Id.*

<sup>44</sup> Ross, *supra* note 35.

<sup>45</sup> *Id.*

destruction of tools/products.<sup>46</sup> Once a complaint is filed, the time to trial is usually less than a year.<sup>47</sup> After the accused infringer submits a timely answer, the court will usually give the parties a couple of months to submit their evidence in preparation for the trial.<sup>48</sup> However, “there is no discovery procedure, as there is in the United States, whereby revealing documents are produced, and development, sales, and profit information are revealed to the lawyers for the opposing party.”<sup>49</sup> Although the use of damages experts is permitted by law for both parties, it generally does not occur.<sup>50</sup> Thus, actual damages for infringement are difficult to determine because of the lack of evidence.<sup>51</sup> In the case of trademark infringement, statutory damages are adopted in most cases.<sup>52</sup> Under the current trademark statute, the maximum amount of damages is approximately RMB 500, 000 (approximately USD 80,000).<sup>53</sup>

The actual trial “consists of opening statements by the parties, a court-conducted investigation of the evidence and witnesses, a debate usually under questioning by the court, and brief closing statements.”<sup>54</sup> However, it is important to note that a trial for infringement in China “is usually preceded and followed by settlement negotiations

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<sup>46</sup> China IPR SME Helpdesk, *supra* note 37, at 3.

<sup>47</sup> Ross, *supra* note 35.

<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

<sup>50</sup> *Id.*

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

<sup>53</sup> Trademark Law of the People’s Republic of China art. 56 (promulgated by the Standing Comm. Nat’l People’s Cong., effective October 27, 2001), [http://www.saic.gov.cn/sbjenglish/flfg1\\_1/flfg/201012/t20101227\\_103092.html](http://www.saic.gov.cn/sbjenglish/flfg1_1/flfg/201012/t20101227_103092.html) (China). Article 56 states: “Where it is difficult to determine the profit that the infringer has earned because of the infringement in the period of the infringement or the injury that the infringer has suffered from the infringement in the period of the infringement, the People’s Court shall impose an amount of damages of no more than RMB 500, 000 yuan according to the circumstances of the infringement.” *Id.*

<sup>54</sup> Ross, *supra* note 35.

mediated by the judge.”<sup>55</sup> If both parties cannot agree upon a settlement then the “judge will retire to consider his decision and will hand down a judgment in due course.”<sup>56</sup>

The third enforcement mechanism is to subject intellectual property violations to criminal sanctions. Recently there has been a dramatic increase in the number of criminal cases involving intellectual property. The 2012 White Paper reports that Chinese courts handled 13,104 IPR-related criminal cases, up 130 percent year-on-year.<sup>57</sup> In such criminal cases, the PRC government has the option to subject IPR violators to harsh punishments.<sup>58</sup> Although rare, such prosecutions do take place as evidenced by the case of Xiao Zhenjiang.<sup>59</sup> In 2012, Xiao was sentenced to life in prison for counterfeiting Hermès bags.<sup>60</sup> The apparent basis for Xiao’s sentence was violation of Article 140 of the Criminal Law, “which criminalizes Producing and Marketing Fake or Substandard Commodities and calculates the length of sentence based on the estimated value of the goods.”<sup>61</sup> Nevertheless, the extent to which the PRC actually uses criminal law to prosecute IPR violations remains relatively infrequent.<sup>62</sup>

U.S. companies that fall victim to infringement in China typically will not pursue any of the aforementioned mechanisms of enforcement. Many believe that U.S. companies are discouraged from filing meritorious lawsuits because of the small

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<sup>55</sup> China IPR Helpdesk, *supra* note 37 at 3.

<sup>56</sup> *Id.* There is no specific time frame attached to when a judge has to hand down the decision. For more discussion on judicial enforcement see Sepetys & Cox, NERA, *supra* note 43.

<sup>57</sup> See *China Issues White Paper on Intellectual Property Protection*, CHINA BRIEFING (Apr. 29, 2013), <http://www.china-briefing.com/news/2013/04/29/china-issues-white-paper-on-intellectual-property-protection.html>.

<sup>58</sup> Margaret K. Lewis, *Criminal Law Pays: Penal Law’s Contribution to China’s Economic Development*, 47 Vand. J. Transnat’l L. (forthcoming 2014).

<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

<sup>61</sup> *Id.*

<sup>62</sup> *Id.*

compensation that is awarded in comparison to their losses.<sup>63</sup> In addition, “high criminal thresholds, as well as difficulties in initiating or transferring cases for criminal prosecutions” result in limited deterrence.<sup>64</sup> Nevertheless, U.S. companies that do business in China still, although, rarely, pursue infringers of their intellectual property rights. In the next section, this Article will discuss third-shift practices in China and the U.S. company of New Balance that actually attempted to use judicial mechanism of enforcement in China.

## **II. THE PROBLEM OF THE THIRD-SHIFT**

In order to understand the problem of the third-shift we must first examine the environment of which it is allowed to thrive in. This section will describe the circumstances that lead to third-shift problems, beginning with a discussion on outsourcing to China. Secondly, this section will describe the actual problem of the third-shift. Lastly, this section will discuss two of the few, if not only, publicized cases of apparent third-shift production in China.

### Outsourcing to China

For the last two decades, U.S. companies have used outsourcing as a means of driving down the prices of consumer goods.<sup>65</sup> Outsourcing occurs when a company for instance a U.S. company, chooses to employ a company in a country with cheaper production costs to manufacture the company’s products.<sup>66</sup> U.S. companies typically outsource the manufacturing of products to avoid the high wages and costs of producing

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<sup>63</sup> Sepetys & Cox, NERA, *supra* note 43 at 2.

<sup>64</sup> *Id.*

<sup>65</sup> Tim Phillips, Knockoff: The Deadly Trade In Counterfeit Goods 25 (2005).

<sup>66</sup> *Id.*

in the United States.<sup>67</sup> U.S. companies will often outsource the manufacturing of products to countries like China, where production can be done very cheaply because of low wages, labor abundance, and few health and safety regulations.<sup>68</sup>

Outsourcing to a company in China begins with a U.S. company entering into a licensing agreement with a Chinese manufacturer—often called an Original Equipment Manufacturer (OEM) company.<sup>69</sup> The U.S. company will grant the OEM a license to manufacture a specific number of products.<sup>70</sup> The U.S. company entrusts the OEM with the company’s intellectual property rights in order to enable the OEM to make the company’s products. It is from this relationship that the problem of the third-shift emerges. Say the U.S. company of NIKE orders 100,000 sneakers from its Chinese OEM. The OEM fills the order from NIKE during its two eight-hour day shifts but then runs off 20,000 additional sneakers during a “third-shift” at night.<sup>71</sup> Often times the OEM will use inferior materials to make the third-shift counterfeit products.<sup>72</sup>

Third-shift products will usually look like the authentic product because both products (the third-shift product and the authentic product) were manufactured using the same machines.<sup>73</sup> However, although the two products may look the same, the third-shift product is usually of a lower standard, which can become very dangerous for

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<sup>67</sup> *Id.*

<sup>68</sup> Michele Nash-Hoff, *Viewpoint: Why is China Cheaper?*, INDUSTRY WEEK (Aug. 18, 2011), <http://www.industryweek.com/environment/viewpoint-why-china-cheaper>.

<sup>69</sup> Dan Harris, *Not Exactly Counterfeit—New Balance Shoes and China’s “Third Shift,”* China Law Blog (May 1, 2006), [http://www.chinalawblog.com/2006/05/not\\_exactly\\_counterfeit\\_new\\_ba.html](http://www.chinalawblog.com/2006/05/not_exactly_counterfeit_new_ba.html).

<sup>70</sup> Phillips, *supra* note 65, at 26

<sup>71</sup> The OEM owner essentially turns the factory into a twenty-four hour operation, with the unofficial extra shift using shoddy materials, unofficial labor, and safety shortcuts. Phillips, *supra* note 65 at 26.

<sup>72</sup> Parloff, *supra* note 16.

<sup>73</sup> Phillips, *supra* note 65, at 26.

consumers.<sup>74</sup> Once the OEM has produced the third-shift products, the OEM will both figuratively and literally sell the third-shift counterfeits out the back door.<sup>75</sup> Alternatively, an OEM may choose to sell the “night shift” to a counterfeiter.<sup>76</sup> Nevertheless, an OEM stands to make a huge profit by solely producing and selling third-shift counterfeits for itself.<sup>77</sup> The OEM can make a large profit because of the use of cheap materials and labor and also because the OEM avoids paying the U.S. company a licensing fee.<sup>78</sup>

The relationship between a U.S. company and an OEM is referred to as a “self-reporting relationship.”<sup>79</sup> The relationship is “self-reporting” because the OEM “declares how many products it made and pays a licensing fee to the [U.S.] company based on that figure.”<sup>80</sup> The opportunity to provide false figures is apparent, as the OEM is the only one reporting how much product the OEM is producing. The global accountancy firm of KPMG found that the self-reporting economy is worth approximately \$500 billion “but, when it surveyed 11 companies that used outsourcing as a way of manufacturing products, 70 percent of the relationships produced reporting errors.”<sup>81</sup> Of the cases that produced errors, some were simple accounting errors, but other cases were because the OEM lied in its self-reporting, just so the OEM could pay less in licensing fees.<sup>82</sup>

### Third-shift Production

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<sup>74</sup> *Id.* Typically, an OEM that is producing third-shift goods will use either inferior material to make the third-shift goods or alternately use scrap material from the production of authentic goods. Harris, *supra* note 69.

<sup>75</sup> Phillips, *supra* note 65, at 26.

<sup>76</sup> Parloff, *supra* note 16.

<sup>77</sup> Phillips, *supra* note 65, at 26.

<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

Third-shift production has become such a severe problem that many U.S. companies cannot tell whether an unauthorized product is just a typical counterfeit (i.e. a product bearing a trademark that its maker was unauthorized to use) or if the unauthorized product was created during a third-shift.<sup>83</sup> This was illustrated by the case of *Too Inc. v. TJX Cos.*<sup>84</sup> In *Too Inc. v. TJX Cos.* Too Inc., which operates the Limited Too chain of girl clothing stores, learned that discount store TJ Maxx was selling thirty-one different styles of Limited Too clothing at markdowns (653,000 garments in total).<sup>85</sup> However, TJ Maxx was stocking more units of the garments than was ever ordered by Too Inc. from its Asian suppliers, (a majority of which are located in Hong Kong).<sup>86</sup> In addition, the garments that Too Inc. did order were still being sold in Too's stores.<sup>87</sup> Too Inc. ended up suing TJ Maxx for trademark infringement in the Southern District of Ohio in order to stop the sales.<sup>88</sup> During the suit, the lawyers for Too Inc. admitted that they were unsure of whether the garments were a typical counterfeit or whether the garments were a product of a third-shift.<sup>89</sup>

The distinction between an unauthorized product being a counterfeit or a third-shift product comes into play when a judge has to decide if the court should enjoin the sales. Judges can enjoin discounters under the Lanham Act from selling counterfeits, but some judges will let discounters sell third-shift goods because of the view that third-shift goods are "legally genuine."<sup>90</sup> However, the judge in the *Too Inc.* case found that even

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<sup>83</sup> Parloff, *supra* note 16.

<sup>84</sup> *Too, Inc. v. TJX Cos.*, 229 F. Supp. 2d 825 (S.D. Ohio 2002).

<sup>85</sup> Donald E. deKieffer, *Underground Economies and Illegal Imports* 14 (2010).

<sup>86</sup> *Id.*

<sup>87</sup> *Id.* Most discount stores sell clothes that are out-of-season and thus it is suspicious if a discount store is selling items that are still being sold in a brand name store.

<sup>88</sup> *Id.*

<sup>89</sup> *Id.*

<sup>90</sup> *Id.* See 15 U.S.C. §§ 1051 (2014).

third-shift goods were a form of trademark infringement and thus enjoined the sales.<sup>91</sup> Although the *Too Inc.* case highlights how the issue of third-shift goods can come before a court in the United States, it does not illustrate how the problem is handled from the point of view of where the third-shift good was actually produced. For a better understanding of that we look to the case of New Balance shoes.

#### New Balance Shoes

The case of New Balance shoes differs slightly from the typical third-shift production scenario. The New Balance case demonstrates what happens when a U.S. company terminates its contract with an OEM in China and that OEM does not stop production.

New Balance shoes began outsourcing to China in the 1990s.<sup>92</sup> As of 2006, seventy percent of New Balance shoes were made in China by OEMs.<sup>93</sup> One of New Balance's OEM use to be a man named Horace Chang, who owned a factory in Yang Jiang City.<sup>94</sup> Initially, Chang made New Balance shoes only for export, but in 1995, at Chang's request, New Balance licensed him to also distribute the shoes in the Chinese market.<sup>95</sup> Following modest initial sales, Chang found success selling an inexpensive New Balance style known as the "Classic."<sup>96</sup> The "Classic" shoe is described as a "colorful fashion shoe" with no midsole engineering, which is typically found in high-performance shoes.<sup>97</sup>

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<sup>91</sup> deKieffer, *supra* note 85, at 14. The court in *Too Inc.* found that the trademark infringement in third-shift goods was less serious than counterfeiting. *Id.*

<sup>92</sup> Parloff, *supra* note 16.

<sup>93</sup> *Id.*

<sup>94</sup> *Id.*

<sup>95</sup> *Id.*

<sup>96</sup> *Id.*

<sup>97</sup> *Id.*



In June 1999, Chang met with New Balance executives and announced that he projected sales of 250,000 in China for the “Classic” shoe.<sup>98</sup> Although shocked by this figure, New Balance executives became fearful that the New Balance brand was becoming associated in China with a fashion shoes instead of a performance brand.<sup>99</sup> Consequently, New Balance told Chang to stop selling the “Classics.”<sup>100</sup> However, Chang did not stop, instead he ordered material to produce 450,000 pairs of the shoe.<sup>101</sup>

In August 2009, New Balance terminated Chang’s license to make and distribute the “Classics.”<sup>102</sup> Upon termination, the contract required Chang “to return to New Balance all its confidential technical, production, sales, and marketing information, including molds, specifications, signs, labels, packages, wrappers, and ads.”<sup>103</sup> However, Chang did not and instead continued to sell the shoes, and even tried to sell the shoes outside of the country.<sup>104</sup>

To help stop the bleeding, New Balance made a request to the provincial divisions of China’s AIC to seize the unauthorized shoes from Chang’s factory. The AIC did seize about 100,000 pairs of Chang’s shoes from his stores and factories.<sup>105</sup> The shock to New Balance would not be the amount of shoes that was seized from Chang, but instead would be the discovery that Chang “had launched a competing line of classic-style sneakers

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<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

<sup>101</sup> *Id.*

<sup>102</sup> *Id.* The termination was effective December 31, 1999. New Balance’s sourcing department made the discovery that Chang was still producing because of his large order for materials to produce the unauthorized sneakers. *Id.*

<sup>103</sup> *Id.*

<sup>104</sup> *Id.* New Balance is unsure whether Chang continued to produce the “Classics” after 1999 or if he was just selling stockpiled inventory. *Id.*

<sup>105</sup> *Id.*

under his own brand.”<sup>106</sup> Chang’s own shoe brand was called “Henkees” and had a logo on the saddle of the shoe that appeared to be a distorted “Hi.”<sup>107</sup> The “Hi” on the shoe looked very similar to New Balance’s block N saddle sign.<sup>108</sup> New Balance had an arbitration clause in its contract with Chang, with all disputes to be heard by an international arbitrator applying Massachusetts law.<sup>109</sup>

Although the international arbitrator did assess the damages of New Balance’s case, it could not provide an injunction for Chang to stop selling the New Balance “Classics.”<sup>110</sup> Thus, in 2000 New Balance sued in Shenzhen Intermediate People’s Court in order to obtain an injunction. In February 2002, the Shenzhen court found in favor of Chang—“[T]he court found that while New Balance had terminated its licenses with Chang’s Hong Kong operating company, it had failed to do so with respect to Chang’s Yang Jiang factory.”<sup>111</sup> The court also found that the Yang Jiang’ factory’s license to make the shoes, carried an implied license to distribute the shoes without having to pay any royalties.<sup>112</sup> This came as a complete shock to New Balance since New Balance had never licensed the Yang Jiang factory to distribute New Balance shoes.<sup>113</sup>

Following Chang’s victory, the lawyers for New Balance appealed to the Provincial High Court. The High Court heard the case in 2002 and it was months before New Balance heard any word on the Court’s decision. New Balance was notified through two intermediaries that New Balance could have the courts decision for the hefty price of

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<sup>106</sup> *Id.*

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

<sup>113</sup> *Id.*

\$300,000.<sup>114</sup> In September 2003, after multiple monetary requests through intermediaries for the lead judge on the three-judge panel for the case, and after several New Balance rejections of such requests, New Balance reported the corrupt practices to the province’s supervisory bureau for courts.<sup>115</sup> In April 2004, following a request by New Balance, the lead judge was replaced.<sup>116</sup> Finally, in January 2005, the Guangdong High Court made its ruling, affirming in favor of Chang.<sup>117</sup> New Balance was completely dissatisfied by the decision and thus petitioned for a rehearing in spring 2006.<sup>118</sup> As of May 2006 the rehearing had not taken place. Nevertheless, estimating New Balance’s damages under United States standards does not have to be estimated as New Balance’s international arbitrator awarded New Balance \$9.9 million in damages.<sup>119</sup>

Following the incident with Chang, New Balance implemented a number of protective measures for future dealings with OEMs. New Balance is now more vigilant in monitoring its supply chain—researching and checking out OEMs in advance.<sup>120</sup> New Balance has since reduced the number of OEMs it does business with in China.<sup>121</sup> In addition, New Balance includes stringent audit clauses in their contracts with OEMs and enforces those clauses.<sup>122</sup> Lastly, New Balance now embeds encrypted information in

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<sup>114</sup> *Id.* The intermediaries were the mouthpieces of the lead judge on the case who wanted New Balance to pay the judge in order to get the Court’s decision. *Id.*

<sup>115</sup> *Id.* Although it appears that the lead judge handling the New Balance case was in fact corrupt, there is also what is sometimes referred to as “false corruption” in China. Essentially “false corruption” is when a intermediary claims to be seeking money on the behalf of a Chinese judge, but really that intermediary is really just acting on his or her behalf to pocket the money. Harris, *supra* note 69.

<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> *Id.*

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

<sup>121</sup> Berman, *supra* note 14 at 196.

<sup>122</sup> Parloff, *supra* note 16.

security tags in its shoes and monitors the amount of tags it issues to help battle third-shifts.<sup>123</sup>

The case of New Balance shows the importance of managing and controlling both OEMs and intellectual property rights in China. U.S. companies cannot keep treating counterfeiting as a so-called “soft crime” or “cost of doing business” because while counterfeiting increases, consumers’ faith in U.S. companies can potentially decrease. In the next section this Article will discuss the importance of battling third-shift counterfeiting.

### **III. WHY THE UNITED STATES AND CHINA NEED TO MAKE BETTER EFFORTS TO BATTLE THIRD-SHIFT COUNTERFEITING**

The problem of the third-shift exists and both the United States and China need to make better attempts to solve the problem in order to calm increasing concerns surrounding counterfeits and restore confidence in the consumer goods market. Typically, U.S. companies will not admit to having experienced third-shift activity.<sup>124</sup> U.S. companies usually do not admit to the third-shift problem because it essentially gives off the appearance that the U.S. company did not conduct sufficient due diligence.<sup>125</sup> Remember, the third-shift problem is created by people that the U.S. company hired, and thus the U.S. company could suffer bad press or be looked at as untrustworthy to consumers. When the New Balance case came to light, other U.S. companies that do business with OEMs in China were asked about the issue—of those companies many declined to discuss the issue or denied ever experiencing the issue.<sup>126</sup>

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<sup>123</sup> *Id.*

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

Moreover, even if a U.S. company does experience a third-shift problem, the U.S. company will usually choose not to litigate in Chinese courts.<sup>127</sup> The main reason for choosing not to litigate is because doing so would publicize the U.S. company's failure to do sufficient due diligence and also because the U.S. company does not want to alienate local Chinese officials with whom the U.S. company deals with.<sup>128</sup> Additionally, as discussed earlier, U.S. companies may feel as though pursuing infringers is just not financially worth it due to low damage awards.

Nevertheless, the secret of the third-shift is "out," and the United States and China need to admit it is a problem and start taking steps to combat the problem. Third-shift goods, like any other counterfeit, pose a huge risk to both consumers and companies alike. Consumers deserve to feel confident when they purchase a product that it is authentic and safe to use. U.S. companies that outsource to China must make better efforts to combat third-shifts because their reputation depends on providing such authentic and safe products. In the next section, this Article will discuss the pitfalls of attempted solutions to battle third-shifts.

#### **IV. PITFALLS OF ATTEMPTED SOLUTIONS TO BATTLE THIRD-SHIFTS**

When trying to find a solution to target the third-shift problem, there have been a number of attempted solutions. The first attempted solution has been for U.S. companies to provide OEMs with "one or more discrete components of a product such as a sew-on label."<sup>129</sup> The idea here is that the U.S. company will closely control the distribution of the such components and each component will contain track-trace technology (in most

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<sup>127</sup> *Id.*

<sup>128</sup> *Id.*

<sup>129</sup> deKieffer, *supra* note 85.

cases covertly).<sup>130</sup> The component that the U.S. company chooses becomes a “control component,” meaning that the U.S. company provides to the OEM only enough tracking components to fill the U.S. company’s order of the OEM produced goods.<sup>131</sup> Consequently, if an OEM decides to run a third-shift and includes fake “control components” in the final third-shift product, the U.S. company will easily be able to detect the fake “control component.”<sup>132</sup> Although the U.S. company can detect a counterfeit product because of the presence of a fake control component, this attempted solution does not remedy the production of the counterfeit in the first place. This sort of remedy would be beneficial in cases like *Too, Inc.*, where the means of production of the unauthorized garments was unclear. However, the case of *Too, Inc.*, came after hundreds of thousands of unauthorized garments already entered into the United States and into a discount store. The goal of remedying third-shift production should be just that—remedying the *production*.

A second attempted solution to address the problem of the third-shift has been to closely monitor OEMs. Similar to what New Balance did, this solution includes multiple subparts. In monitoring OEMs a U.S. company would implement the following procedures: (1) choose OEMs who have a history of being honest producers; (2) conduct surprise inspections of the OEM’s factories; (3) make sure the OEM returns all confidential information and intellectual property information upon termination of the

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<sup>130</sup> Track-trace technology can be specialty inks, radio frequency microchips called taggants, or forensic tracers. Often times “these covert technologies are embedded into labels and inks or directly into packaging components, providing a means to track diverted products and deter counterfeiters via invisible serial numbers, bar codes and so-called digital license plates that can be uncovered only with special readers or light sources...[F]orensic markers can also be embedded directly into the product itself, allowing companies to test samples of finish formulations for authenticity.” *Id.* (citing Christine Esposito, *Keeping It Real*, Beauty Packaging (April/May 2008), <http://www.beautypackaging.com/articles/2008/05/keeping-it-real>).

<sup>131</sup> *Id.*

<sup>132</sup> *Id.*

contract with the OEM; and (4) use multiple OEMs for the same product so that one OEM does not have enough information to copy a U.S. company's good.<sup>133</sup>

Choosing an OEM that has an honest history seems like a fairly simple solution. However, if third-shifts often go undetected how would a U.S. company *really* know that an OEM is truly an honest producer? In addition, an OEM can falsify records since the OEM essentially is in charge of its own doings in China.

Secondly, although surprise inspections could reveal third-shift practices, an OEM still has essentially home-court advantage. More specifically, an OEM can hide all third-shift products so that when, and if an inspector comes, the third-shift goods are hidden and out of sight.<sup>134</sup> In addition, an OEM can claim that suspiciously third-shift goods are actually "factory overruns," the so-called "oops, we made a few too many" goods.<sup>135</sup> Lastly, sending someone to China to conduct surprise inspections may become costly for a company.

Thirdly, ensuring that OEMs return confidential information and intellectual property rights seems like an obvious solution, but as demonstrated by the New Balance case, it is extremely difficult in practice. Essentially once a U.S. company outsources, it gives the OEM the specifications and blueprints to make the U.S. company's product.<sup>136</sup> It is comparable to the posting of an unwanted image on the Internet. Once an image is posted online it is open to be seen by the world. Although the post can eventually be taken down, it cannot be erased from those who already have seen it, saved it, or copied it. Often times an OEM will take a U.S. company's information and blueprints to a

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<sup>133</sup> Berman, *supra* note 14 at 191.

<sup>134</sup> Phillips, *supra* note 65, at 26.

<sup>135</sup> *Id.*

<sup>136</sup> Parloff, *supra* note 16.

factory down the road (typically owned by a relative) in the same county, and in no time there are counterfeits of the U.S. company's product throughout the county.<sup>137</sup> In addition, once a U.S. company shuts down production in a factory in China, the same factory will spring back up a few months later, making counterfeit products.<sup>138</sup> The resurrected factory owner already knows where to buy the raw materials and knows how to move the product, so it is a relatively simple transition from authentic to counterfeit production.<sup>139</sup>

Lastly, although multiple OEMs seems on its face as the best solution to help counter the problem of the third-shift it still does not stop an OEM from using what information it does have to make counterfeits. For instance, if Apple outsources to an OEM in China to make the non-electronic components of an iPhone and outsources to Taiwan to make the electronic components of the iPhone, Apple is still disclosing a number of intellectual property right abroad. In addition, in the technological world that we live in now, most products require assembly in one place. Lastly, the costs of essentially splitting production across two different places or even countries may not be financially worth it for some companies.

All of the abovementioned "solutions" are lacking in aspects of feasibility, both physically and financially. This Article proposes the solution of a China implemented whistleblowing initiative to report third-shift practices. The next section will discuss current Chinese whistleblower initiatives as evidence of why third-shift whistleblower program might be more effective.

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<sup>137</sup> In the 1990's this is exactly what happened to the motorbike maker Yamaha. A partner of Yamaha in China sold Yamaha's technology to a rival manufacturer. Within four months, counterfeit Yamahas were being sold throughout China. Parloff, *supra* note 16.

<sup>138</sup> *Id.*

<sup>139</sup> *Id.*



## V. PROPOSED SOLUTION: WHISTLEBLOWING PROGRAM FOR REPORTING THIRD-SHIFT PRACTICES

In order “to solicit the assistance of citizens in law enforcement” China inserts into many regulatory rules, provisions that financially reward informants.<sup>140</sup> More specifically, “Over the past two decades, the state has established a plethora of laws and regulations to sanction illegal practices such as sales of fake products or tax evasion, and provides material rewards to those who assist in the law enforcement.”<sup>141</sup> The amount of the reward is normally calculated in proportion to the reported violation.<sup>142</sup> The whistleblowing reward is then paid out once a tip is authenticated or a successful prosecution results.<sup>143</sup> The administrative agency that investigates the whistle blower tip is in charge of paying out the reward.<sup>144</sup> Additionally, because some whistleblowing “rewards are substantial and noncompliance is rampant in China” there has been an emergence of “professional whistleblowers” who engage “full-time in seeking out illegal practices and claiming compensations from the violators or rewards from relevant government agencies.”<sup>145</sup> A closer examination of China’s recent and apparent success

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<sup>140</sup> Ji Li, *Suing the Leviathan-- An Empirical Analysis of the Changing Rate of Administrative Litigation in China*, 10 J. Empirical Legal Stud. 815, 836 (2013) [hereinafter Li, *Suing the Leviathan*].

<sup>141</sup> Ji Li, *Dare You Sue the Tax Collector? An Empirical Study of Administrative Lawsuits Against Tax Agencies in China*, Pac. Rim L. & Pol’y J. 25 (forthcoming 2014), available at <http://ssrn.com/abstract=2256021>. [hereinafter Li, *Dare You Sue*](citing Section 96, P.R.C. Food Safety Law (June 2009); Section 49, P.R.C. Law for the Protection of Consumer Rights (October 1993); Section 5, Measures re Rewarding the Reporting of Tax Evasion (July 2005)).

<sup>142</sup> *Id.* Li, *Suing the Leviathan*, *supra* note 140, at 836

<sup>143</sup> *Id.*

<sup>144</sup> For example, the AIC would pay a reward for an authenticated report of corruption. *Whistleblowing in China and the United States*, MWE China Law Offices, <http://www.mwechinalaw.com/news/2013/cia0813d.htm> (last visited Apr. 19, 2014) [hereinafter MWE China Law].

<sup>145</sup> Li, *Dare You Sue*, *supra* note 141 at 26 (citing Zhengfang Tang, *Zhongguo Sanqian Zhiye Dajieren: Qingjia Dangchan Chihachong* (“Three Thousand Professional Whistleblowers in China”), Nanguo Zaobao (Jan 22, 2008), available at <http://www.cctv.com/community315/special/C20532/20080122/104785.shtml>, last checked on August 23, 2013).

with whistleblower initiatives supports this Article's proposition that implementing a whistleblower program can help combat third-shift practices. The Article will first discuss China's corruption whistleblower initiatives. Second, the Article will discuss tax whistleblowers.

### Corruption Whistleblowers

China's whistleblower initiative to report political corruption is one of China's most recent and fruitful whistleblower programs. Most corruption whistleblowing in China takes place on the Internet, where a wide audience can be reached.<sup>146</sup> As such, whistleblowing in China has become a frequent phenomenon, with news reports and cases of corruption surfacing throughout the country.<sup>147</sup> "According to the Chinese Government's Fourth Working Conference on Whistleblowers in 2008, more than 70 percent of prosecutions of government officials for corruption were based on whistleblower tips."<sup>148</sup>

In 2009, China's Central Commission for Discipline Inspection (CCDI), the Communist party's anti corruption authority, setup a website for citizens to report corruption.<sup>149</sup> Although there are no definitive reports on the number of tips the site received, the CCDI claims that from 2008 to 2012 the commission received 301,000 whistleblowing reports online.<sup>150</sup> In September 2013, the CCDI launched a new whistleblowing website to report corruption and to also post official statements on

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<sup>146</sup> *China to Protect Online Whistleblowers, but Only Via Official Site*, Reuters, (Sep. 12, 2013, 5:56 AM), <http://www.reuters.com/article/2013/09/12/us-china-corruption-idUSBRE98B09B20130912> [hereinafter Reuters, *China to Protect*].

<sup>147</sup> *See China Media: Ukraine Crisis*, BBC, (Apr. 18, 2014, 3:14PM), <http://www.bbc.com/news/world-asia-china-27076190>.

<sup>148</sup> MWE China Law, *supra* note 144.

<sup>149</sup> Reuters, *China to Protect*, *supra* note 146. For the CCDI's 2009 whistleblowing website See [http://www.12388.gov.cn/html/jb\\_xz.html?\\_ga=1.11812148.1481983114.1394386787](http://www.12388.gov.cn/html/jb_xz.html?_ga=1.11812148.1481983114.1394386787). For the actual homepage for the CCDI See <http://www.ccdi.gov.cn>.

<sup>150</sup> Reuters, *China to Protect*, *supra* note 146.

officials being investigated.<sup>151</sup> China's decision to launch the new site came as a response to the influx of Chinese citizens taking to social media to expose and criticize corruption.<sup>152</sup> According to the new site, the Chinese government would legally protect whistleblowers from retribution if they report corruption through the site.<sup>153</sup> During a webcast on the new website, Cui Shaopeng, the secretary general of the CCDI, explicitly stated that the commission would "severely deal with revenge attacks."<sup>154</sup> Additionally, Cui noted that citizens that file reports using their real name and contact details would be given priority.<sup>155</sup> However, the CCDI site also makes clear that "whistle-blowers are responsible for the authenticity of their reports" and that reporting false information is a crime.<sup>156</sup> In terms of compensation for reporting corruption, the award amount tends to vary depending on which local Chinese government authority investigates the report.<sup>157</sup> "For example, the AIC of Shandong Province awards small sums of RMB 300 to 1,000 (approximately USD 50 to 166) for each tip, while the AIC of Yangjiang City in Guangdong Province caps rewards at RMB 30,000 (approximately USD 5,000)."<sup>158</sup>

Following the launch of the new whistleblowing site, many Chinese citizens expressed skepticism on how effective the new anti-corruption scheme would be in targeting corruption.<sup>159</sup> The main suspicion amongst citizens was that complaints filed through the site would be ignored. Additionally citizens feared that corruption

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<sup>151</sup> *Id.* For the new 2013, whistleblowing website See <http://fanfu.people.com.cn/wljb/>.

<sup>152</sup> *Chinese Government Launches Whistleblowing Site*, Circa News, (Sep. 13, 2013, 9:58 AM), <http://cir.ca/news/whistleblowing-in-china> [hereinafter Circa].

<sup>153</sup> *Id.*

<sup>154</sup> *Online Whistleblowers to Be Protected From Attacks*, China.org.cn, (Sep. 13, 2013), [http://www.china.org.cn/china/2013-09/13/content\\_30016245.htm](http://www.china.org.cn/china/2013-09/13/content_30016245.htm).

<sup>155</sup> *Id.*

<sup>156</sup> Circa, *supra* note 153.

<sup>157</sup> MWE Law, *supra* note 144.

<sup>158</sup> *Id.*

<sup>159</sup> Reuters, *China to Protect*, *supra* note 149.

whistleblowers would be arrested or attacked.<sup>160</sup> Such concerns are not totally without merit. Following the launch of the CCDI's 2009 website, authorities investigated some of the online accusations and jailed several low-level officials.<sup>161</sup> However, officials at the commission refuse to comment on how many reports the 2009 CCDI site actually received.<sup>162</sup> Following the launch of the CCDI's 2013 whistleblowing site, Zhu Ruifeng, one of China's most prominent whistleblowers, stated the commission "won't go after the really top corrupt officials."<sup>163</sup> If this sort of selective targeting exists in the implementation of the new whistleblower site, many citizens may choose alternate Internet channels for their whistleblowing.

As of August 2013, there were approximately three dozen Chinese whistleblowers that regularly posted reports online about alleged corruption and misconduct.<sup>164</sup> The problem with reporting corruption elsewhere on the Internet is that the Chinese government will not legally protect such whistleblowers from revenge attacks. As such, highly publicized news reports show that Chinese bloggers are increasingly being subjected to physical and verbal attacks over their reports of corruption.<sup>165</sup> On July, 8, 2012, blogger and self-styled whistleblower Li Jianxin was stabbed and splashed with

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<sup>160</sup> *Id.*

<sup>161</sup> *Id.*

<sup>162</sup> *Whistleblowers Pay Price Even As China Vows To Fight Corruption*, Reuters, (Aug. 5, 2013, 8:21 AM), <http://in.reuters.com/article/2013/08/05/china-corruption-whistleblowers-idINDEE97400N20130805> [hereinafter Reuters, *Whistleblowers Pay Price*].

<sup>163</sup> Reuters, *China to Protect*, *supra* note 149. Zhu Ruifeng runs a whistleblowing website called "People Supervision Net." In 2012, Zhu released a video of Lei Zhenghu, a district party chief of Chongqing, having sex with his much younger mistress. Communist Party officials are explicitly forbidden from having mistresses. Following the release of Zhu's video, Lei was sentenced to thirteen years in jail for bribery. See Reuters, *Whistleblowers Pay Price*, *supra* note 162.

<sup>164</sup> *Id.* This figure is estimated by Reuters and is based on the number of microblogs as well as media reports. *Id.*

<sup>165</sup> *Id.*

acid by two unidentified men.<sup>166</sup> Most of Li's information comes from informants, but none of his posts have led to investigations.<sup>167</sup> Li's use of informants highlights the potential of possibly posting false information. In such a case, bloggers like Li would have to be weary of more than just physical attacks. On September 9, 2013, China's top court and prosecutor issued a judicial interpretation to crackdown on "online rumors."<sup>168</sup> According to the judicial interpretation, "people will be charged with defamation if online rumors they create are visited by 5,000 internet users or reposted more than 500 times."<sup>169</sup> Additionally, the judicial interpretation stated that such defamation could lead to three years in jail.<sup>170</sup>

In sum, recent reports provide evidence that skepticism surrounding the new whistleblower site is not unfounded and could lead to potential pitfalls to cracking down on corruption. Nevertheless, the potential of the whistleblower site remains apparent. In order to further examine whistleblower programs in China, we next turn to tax whistleblowers.

## Tax Whistleblowers

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<sup>166</sup> *Id.* In 2012, Li Jianxin began posting accusations about official misconduct, illegal land grabs and nepotism in the city of Huizhou. The July 2013, attack on Li was not the first time he was subjected to retaliation for his postings. In March 2013, someone tossed a brick through his daughter's bedroom window. *Id.*

<sup>167</sup> *Id.*

<sup>168</sup> *China Threatens Tough Punishment for Online Rumor Spreading*, Reuters, (Sept. 9, 2013, 6:02 AM), [http://www.reuters.com/article/2013/09/09/us-china-internet-idUSBRE9880CQ20130909?feedType=RSS&feedName=technologyNews&\\_ga=1.46202919.1481983114.1394386787](http://www.reuters.com/article/2013/09/09/us-china-internet-idUSBRE9880CQ20130909?feedType=RSS&feedName=technologyNews&_ga=1.46202919.1481983114.1394386787) [hereinafter Reuters, *Online Rumor Spreading*].

<sup>169</sup> *Id.*

<sup>170</sup> *Id.*

Currently, China “rewards tax whistleblowers who contribute to the detention and prosecution of tax evasions a portion of the levies and fines subsequently assessed (capped at 5% of the deficiency).”<sup>171</sup> In addition, “Article 20 of the *Administrative Rules re Reporting Tax Violations*, issued by the national office of the STB, provides that tax report centers should notify the informant of the investigation result if he so requests.”<sup>172</sup> Once a tax whistleblower reports a suspected tax evasion to the local tax center the tax center investigates the tip for validity. If the local tax center does not investigate the tax whistleblower’s report of possible tax evasion, the tax whistleblower can put in additional requests to push the investigation.<sup>173</sup> Once a tax evader is prosecuted the tax whistleblower receives his reward. Tax whistleblowers also have the ability to file a lawsuit to challenge the award.<sup>174</sup>

Like the corruption whistleblower initiative, the tax whistleblower is rather organized and sophisticated, and most importantly, it is actually used. Both the corruption and tax whistleblower initiatives provide evidence that whistleblower initiatives in China have the ability to be successful. In the next section, this Article will discuss the proposed solution of a third-shift whistleblower initiative.

### Third-shift Whistleblower Initiative

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<sup>171</sup> Li, *Dare You Sue*, *supra* note 141, at 24 (citing Rules re Awards for Reporting Tax Law Violations (税收违法案件举报奖励办法), promulgated on July 27, 2005, available at the STB’s official website, <http://www.chinatax.gov.cn/n8136506/n8192153/n8192242/n8192667/n8194601/8248300.html>, last checked on August 2, 2012). See *Id.* at 23-27 (discussing a number of tax whistleblower cases and the evolution of the tax whistleblower phenomenon in China).

<sup>172</sup> Li, *Dare You Sue*, *supra* note 141, at 24 (citing Administrative Rules re Reporting Tax Violations, available at <http://www.chinatax.gov.cn/n8136506/n8136593/n8137537/n8138502/10640001.html>, last checked on August 23, 2013).

<sup>173</sup> Li, *Dare You Sue*, *supra* note 141, at 25 (citing Zhiqiang Huang, Jubao Shangjia Taoshui Jinhua Yiyuan Jiangli (“Reporting of Tax Violation Awarded One Yuan Only”), *Dongfang Zaobao* (Sept 24, 2011)).

<sup>174</sup> Li, *Dare You Sue*, *supra* note 141.

A proposed solution to help combat the third-shift problem is a Chinese implemented, and U.S. supported, whistleblowing program that allows the reporting of third-shift practices. Inserting whistleblower provisions into China's IPR laws and regulations to reward the reporting a third-shift practices can help expose such operations. Then, similar to the CCDI reporting website for corruption, the AIC can launch a website that allows for the reporting of third-shift practices. In order to be a successful program, the AIC or another IPR related agency would have to extend legal protection for informants that report such practices. Protection from retaliation is essential because most reporting would arguably be done by an employee of an OEM or by someone who knows a person working a third-shift. In addition, in order to encourage the whistleblowing, citizens must feel like they are going to be protected from any retaliation, be it local government retaliation or from other third-party citizens.

The pitfalls of a third-shift whistleblower website would be similar to those of the CCDI's website for corruption. One major pitfall would be that the government agency in charge with investigating the reports may choose to not investigate certain reports. For instance, the government agency may not want to pursue a tip if it would result in loss of a number of jobs in a specific region. This sort of selective enforcement could greatly hamper the whistleblowing initiative.

Nevertheless, the third-shift whistleblower program could serve both China and American interests. China continues to claim it is interested in cracking down on counterfeiting and the launching of the website would make the bold statement that they truly are making an effort. Additionally, however, China would have to release official reports of investigations and the outcomes of such investigations via the respective

government agency website. For third-shift whistleblower reports that yield successful results, the reward should be based on a percentage of the actual damages the IPR owner sustained. For example, a possible reward could be five percent of the total profit that was diverted from the IPR owner to the third-shift good producer.<sup>175</sup>

## **CONCLUSION**

The first step in solving the problem of the third-shift is for both China and the United States to admit that they have and had a problem. Once China and the United States accept the problem they will be better equipped to start combatting it. All counterfeit products pose threats to both consumers and companies alike. Third-shift counterfeiting is essentially counterfeiting “right under the nose” and as such it should be the first kind of counterfeiting addressed by companies. By launching a third-shift whistleblowing site, the United States and China will be taking a bold stand against counterfeits.