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EXHAUSTION OF TRADEMARKS AND PARALLEL IMPORTS IN CHINA

Daniel Chow*

I. INTRODUCTION

Although the People's Republic of China (PRC or China) has made many efforts to bring its intellectual property laws into compliance with international legal standards set forth in the World Trade Organization's Agreement on Trade Related Intellectual Property Rights (TRIPs) and other major international treaties, China has not taken a clear stance on many intellectual property issues, including trademark exhaustion and parallel imports of trademarked goods. This issue is of interest to many multinational companies (MNCs) that have established manufacturing facilities in China to

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2. Article 6 of World Trade Organization's Agreement on Trade Related Intellectual Property Rights (TRIPs) provides in relevant part that "nothing in this Agreement shall be used to address the issue of the exhaustion of intellectual property rights." Agreement on Trade-Related Aspects of Intellectual Property Rights, art. 6, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, LEGAL INSTRUMENTS-RESULTS OF THE URUGUAY ROUND, 33 I.L.M. 1125 [hereinafter TRIPs]. This provision was placed in TRIPs because, during the TRIPs negotiations, nations could not agree on one single regime for exhaustion of intellectual property rights. Exhaustion is also not addressed in any other major international intellectual property treaty. As a result, each nation decides on its own rules regarding exhaustion. The issue considered in this Article is exhaustion of trademark rights; a different set of rules are often applied to exhaustion of copyrights and patents.

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produce and sell goods in the China market. Parallel imports, or gray market goods, can undercut the price of goods manufactured by MNCs in China and compromise the ability of MNCs to exercise control over the sale and disposition of its goods.

A typical scenario involving parallel imports arises in the following way: The brand owner, a MNC, registers a trademark in China. The brand owner sets up a manufacturing facility in China in the form of a joint venture with a local Chinese partner or a wholly foreign owned enterprise (WFOE). The brand owner, the registered owner of the trademark, then licenses the trademark rights to its China joint venture, or WFOE, which serves as a manufacturing facility to produce the trademark goods for sale in China and, in some instances, for export to countries abroad, such as the United States. The goods exported from China are purchased abroad by a distributor in a foreign country who attempts to import the goods back into China.

3. Most of the world's most powerful MNCs now have a presence in China; thus, the resolution of the parallel imports issue raised in this Article will be of significant importance. See DANIEL C.K. CHOW & THOMAS J. SCHOENBAUM, INTERNATIONAL BUSINESS TRANSACTIONS: PROBLEMS, CASES, AND MATERIALS 488 (2d. Ed. 2010).

4. In this Article, the terms “parallel imports” and “gray market goods” are considered to be synonymous and will be used interchangeably.

5. Many MNCs wish to engage in price discrimination between national markets, i.e., charge different prices depending upon the economic conditions of the target nation. Price discrimination can be maintained only if the markets are segregated. If there is horizontal movement of goods between markets, then low cost goods will enter the market to undercut goods sold at higher prices. See infra Part II.C.

6. Why does the MNC follow this procedure, instead of permitting the joint venture or WFOE to register the trademark in its own name? If the MNC registers the trademark and then licenses it, the MNC is the owner of the trademark. If the MNC permits the China joint venture or WFOE to register the trademark, then the China entity is the owner of the trademark. A joint venture or WFOE is considered to be a separate legal entity and is a creature of Chinese law. Even if the MNC owns the joint venture in part or the WFOE in its entirety, the separate entity status of the Chinese companies means that the MNC is not entirely in control of the intellectual property and there is a possibility that the Chinese company will assign the intellectual property to an unrelated third party. This risk cannot occur if the MNC is the registered owner and licenses the intellectual property to the Chinese business entity. Most MNCs wish to maintain the principle that they are the owners of their intellectual property rights worldwide; a failure to maintain this principle might mean that the MNC will lose control of its intellectual property rights or lose them altogether, resulting in a business catastrophe. For further discussion, see CHOW & SCHOENBAUM, supra note 3, at 324–25.
In variations of the typical scenario, the brand owner enters into a licensing agreement with a licensee in a third country (such as Japan or Thailand) to manufacture the goods for sale in a foreign market. A third party (such as a distributor) then purchases the goods in the third country and attempts to import them into China where the brand owner has licensed its registered trademark to its joint venture, or WFOE. In these situations, the trademark owner or its licensee attempts to block the importation of the parallel goods with the strength of the exclusive rights created by the registered trademark; the claim by the trademark owner or the licensee is that importation of the parallel imports without its consent will constitute an infringement of the exclusive rights of the owner's PRC trademark.

Whether or not the owner or licensee of the registered trademark can block the importation of the gray market goods depends on what position China adopts on trademark exhaustion and parallel imports. If China takes the position that the first sale of the goods to a purchaser abroad exhausts the trademark rights—a position commonly known as international exhaustion—then the trademark owner will be unable to block the importation of the parallel imports. The rule of international exhaustion holds that the trademark owner has reaped the full benefits of the trademark once the goods are sold abroad and that the trademark rights are exhausted or terminated upon that sale. If China takes the position that the first sale of trademarked goods must occur within China before trademark rights are exhausted—a position known as national exhaustion—then the licensee or brand owner will be able to block the imports of gray market goods that are manufactured abroad and first sold abroad. The rule of national exhaustion holds that the trademark rights are exhausted only if the first sale occurs in the nation where the

9. Id.
10. See id.
trademark is registered and the trademark rights were created. 11 Unless the first sale occurs in the nation, trademark rights are not exhausted and the trademark owner continues to have the right to control the distribution of the trademarked goods. Under the rule of national exhaustion, the trademark owner can prevent the importation of the trademark goods without its prior authorization.

As of the publication date of this Article, China's position on exhaustion of trademark rights is uncertain. China's statutory regime contains nothing that directly addresses the issue; the few cases that have involved parallel imports have failed to resolve the issue definitively. Some commentators believe that a recent case decided in 2009 supports a rule of international exhaustion, allowing the importation of gray market goods into China without the prior authorization of the trademark owner under certain conditions. 12 A closer examination of the cases, however, indicates that it is difficult to articulate any coherent doctrinal position on the issue of parallel imports based on these cases. Even if, as some cases indicate, parallel imports will be permitted when certain conditions are met, there are many practical hurdles that can prevent an importer of gray market goods from satisfying such conditions.

At present, cases involving parallel imports of trademarked goods do not commonly arise in China. Parallel imports tend to occur when the brand owner can produce the goods at lower costs in a foreign market; the goods are purchased in the foreign market and imported into the target market where the imports can undercut the price of the goods produced and sold in the target market. China's low labor costs are a primary reason why China has become the manufacturing base for many MNCs in the modern global

11. For example, a gray market goods situation would arise when the goods are first sold in China, and an MNC manufactures and sells the goods in China. The purchaser then exports the goods to Country X, a foreign nation. A distributor in Country X purchases the goods and then exports them to China. Under a rule of national exhaustion, the goods must be allowed entry into China.

For now, China's low labor costs and the high quality of the goods produced by its skilled and industrious workforce are factors that make it unlikely that goods produced in other countries can be purchased at a lower price and imported into China. For this reason, only three cases involving parallel imports have ever been decided in Chinese courts, all of which are discussed in detail below. As China and other countries in Asia continue to develop, however, labor costs in China will continue to rise. MNCs may shift their international manufacturing to countries with lower labor costs than China, such as Vietnam, Cambodia, Thailand, and other countries in Southeast Asia or other regions of the world. When this shift occurs, it is likely that cases involving parallel imports will arise with greater frequency in China. For this reason, China will need to take a clear position on parallel imports.

In deciding which position to adopt on parallel imports, China is driven by several conflicting considerations. China is sensitive to the perception that it lacks respect for intellectual property rights and that its legal regime does not adequately protect foreign technology. China has come under a torrent of harsh criticism for being the largest source of counterfeit products and other forms of commercial piracy in the world. Because China is already generally viewed as lacking respect for intellectual property rights, China may feel some pressure to adopt a position on parallel imports that is consistent with the doctrine of other major trading powers, such as the United States, Japan, and the European Union (EU). China does not want to be perceived as a renegade country that adopts positions on intellectual property that are

17. See id.
18. The position of these countries and territories on exhaustion is discussed infra Part III.
at odds with the positions of other major trading powers. These factors could push China in the direction of adopting some version of international exhaustion, similar to positions adopted by Japan, the United States, and the EU, which allow parallel imports at least under certain conditions. At the same time, however, China espouses mercantilist trade policies that are intended to advance its competitive position in the world at the expense of its major competitors. China will also perceive the need to protect its own national economic and commercial interests in adopting new legal rules on technology and intellectual property. National self-interest might support a rule of national exhaustion by allowing the trademark owner, or its licensee, to block the importation of parallel imports unless the first sale occurs within China. This Article will examine these competing interests in further detail, analyze why courts in China have been reluctant to adopt a clear position on parallel imports, and explain why a legislative amendment to the Trademark Law of the People’s Republic of China (hereinafter Trademark Law) is likely necessary before China’s position on parallel imports is made clear.

II. RELEVANT LAWS AND CASES

Current PRC legislation contains no provisions that directly address the legality of parallel imports of trademarked goods. The most pertinent legislative provision is contained in Article 52 of the Trademark Law, which provides in relevant part:

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;

\[\ldots\]

(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.\(^\text{21}\)

Article 52(5) has been interpreted by a recent case to provide protection against parallel imports on the theory that such imports can cause "prejudice to the exclusive right" to a "registered trademark."\(^\text{22}\) Other than this single provision, there is no other legislative guidance in China's laws on the issue of parallel imports of trademarked goods and exhaustion of trademark rights. The provision itself is so general and broad that the text offers little direct guidance on its own. However, there is now case authority providing some indication of how this provision is interpreted by Chinese courts in parallel import cases.\(^\text{23}\) A review and analysis of the existing cases follows below.

**A. Lihua v. Business Trading Co.**

The earliest known case involving parallel imports is *Lihua v. Business Trading Co.* (hereinafter *Lux*), decided in 1999.\(^\text{24}\) In *Lux*, the plaintiff, Shanghai Lihua Co. Ltd., was a joint venture between Unilever Co. Ltd. (a multinational consumer products company based in the Netherlands) and a

\[^{21}\text{Id.}\]
\[^{22}\text{See Haiying, supra note 12; infra Part II.}\]
\[^{23}\text{Cases decided by courts in China do not have precedential value; however, they provide an indication of how courts approach issues and are of some value in predicting how future cases might be decided. The sole exceptions are decisions by the Supreme People's Court, the highest court in China, which is highly influential and has asserted broad legislative powers. See Daniel C.K. Chow, The Legal System of China in a Nutshell 211 (2d ed. 2009).}\]
\[^{24}\text{There is no official system of case reports in China; thus, many cases have no official records of any kind. Courts also do not issue opinions containing the reasoning used in decisions, but will often only issue a one or two sentence judgment. The rationales of cases discussed in this Article are known because of accounts by witnesses, lawyers, or, in some instances, by judges who decided the cases or who were present during the trials. The account of the *Lux* case is based on a description in Xiang Yu, The Regime of Exhaustion and Parallel Imports in China, 26 EUR. INTELL. PROP. REV. 105, 106–07 (2004).}\]
local Chinese business entity. On September 22, 1997, Shanghai Lihua entered into a trademark licensing agreement with Unilever, the owner of the registered trademark in China, for the use of the trademark “Lux,” used for soaps, and its Chinese trademark “Lishi” (a transliteration of Lux) in China. Shanghai Lihua agreed to manufacture consumer products and sell them under Unilever’s world famous trademarks in China. On October 5, 1998, Shanghai Lihua (the licensee) entered into a revised agreement, under which the licensee acquired exclusive rights to use the trademarks in China. The revised agreement also authorized the licensee to take any measures that it deemed necessary against any infringer of the trademarks. Later Shanghai Lihua took the necessary steps to register the licensing agreement with the State Trademark Office and the General Administrations of Customs. The registration of the licensing agreement was necessary to ensure that it would be recognized as lawful by the appropriate PRC authorities.

On May 28, 1999, the Customs authorities in the city of Foshan, in Guangdong Province of southern China, discovered and seized 895 boxes of Lux branded soap manufactured in Thailand and imported into China by the Business Import and Export Trading Company, a state owned enterprise in the Guangzhou Economic and Technology Development Zone. Shanghai Lihua subsequently brought an action in the Guangzhou Intermediate People’s Court, seeking an order to compel the defendant to cease importing and selling the goods.


32. Yu, supra note 24, at 106–07.

33. Id.
under those marks without prior authorization from the plaintiff. 34 The Guangzhou Intermediate People's Court accepted plaintiff's argument that the unauthorized importation and sale of the trademarked goods was an infringement of the plaintiff's exclusive license to the marks. 35 As a defense, the defendant claimed that the goods were parallel imports, but the court rejected the argument on the grounds that the defendant failed to prove that the use of the Lux trademarks in Thailand were authorized by Unilever. 36 The court ordered the defendant to cease importing the goods, pay damages in the amount of RMB 50,000 (about US $8,000), and publish an apology to the plaintiff in a popular local newspaper. 37

The facts of Lux suggest that a true parallel import situation was involved and presented an opportunity for the court to rule squarely on whether the importation of gray market goods, without the permission of the trademark owner or its licensee, constituted an infringement of the trademark. The court avoided reaching the parallel imports issue, however, by holding that the defendant failed to prove that it had made the Lux products under the authorization of Unilever. 38 In other words, the court held that the goods in that case were counterfeit goods and could be barred from importation on that simple basis. Undoubtedly, the parallel import issue was a much more complex and sophisticated issue for the court than the straightforward issue of whether the goods were counterfeits. The case also arose early in China's economic reform era, and the court may have lacked confidence in its ability to rule on such a complex issue with no precedent or existing authority in China. Unfortunately, the court's ruling—that the defendant's goods were counterfeit and could be banned—did not illuminate whether parallel goods could be imported into China without the prior authorization of the trademark owner or its exclusive licensee. The case may also indicate that the courts are reluctant to tackle novel and difficult issues.

34. Id.
35. Id.
36. Id.
37. Id.
38. Id.
B. Fahuayilin Inc. v. Shijihengyuan Inc. & Taipingyang Department Store

A second case related to parallel imports was decided in 2003 by the Beijing No. 2 Intermediate People’s Court.\(^39\) This case is significant because it is the only known authority, of any kind, that allowed the importation of gray market goods without the prior authorization of the trademark owner or its licensee. As we shall see, however, the case itself arose under a special set of circumstances and may be of limited value in predicting how courts will decide future cases involving parallel imports.

In *Fahuayilin Inc. v. Shijihengyuan Inc. & Taipingyang Department Store* (hereinafter *An’ge*),\(^46\) the plaintiff, Beijing Fahuayilin Commercial Company, signed a contract on October 30, 2000 to obtain an exclusive license for the use of the trademark “An’ge” from the An’ge Co. Ltd. of France.\(^41\) The French company was the owner of the “An’ge” trademark and licensed the exclusive use of the trademark to the plaintiff.\(^42\) The licensing agreement also provided the plaintiff with the exclusive right to sell clothing with the “An’ge” trademark in the cities of Beijing, Chongqing, and several other cities and provinces.\(^43\) Since about 2001, defendant Beijing Shijihengyuan Company had also supplied clothing with the “An’ge” trademark in the Taipingyang Department store in Chongqing,\(^44\) a large city in the Sichuan Province of western China. The defendant imported the clothing from Hong Kong through Hong Kong Ruijin Company, the licensee of An’ge Co. Ltd. of France, which had the right to sell An’ge clothing in Hong Kong.\(^45\)

On August 8, 2001, the plaintiff sued the defendant in a Beijing trial court, claiming that the defendant’s actions infringed on the plaintiff’s exclusive right to sell clothing with the “An’ge” trademark and was in breach of the Anti-Unfair Competition Law (AUCL).\(^46\) The plaintiff asked the court to

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\(^{39}\) See *id.* at 108–09.

\(^{40}\) The account of this case is based on a description in *Yu, supra* note 24, at 108–09.

\(^{41}\) *Id.*

\(^{42}\) *Id.*

\(^{43}\) *Id.*

\(^{44}\) *Id.*

\(^{45}\) *Id.*

\(^{46}\) *Id.* See also *Anti-Unfair Competition Law of the People’s Republic of*
order the defendant to stop its actions of unfair competition and to compensate the plaintiff for economic losses.\textsuperscript{47} The plaintiff brought its case under the AUCL because the French company had not registered the "An'ge" trademark in China and, therefore, could not sue for trademark infringement.\textsuperscript{48} The French company failed to register the trademark and, therefore, it had not acquired valid trademark rights under the PRC Trademark Law, which only recognizes registered trademarks.\textsuperscript{49} Rather, the plaintiff was relegated to suing under Article 5 of the AUCL, which provides in relevant part:

Managers should not use the following unfair methods in their business transactions which can damage other competitors:

(1) to feign the others' registered trade mark;

(2) to use the specific name, package, decoration of the famous or noted commodities, or use a similar name, package, decoration of the famous or noted commodities, which may confuse consumers distinguishing the commodities to the famous or noted commodities;

(3) to use the name of other enterprise or personal name and make people confuse this commodity to the other's commodity;

(4) to feign or pretend to be the certificate of attestation, mark of fame and high qualification, to feign the certificate of originally produced place of the commodities, which make others misunderstand the qualification of the commodities because of the false certificates.\textsuperscript{50}

The plaintiff asserted a cause of action under AUCL Article 5(2) above, which is similar to a claim of passing off under U.S. law.\textsuperscript{51} A crucial component of these claims under the

\textsuperscript{47} Yu, supra note 24, at 108.

\textsuperscript{48} Id.

\textsuperscript{49} Id.


\textsuperscript{51} Article 5(2) of the AUCL applies only to "famous" trademarks. See id. The court did not address the issue of fame in this case. "Passing off" occurs when a competitor of a trademark holder used the holder's marks on the
AUCL is consumer confusion—the consumer must be confused by the actions of the defendant in passing off its products as those of the plaintiff.

The trial court rejected the plaintiff's claim of unfair competition on the ground that the defendant had also validly acquired a right to sell "An'ge" clothing in China from the An'ge Co. of France. The Beijing Intermediate People's Court agreed with the trial court's decision and elaborated on the failure of the plaintiff to sustain its claim under the AUCL. The Intermediate People's Court found that the plaintiff had acquired the exclusive right to sell "An'ge" branded clothing in certain cities and regions of China, but the gray market goods, legally imported from Hong Kong and sold by the defendant, were genuine "An'ge" products manufactured and sold by An'ge Co. of France in Hong Kong. The Hong Kong distributor had acquired these genuine items from the French company in Hong Kong and had legally shipped them to the defendant in China. The Intermediate People's Court found that there could be no consumer confusion because the gray market items sold by the defendant were genuine and identical, or substantially similar, to "An'ge" goods manufactured and sold in China.

The facts in the An'ge case represent a true parallel goods situation: An'ge Co. of France, the brand owner and licensor, had entered into a licensing agreement with a Chinese distributor, who then attempted to export the goods to the defendant into China. This case presented an opportunity for competitor's own goods and passed them off as the holder's goods. This caused confusion among consumers and consumers might suffer harmed if the goods that were passed off were of an inferior quality. The competitor would also be taking a free ride on the goodwill established by the holder's mark. See CHOW & LEE, supra note 7, at 474. The tort of "passing off" is similar to, but different from, counterfeiting. A counterfeiter is intended to deceive consumers into thinking that they are purchasing a genuine article of the trademark holder. The counterfeiter is usually not a legitimate producer of any goods, but is in the business of creating fakes. A trader who passes off is often a legitimate competitor of the trademark holder and is in the lawful business of producing its own line of goods but may use a similar trademark (or trade dress) to confuse consumers into thinking that they are buying goods that are produced by the trademark owner or that are affiliated with the trademark owner.

52. Yu, supra note 24, at 108.
53. Id.
54. Id.
55. Id.
56. Id.
the courts to rule directly on the legality of importing gray market goods without the prior authorization of the trademark owner or its licensee. In this case, however, the trademark was not registered in China, so the plaintiff could not proceed under the Trademark Law (applicable only to registered trademarks) and had to proceed under the AUCL. A claim under the AUCL is based on business torts concepts and not on trademark rights; thus, the court was unable to rule on whether the licensee or trademark owner's rights in the trademark were exhausted. The court considered a claim based upon preventing consumer confusion. In a trademark claim, the owner or licensee could have argued that the exclusive territorial rights to the trademark allowed the owner to ban the importation of gray market goods, even in the absence of consumer confusion. While consumer confusion is crucial to a claim under the AUCL, consumer confusion is not necessary under a trademark theory that asserts the right to ban the gray market goods on the basis of the exclusive territorial rights to use the trademark. In other words, even though the importation of gray market goods might not violate the AUCL because of the absence of consumer confusion, a court might hold that the importation violated the PRC Trademark Law based on the exclusive rights to the trademark, which were not exhausted by a first sale abroad. Unfortunately, the court did not have an opportunity to rule directly on the exhaustion claim because the plaintiff could not assert a claim under the Trademark Law and, instead, relied on the AUCL.

Commentators have suggested that the court's reliance on the AUCL implies that parallel imports must be identical or substantially similar to the trademark goods for those goods to be permitted entry into China. The reasoning behind this view is that consumer confusion might exist in cases where the gray market goods are different in significant respects, or of lower quality. Then the imports might cause consumer confusion, at least in the absence of a clear label on the goods declaring the differences. Thus, the facts of the An'ge case suggest that it is of limited application in parallel

57. Id.
58. See id.
59. See id.
import cases involving trademarked goods: in An'ge, the gray market goods were identical or substantially similar to the trademarked goods; the trademark owner or the licensee could not rely on the Trademark Law because the mark was unregistered but had to resort to the AUCL to exclude the goods. Today, most MNCs immediately register their trademarks as part of the process of doing business in China.60

C. Michelin Group v. Tan Guoqiang and Ou Can

A third case involving parallel imports was decided in 2009.61 It is generally considered the most important existing case because it comes closest to taking a clear stance on the exhaustion doctrine. In Michelin Group v. Tan Guoqiang and Ou Can, the Michelin Group, a French MNC, registered a trademark for “MICHELIN & device” in China.62 Michelin’s China affiliate manufactured Michelin branded tires in China to be sold in the Chinese market.63 Michelin also entered into a licensing agreement with a Japanese licensee that authorized the licensee to manufacture tires in Japan and to sell the Japanese-made Michelin branded tires to buyers in Brazil.64 The defendants, Tan Guoqiang and Ou Can, were

60. See, e.g., New Progress in China’s Protection of Intellectual Property Rights (Apr. 28, 2005), available at http://www.chinareview.com/eng/bjql/t193102.htm (“Both the number of applications for trademark registration from foreigners and the number of registered foreign trademarks have kept increasing. In 1982, there were 1,565 foreign applications for trademark registration in China. The number exceeded 20,000 in 1993 and exceeded 60,000 in 2004. Before 1979, only 20 countries and regions had 5,130 trademarks registered in China. By the end of 2004, 129 countries and regions had had 403,000 trademarks registered in China. This represents almost an 80-fold increase over that in 1979, accounting for 18 percent of the total number of registered trademarks in China.”); see also Introduction of China’s Intellectual Property System (June 14, 2008), available at http://www.gov.cn/english/2008-06/14/content_1016453.htm (“By 2006, foreigners’ registered trademarks in China had reached 490,000. Multinational companies (MNCs) have set up an increasing number of R&D centers in China. All these demonstrate that IP laws have been enforced firmly in China, which (sic) applauded by foreign investors.”); White Paper Maps out China’s IPR progress, CHINA DAILY, June 8, 2009, available at http://www.chinadaily.com.cn/bw/2009-06/08/content_8257808.htm (“The number of overseas trademark registration applications continued to rise rapidly reaching 108,000, up 4.85 percent.”).

61. See Haiying, supra note 12.

62. Id.

63. Id.

64. Id.
tire dealers in China who purchased the Japanese-made Michelin tires, which were less expensive than the locally manufactured Michelin tires, and imported them into China. Michelin then sued the tire dealers in the Changsha Intermediate People’s Court for an order prohibiting the defendants from importing the gray market tires. Michelin had a registered trademark and was able to assert an infringement claim under the PRC Trademark Law. The issue seemed to be brought squarely before the court: could the owner of a registered trademark assert the exclusive rights under trademark law as a basis to exclude the unauthorized importation of gray market goods?

Once again, however, the court found an alternative ground to resolve the case and avoided deciding the case on the basis of the parallel imports issue. The court found that the gray market tires had not obtained a Chinese compulsory product certification (the so-called 3C certification), a government approval that indicates the product meets national safety standards. The court held that if the uncertified gray market goods had quality and safety problems, consumers would attribute the problems to Michelin and thereby damage Michelin’s reputation in China. The court appeared to find that the importation of the gray market goods under these conditions would cause “prejudice to the exclusive right” of the owner of a “registered trademark” within the meaning of Article 52(5) of the Trademark Law. In other words, the importation of the gray market goods without health and safety certifications would violate the PRC Trademark Law.

The Michelin case is significant because the court acknowledged the existence of the gray market goods and decided the case under the Trademark Law. In the Lux case

65. Id.
66. Id.
67. Id.
69. See Haiying, supra note 12.
70. Id.
71. Id.
discussed above, the court considered the goods to be counterfeit, but not as parallel imports. In the An'ge case, the court recognized the existence of the gray market goods but decided the case on the basis of AUCL. Although the Michelin court refused to allow the entry of the gray market goods, a number of commentators have argued that Michelin provides a roadmap for the successful importation of gray market goods into China.\textsuperscript{72} If the importer in Michelin had obtained the 3C certification, the court would have allowed the tire dealers to import the gray market goods without the prior authorization of the trademark owner.\textsuperscript{73} The case is considered to be the clearest indication that the PRC follows a regime of international exhaustion, permitting imports of gray market goods into China without the prior permission of the trademark owner, so long as the first sale occurred abroad.

A closer analysis of Michelin and the practical and political realities of doing business in China, however, indicates that obtaining the required approvals will be difficult and that many hurdles continue to prevent the importation of gray market goods into China. First, China has myriad regulations controlled by different administrative bureaus that can potentially apply to imported products.\textsuperscript{74}


\textsuperscript{73} See Haiying, supra note 12; see also Jia Yau, Parallel Imports in China Are Forbidden for Goods Without 3C Approval, MCDERMOTT NEWSLETTERS IP UPDATE (Aug. 2009), http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/2a1f1ad9-cafc-41a8-acd7-b857618d6ade.cfm.

Obtaining all of these approvals can be time consuming and burdensome. The 3C certification applies not only to tires but also to at least twenty other categories of goods. There are also other health and safety regulations that may apply to the same goods. If an importer of gray market goods approaches a PRC authority for certification and the authority refuses, there is no further recourse and the denial marks the end of the matter. This is a likely outcome because PRC bureaucrats are usually risk averse and are reluctant to take actions of questionable legality that might create problems later with their superiors or other bureaucracies. If a PRC official issues an approval that is later found to be improper or illegal, the official might be subject to discipline in the form of a reprimand or censure or, in extreme cases, the official might be subject to a sanction in the form of an unfavorable transfer or a missed promotion. Instead, PRC bureaucrats tend to give their approval for matters where there is clear legal authority so that their actions will not be questioned later.

In the case of parallel imports, there is no clear authority in any written statute or regulation and legal authority that might exist in case law is unclear, as the earlier discussion indicates. Moreover, the review and analysis of the cases set forth above indicates that the cases are, at best, unclear with respect to whether parallel imports are allowed into China without the prior permission of a registered trademark owner. Even if a court were to expressly rule that gray market goods could be imported without the consent of the trademark owner, the PRC approval authorities may not be willing to rely on the case, and may insist on a statutory directive. Courts do not have the same status or authority in China as they do in the United States; therefore, a decision by

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77. See Chow, supra note 16, at 755.
any court—other than possibly the Supreme People's Court—may be disregarded by China's bureaucracies as an inadequate authority.\(^{78}\) It is unlikely that a PRC national-level approval authority will be impressed with a decision rendered by an intermediate-level people's court in a distant province. This is especially true when the decision itself does not squarely address the gray market issue, and the rationale must be deduced from the case. Moreover, because none of the cases discussed in this Article was recorded in any officially-recognized form, the arguments must be made to the authorities on the basis of a judge or lawyer's recollections of the case set forth in an unofficial account. Again, this will hardly impress the PRC approval authorities.

Under the facts in *Michelin*, a more likely scenario is that when the tire importers approach PRC authorities for a 3C certification, the authorities will require the tire dealers to prove that the imports are authorized by Michelin, the registered trademark owner. Proof that the imports are authorized by Michelin would protect the officials from criticism that they have illegally certified the tire importers. Permitting the importation of the gray market goods without Michelin's permission might expose the officials to criticism or censure in the future. In other words, the officials will be safe from such criticism if they refuse to certify the goods or agree to certify the goods only after Michelin consents to the importation. And if the officials permit the entry of the parallel imports under any other circumstances, they expose themselves to legal risk. Of course, Michelin will most likely refuse to provide permission to the tire importers and the necessary approvals will be impossible to obtain, thereby preventing the entry of the gray market tires. The practical reality is that, in many cases, obtaining health and safety approvals presents difficult, if not insurmountable obstacles.

The review of the existing cases involving parallel imports in China indicates that there are several hurdles that need to be overcome before parallel imports will be permitted. A summary of those hurdles is provided here:

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78. Courts are not given any special status under the PRC legal system; they are but one part of the bureaucratic mechanism. See generally Randall Peerenboom, *Ruling the Country in Accordance with Law: Reflections on the Rule and Role of Law in Contemporary China*, 11 *Cultural Dynamics* 315 (1999).
(1) A court or other PRC authority may find that the importer has failed to offer adequate proof that the parallel imports were produced abroad with the authorization of the trademark owner. If the court rules in this way, the parallel imports will be treated as counterfeits, subject to seizure by PRC authorities and barred from entry into China. A court may rule that the goods are unauthorized in order to avoid reaching the parallel imports issue. 79

(2) A court or other PRC authority may find that the parallel imports are permitted under the Anti-Unfair Competition Law if the parallel imports are genuine goods and do not cause consumer confusion. 80 For this finding to occur, however, the trademark must be unregistered and the goods must be substantially similar or identical. If the trademark is registered, the trademark owner will be able to rely on the Trademark Law, which does not require consumer confusion. If the gray market goods are physically different, the court may refuse entry on the grounds that the goods might cause consumer confusion. It is unknown whether the courts will deem clear labeling sufficient to dispel consumer confusion.

(3) A court may allow parallel imports under the Trademark Law, but the importer will need to obtain any relevant government approvals indicating that the goods meet all national health and safety standards. 81 For practical reasons, these approvals may be difficult or impossible to obtain.

The review of the sparse judicial authorities in China indicates that it may prove difficult for importers to satisfy all of the conditions for the importation of gray market goods. The cases do not provide clear guidance on whether parallel imports are permitted and, if so, under what conditions. This result should not be surprising. With the exception of the Supreme People's Court, courts in China do not view themselves as having a law-making function; rather, courts tend to apply the law mechanically and are not inclined to

80. See id. at 108–09 (discussing the Fahuayilin Inc. v. Shijihengyuan Inc. & Taipingyang Dep't Store holding).
81. See Haiying, supra note 12.
generate a clear rule of law in a situation where a competent legislative body has not already created one. In addition, as the next part of this Article will discuss, the issue of parallel imports is controversial and implicates important national policies. Like other bureaucratic entities in China, lower-level courts are risk-averse and are not inclined to take a position on a controversial subject. Due to these factors, the reasoning of the lower courts in parallel import cases has hardly been clear, authoritative, or decisive. Until one is enacted, they may continue to decide cases with reasoning that is evasive or riddled with qualifications and exceptions, creating a muddled picture on the legality of parallel imports.

Unlike the lower courts, the Supreme People's Court (SPC) has asserted broad interpretative powers that are equivalent to legislative powers. The court has frequently issued judicial interpretations of laws that resemble legislative enactments, complete with numbered articles and provisions. To date, the SPC has not issued any legislation regarding parallel imports. This lack of any interpretive legislation by the SPC may be the result of deference to the Standing Committee of the National People's Congress, which issued the original legislation: the Trademark Law.

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82. See Chow, supra note 23, at 177. The basis of the Supreme People's Court's (SPC) authority to exercise legislative powers is of doubtful legality. Id. at 179. The SPC's power to issue judicial interpretations in reply to queries concerning the specific application of law from lower courts appears to be within its authority, because the SPC has often issued an interpretation of a specific law soon after it is enacted for the purpose of elaborating on the significance of the law. These interpretations are often longer than the laws themselves and resemble the laws in both form and substance. For example, after the National People's Congress in 1991 enacted the Civil Procedure Law, consisting of 270 articles, the SPC issued an interpretation consisting of 320 articles in 1992. After the National People's Congress issued the General Principles of Civil Law consisting of 156 articles in 1987, the SPC issued an interpretation consisting of 200 articles. These so-called interpretations can hardly be considered to be judicial interpretations in response to queries concerning the special application of laws. Rather, they are a form of supplemental legislation often issued in consultation after extensive negotiations by the SPC with the PRC's legislative and administrative organs. There is no basis for these laws in the PRC Constitution or in any express laws that delegate power from the National People's Congress to the SPC. See id.

83. See id. at 178.

84. The National People's Congress (NPC) is deemed by law to be China's main legislative body and is considered in theory to be China's highest authority. See id. at 88, 146. The NPC only convenes once a year for several weeks; the NPC Standing Committee is a permanent body that acts when the NPC is not in session. See id. at 92.
A clear legislative directive from the Standing Committee or the National People's Congress itself is needed that directly addresses the issue of parallel imports and takes a definitive position on whether they are allowed entry into China without the prior authorization of the owner of the registered trademark. This directive should take the form of an amendment to the Trademark Law. At present, no amendment or revision has been enacted or is in the progress of being enacted. The issue is more complex and controversial than it might first appear because it involves a number of competing policy interests in areas that are very important for China at this stage in its economic development. The next part of this Article reviews these competing interests.

III. THE DEBATE OVER PARALLEL IMPORTS IN CHINA

The debate over whether to permit parallel imports of trademarked goods in China implicates important and sensitive political, economic, and legal issues. The discussion below reviews the most important of these issues.

A. Harmonization with International Standards

China is sensitive to the perception that it does not respect foreign sourced intellectual property rights and technology.\textsuperscript{85} China has been portrayed frequently in the media as tolerating, or even supporting, massive levels of counterfeiting and commercial piracy,\textsuperscript{86} and many commentators consider China to be a renegade nation on IP issues. To counter this perception, China may feel pressured to adopt an exhaustion regime that is comparable to the major trading powers with which China now compares itself.

\footnotesize{\textsuperscript{85} See, e.g., Wang, supra note 1, at 258 ("China has devoted much manpower, materials, and financial resources to intellectual property protection and mobilized various institutions to carry out acts of cracking down on counterfeiting and burglary copyright. . . . As a system, intellectual property protection includes the legislative protection, administrative protection, juridical protection, protection of collective managerial organization of intellectual property, technical protection, and the self-relief of the intellectual property owner. The protection in these six aspects is interpenetrated and interworked, forming a stereoscopic line of defense of socially comprehensive harnessing.").}

The United States adopts a regime of national exhaustion for trademarks, but contains so many exceptions that it is a de facto regime of international exhaustion. Japan has a regime of international exhaustion, and the EU has a mixed regime of regional exhaustion, which in many respects is similar to a regime of international exhaustion. China has yet to take a definitive position, but may feel pressured to adopt some version of a regime of international exhaustion consistent with the position of the other major trading powers.

B. Economic Benefits of Gray Market Goods

The economic rationale in China for allowing parallel imports—and adopting a rule of international exhaustion—is to create more choices for consumers and lower prices for the same or similar products. Distributors import gray market goods because they are cheaper than the comparable, genuine goods produced in China. In the case of Michelin, for example, the tires produced in Japan for export to Brazil were priced lower than the comparable tires manufactured by Michelin in China. Importing gray market goods will benefit consumers who can pay less for similar goods. Paying less for goods is the equivalent of an increase in personal income for consumers, an overall economic benefit for China.

Some commentators in China believe that allowing the importation of gray market goods will also increase employment. They argue that the lower priced gray market goods will force the manufacturers of genuine goods in China to reduce their prices, and that lower prices will stimulate consumer demand. If the manufacturer of the goods in question has excess capacity—that is, additional capacity to produce more goods—then the increased output may lead the manufacturer to hire additional workers, resulting in increased employment for China.

87. See Chow & Lee, supra note 7, at 845, 852.
88. See Keith E. Maskus, Parallel Imports, 23 THE WORLD ECON. 1269, 1272 (2000).
89. See Chow & Lee, supra note 7, at 543.
90. See Yu, supra note 24, at 110.
91. See id.
92. See id.
93. See id.
C. Foreign Direct Investment

China depends heavily on foreign direct investment (FDI) as a driver of its economic growth, and FDI plays a significant role in China's remarkable rise in the world economy.\footnote{See Wayne M. Morrison, Cong. Research Serv. Rep. RL33534, China's Economic Conditions 9 (2009).} FDI refers to the influx of capital and technology from foreign investors, mainly MNCs, into China.\footnote{See Chow & Schoenbaum, supra note 3, at 366.} MNCs inject foreign capital and technology into companies known as foreign invested enterprises (FIEs), which are established in China. These FIEs are joint ventures between the MNC and a local Chinese partner or wholly foreign owned enterprises. Most MNCs now have substantial investments in China.

MNCs control much of the world's most commercially valuable technology and intellectual property. The MNCs' transfer of their technology and IP to China is a major reason why China has been able to modernize its economy at a remarkable pace. Among these IP rights are trademarks for some of the world's most valuable brands.\footnote{Among these brands are Coca-Cola and the various brands for shampoo and skin lotion, such as Rejoice, Head and Shoulders, and Oil of Olay, owned by Proctor & Gamble.} Now, MNCs that invest in China routinely register their trademarks (and other IP rights) in China. Most MNCs will likely wish to be able to block the unauthorized importation of gray market goods because such imports will undermine the MNC's ability to engage in price discrimination among different national markets. An MNC desires the ability to price products in different countries at varying prices in accordance with the financial ability of the consumer in that particular country to pay for the goods. For example, an MNC might wish to charge a higher price for its product in Country A, a high-income developed country, and a lower price in Country B, a low-income developing country. The ability to engage in price discrimination, however, depends on segregated markets; if an importer in Country A were able to import gray market goods from Country B at the lower price, the gray market imports would undermine the MNC's ability to engage in price discrimination between national markets. Because China aspires to create a favorable legal environment for FDI, it may want to create the legal tools necessary for MNCs
to block the unauthorized import of gray market goods into China and thus allow MNCs to create segregated markets.

D. Counterfeit and Substandard Products

China is under international pressure to alleviate the world's most serious counterfeiting and commercial piracy problem.\(^97\) Allowing parallel imports will likely lead to greater quantities of counterfeits and substandard products being imported into China, adding to the massive supply of such products already in the market. Allowing parallel imports into China might also encourage a "round trip" for many counterfeits: the counterfeits are manufactured in China and shipped abroad where an unrelated distributor buys the counterfeits for re-import into China. In many cases, it will be difficult to distinguish between counterfeits and parallel imports because clever counterfeiters will simply forge documents showing that the goods were manufactured abroad under the authority of the trademark owner. In China today, some resourceful counterfeiters deliberately manufacture counterfeits with foreign labels—for example, a bottle of shampoo with a label from Thailand or Taiwan—to convince consumers that the product is a gray market good and not a counterfeit.\(^98\) Parallel imports may create an additional opportunity for clever counterfeiters to deceive consumers. Any additional layer of complexity in trade, such as allowing parallel imports, will create opportunities for pirates in China to exploit the complexity by introducing potential confusion—and the more confusion that counterfeiters can create among consumers, the greater their opportunities to sell more counterfeits in China.

E. Trade Policies in Favor of Exports

China has an export-driven economy; a great deal of China's growth in the past two decades is attributable to its export trade,\(^99\) which now ranks second in the world behind

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98. This observation is based on market surveys conducted by the Author in Guangzhou during July–August 2010.
99. See Chow & Lee, supra note 7, at 6. The total cumulative level of FDI in China at the end of 2008 is estimated to be about $880 billion. See Penelope B. Prime, China and India Enter Global Markets: A Review of Comparative Economic Development and Future Prospects, 50 EURASIAN GEOGRAPHY AND
Export trade creates jobs in many of China’s manufacturing industries and earns significant amounts of revenue for China because many countries pay massive amounts for cheap imports of all kinds from China. Many of China’s domestic and international trade policies are designed to encourage exports; adopting a legal doctrine that would allow parallel imports without the prior authorization of the trademark owner would encourage imports, a result in tension with China’s export-oriented policies.

F. Trade Policies in Favor of Protecting Domestic Industries

Critics have accused China of adopting trade policies that are part of an overall mercantilist strategy—i.e., a strategy to use or circumvent the rules of international trade to gain a competitive edge in the modern global economy. This strategy has two prongs: policies that promote exports (see discussion above) from China and policies that create barriers to imports of foreign-made-goods into China to protect domestic industries from foreign competition. Of course,
China denies adopting this approach and argues that this criticism is unfair, but a policy that prohibits parallel imports without the authorization of the trademark owner is consistent with a mercantilist strategy. A doctrine of national exhaustion would protect China's domestic manufacturers from foreign import competition and allow China to develop its domestic industries in a protected, insulated environment.

The examination of the political, economic, and legal issues underlying the debate over whether to permit parallel imports without the prior authorization of the trademark owner demonstrates that there are a number of complex and conflicting issues at play. A number of factors support a rule of national exhaustion that would prohibit parallel imports in China without the prior authorization of the trademark owner. Moreover, such a position would be consistent with China's existing trade policies. Adopting a rule of national exhaustion may be controversial, however, and critics may accuse China of acting in a protectionist manner by serving its own interest at the expense of its trading partners. For these reasons, China may not wish to take any definitive position on parallel imports without a careful and deliberate consideration of the ramifications of its decision. This may

(2009), available at http://www.uscc.gov/researchpapers/2009/AnAssessmentofChina%27sSubsidiesToStrategicandHeavyweightIndustries.pdf. Another issue is China's policy of maintaining an exchange rate for its currency, the Chinese yuan, which is pegged to the U.S. dollar. Many critics argue that the Chinese yuan is undervalued by as much as 40 percent. See Ernest H. Preeg, Exchange Rate Manipulation to Gain an Unfair Competitive Advantage: The Case Against Japan and China, in DOLLAR OVERVALUATION AND THE WORLD ECONOMY 267–84 (C. Fred Bergsten & John Williamson eds., 2003); see also Roya Wolverson, Confronting the China-U.S. Economic Imbalance, COUNCIL ON FOREIGN RELATIONS (Oct. 19, 2010), available at http://www.cfr.org/publication/20758/confronting_the_china_us_economic_imbalance.html ("U.S. policymakers, businesses, and labor groups have argued that the Chinese currency is undervalued by as much as 40 percent against the dollar, making Chinese exports—such as steel pipes and tires—to the United States cheaper and putting massive dollar flows in the hands of the Chinese."). Undervaluation means that a larger number of yuan can be obtained in exchange for U.S. dollars than would be possible under a market exchange rate; this makes Chinese goods available at a cheaper price to the U.S. consumer and U.S. goods available at a more expensive price to the Chinese consumer. This unbalance allows China to export more goods to the United States and to import fewer goods from the United States. See WAYNE MORRISON & MARC LABONTE, CONG. RESEARCH SERV. REP. RS21625, CHINA'S CURRENCY: A SUMMARY OF THE ECONOMIC ISSUES 2–3 (2009).
explain why China’s legislative bodies have not enacted a clear rule and why China’s courts have taken positions that are ambiguous and difficult to interpret between the lines.

IV. CONCLUSION

The issue of parallel imports of trademarked goods in China remains unsettled. Commentators have pointed to the Michelin case as setting forth a rule of international exhaustion and providing a roadmap on how gray market goods can be imported into China without the prior authorization of the trademark owner. This Article has argued, however, that the cases do not provide clear guidance on this issue and that, while Michelin might be read to provide a roadmap with respect to how gray market goods can be imported, it is unlikely that an importer will be able to overcome all of the hurdles necessary to import gray market goods without the permission of the trademark owner. This result should not be surprising: on controversial legal issues, China often takes a position that, in theory, appears to allow a certain result but, in reality, requires the parties to overcome difficult, if not insurmountable, obstacles in most cases. Part of the rationale for this tendency in China is institutional: courts in China, like other bureaucratic units, are not inclined to undertake the risks of asserting a definitive position on a controversial issue when the authoritative legislative power—the National People’s Congress (NPC)—has not spoken definitively. Neither the NPC nor its Standing Committee is likely to take action with respect to the issue of parallel imports without an extended consideration of all of the economic and political ramifications. Given that the issue of parallel imports involves various controversial issues, China’s leaders may be hesitant to take a definitive stance, but may allow the present state of uncertainty and confusion to persist for the near future.

105. See supra note 72.