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Article

## Counterfeiting as an Externality Imposed by Multinational Companies on Developing Countries

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# Counterfeiting as an Externality Imposed by Multinational Companies on Developing Countries

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*Although multinational companies (MNCs) often complain about enormous financial losses from counterfeiting, they are not really harmed by counterfeiting. MNCs cannot substantiate their claims of massive losses through credible evidence; instead, they use methods for calculating losses based upon dubious and spurious assumptions. MNCs make claims about massive economic losses in order to divert attention from the real harms of counterfeiting and their role in perpetuating these harms. While counterfeiting may not truly harm MNCs, counterfeiting does create serious social harms to the countries in which it occurs. The MNCs' introduction of technology and intellectual property into developing countries with weak governments and legal systems creates a predictable and irresistible opportunity for lucrative economic crimes in which criminal organizations and corrupt government officials play a significant role. Counterfeiting provides a significant source of new revenue that strengthens organized crime and further encourages and deepens government corruption. These social harms retard developing countries' progress in the development of the rule of law, human rights, and transparency in government, which combine to intensify a mistrust of government and awareness and fear of crime.*

*These harms from counterfeiting are externalities for MNCs*

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*because the bulk of these harms do not fall upon MNCs themselves but on developing countries. So long as counterfeiting is an externality, MNCs have no incentives to take the full costs of counterfeiting into account; MNCs continue to provide access to commercially valuable intellectual property rights by investing in developing countries and feed the steady rise of the global trade in counterfeit goods.*

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## INTRODUCTION

In recent years, multinational companies (MNCs) have repeatedly warned the public about the unprecedented and staggering financial losses that they claim to be suffering due to a surge in the global trade in counterfeit goods.<sup>1</sup> Recent industry estimates place annual worldwide

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1. This Article focuses on trademark counterfeiting, which refers to the unauthorized use of an identical or substantially similar trademark that belongs to another company's goods. The counterfeit is often identical in appearance to the genuine product and masquerades as a genuine product. Copyright piracy, which refers to the unauthorized copying of the content of movies, music, and business and entertainment software without any effort to use the trademark of the product, will not be the focus of this Article. Patent infringements will also not be discussed in this Article. In any given case involving a single product, several forms of intellectual property rights violations may be involved. For example, a counterfeited product may also involve copyright piracy and patent infringement. The focus of this Article is on trademark counterfeiting, which is generally considered by experts to be the most serious form of commercial piracy in the

losses due to counterfeiting and other forms of commercial piracy in the hundreds of billions of dollars per year.<sup>2</sup> MNCs — owners of the world's most commercially valuable intellectual property — claim that they suffer the vast bulk of these losses. MNCs claim that counterfeiters located in developing countries are the main culprits of this surge in counterfeit goods. According to MNCs, corrupt governments in many of these countries — in particular, China — protect or support counterfeiters that harm their businesses and the global economy.<sup>3</sup>

Despite their claims, however, MNCs are not really harmed by counterfeiting. Upon closer examination, the financial losses that MNCs claim to suffer from lost sales caused by counterfeiting are based on methods that grossly exaggerate both the levels of counterfeit goods sold and the losses suffered.<sup>4</sup> These claims of severe financial losses are unsubstantiated and based upon dubious assumptions that do not withstand scrutiny.<sup>5</sup> The actual losses suffered are most likely only a tiny fraction of the amounts claimed; in dollar terms, lost sales of genuine products due to counterfeits are likely insignificant and cause little or no financial damage to a majority of MNCs.<sup>6</sup> Suppressing counterfeiting is not a major business priority of MNCs — it is part of their larger effort of to control every facet of how their brands are presented to the consuming public.<sup>7</sup> Counterfeiting undermines the ability of MNCs to control their brand image, but these types of harms do not translate into lost sales of genuine products. Harm to goodwill is difficult to measure in economic terms and MNCs have made no attempts to do so, but the economic impact of these harms as measured in lost sales, when and if a scientific study is done, will most likely be revealed to be trivial in comparison to the tens and hundreds of billions of dollars that MNCs claim that they lose to global counterfeiting.

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world with losses that far exceed those for copyright piracy and patent infringements. See DANIEL C.K. CHOW & THOMAS J. SCHOENBAUM, INTERNATIONAL BUSINESS TRANSACTIONS: PROBLEMS, CASES, AND MATERIALS 560–62 (2d ed. 2010). For example, according to industry estimates, the total losses in 2008 from copyright piracy were \$15.9 billion in the business software industry, \$2.6 billion in the entertainment software industry, and \$35.8 billion in the motion picture industry. See *id.* at 557. These figures are dwarfed by the hundreds of billions claimed to be lost due to trademark counterfeiting. See discussion *infra* Part I.

2. See discussion *infra* Part I.

3. China: Intellectual Property Infringement, Indigenous Innovation Policies, and Frameworks for Measuring the Effects on the U.S. Economy 105–09, Inv. No. 332-514, USITC Pub. 4199 (Nov. 2010) (original transcript on file with Virginia Journal of International Law Association) [hereinafter USITC].

4. See *infra* Part I.A.

5. *Id.*

6. See *infra* notes 56–57 and accompanying text.

7. See discussion *infra* Part II.A.

Although MNCs may not be harmed by counterfeiting, substantial harms do occur because of counterfeiting. Most of these harms are social and political costs that fall on the developing countries in which the bulk of counterfeiting occurs. Once the opportunity for counterfeiting is presented (which typically occurs when MNCs introduce commercially valuable intellectual property into developing countries), organized crime, working in conjunction with corrupt governments, quickly seizes the opportunity to earn huge profits from this lucrative but illegal trade in counterfeit goods.<sup>8</sup> Some counterfeit goods, such as foods and drugs, contain substandard and dangerous ingredients that lead to health and safety hazards.<sup>9</sup> Illness and death from counterfeit foods and medicines occur disproportionately in developing countries and least-developed countries,<sup>10</sup> and rarely occur

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8. See Daniel C.K. Chow, *Organized Crime, Local Protectionism, and the Trade in Counterfeit Goods in China*, 14 CHINA ECON. REV. 473, 473–84 (2003).

9. See Press Release, U.S. Food & Drug Admin., FDA Warning on Mislabeled Monkfish (May 24, 2007), <http://tinyurl.com/6gjl9n6> (mislabeled of pufferfish as monkfish); see also David Barboza & Alexei Barrionuevo, *Filler in Animal Feed Is Open Secret in China*, N.Y. TIMES, Apr. 30, 2007, <http://tinyurl.com/2fuvkw> (discussing contamination of pet food and animal feed products); Andrew Bridges, *Imported Food Rarely Inspected*, USA TODAY, Apr. 16, 2007, <http://tinyurl.com/ys7yat> (noting that imported foods are rarely inspected); Jaime Holguin, *Dangers of Imported Shrimp*, CBS NEWS, Sept. 17, 2004, <http://tinyurl.com/p9253> (reporting on wheat gluten and rice protein concentrate mislabeled as wheat flour); Elizabeth Weise, *Buying Only U.S. Food Is a Tall Order*, USA TODAY, July 11, 2007, at 1A (highlighting the difficulty of avoiding Chinese products in the United States), available at <http://tinyurl.com/6488esw>; Rick Weiss, *FDA Finds Chinese Food Producers Shut Down*, WASH. POST, May 11, 2007, at A10 (concerning Chinese companies that tainted pet food ingredients being shut down), available at <http://tinyurl.com/35ugkz>.

10. There is no official definition of a developing country or a least-developed country. The classifications used by the World Bank, although not mandatory, are widely followed. The World Bank divides all countries into four income groups:

Low Income: \$975 or less  
Lower Middle Income: \$976–\$3855  
Upper Middle Income: \$3856–\$11,905  
High Income: \$11,906 and above.

Of these categories, countries that fall within the first three — low income, lower middle income, and upper middle income — are all considered developing countries; high-income countries are not considered developing countries, with the exception of five countries. The five high-income countries that are considered to be developing economies are Hong Kong (China), Israel, Kuwait, Singapore, and the United Arab Emirates. Despite their high per capita income, these five economies are classified as developing countries because of their economic structure or the official opinion of their governments. Several countries with transition economies are sometimes grouped with developing countries based on their low or middle levels of per capita income, and sometimes with developed countries based on their high industrialization. More than eighty percent of the world's population lives in the more than 100 developing countries. The World Bank defines “least-developed countries” as low-income countries where, according to the United Nations, economic growth faces long-term impediments such as structural weaknesses and low human resources development. This category is used to guide donors and countries in

in advanced developed countries, such as the United States.<sup>11</sup> In developing countries where counterfeiting occurs, there is an increase in organized crime, government corruption, and health and safety issues.<sup>12</sup> All of these harms have serious social, political, and human costs. No doubt these harms also result in substantial economic losses, although no comprehensive attempts have been made to quantify them.<sup>13</sup>

Because the bulk of harms from counterfeiting do not fall on MNCs but on the developing countries in which the counterfeiting occurs, counterfeiting is a corporate externality for MNCs.<sup>14</sup> An externality is a cost (or benefit) that is not directly borne by the actor whose conduct causes the externality.<sup>15</sup> Rather, the costs fall on others. Externalities can lead to inefficiencies because the actor does not take into account all of the costs (or benefits) of its conduct.<sup>16</sup> In making their decisions to locate their manufacturing operations overseas in low-cost countries, MNCs do not consider the costs of counterfeiting imposed on developing countries. Like other rational economic actors, MNCs do not consider the social harms created by counterfeiting in their decision-making since MNCs do not bear these costs.<sup>17</sup> But these costs, while external to MNCs, fall upon others. Primarily, they fall on developing countries, their national governments, and their constituencies, including those in advanced industrialized countries, which are being asked to fund the costs of enforcement against the global trade in counterfeit goods. Of course, all conduct creates some externalities and different externalities may attach to the same conduct. The externalities that are the focus of this Article are the social harms imposed on developing countries by counterfeiting.

The analysis above suggests that the real attribution of responsibility for the global counterfeiting problem may be the reverse of what is popularly portrayed in the media. Developing countries are usually

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allocating foreign assistance. For more information, see *Glossary to Beyond Economic Growth*, THE WORLD BANK GROUP, <http://tinyurl.com/ydutfg>.

11. See discussion *infra* Part II.B.3.

12. Telephone Interview with Timothy P. Trainer, President, Global Intellectual Prop. Strategy Ctr., Former Attorney Advisor, U.S. Customs Serv. and U.S. Patent & Trademark Office (Mar. 31, 2011).

13. Some attempts have been made to quantify efficiency losses from government corruption. See discussion *infra* Part I.

14. Simon Mackenzie first elaborated the economic thesis that counterfeiting is an externality for MNCs in Simon Mackenzie, *Counterfeiting as Corporate Externality: Intellectual Property Crime and Global Insecurity*, 54 CRIME L. & SOC. CHANGE 21 (2010). This Article explores some of the legal ramifications of this thesis.

15. The classic discussion of externalities is set forth in Harold Demsetz, *Toward a Theory of Property Rights*, 57 AM. ECON. REV. 347 (1967).

16. See *id.* at 347–50.

17. See Mackenzie, *supra* note 14, at 22–23, 34–35.

shown as the perpetrators or supporters of counterfeiting and commercial piracy, but these countries, not MNCs, in fact suffer the bulk of the harms created by counterfeiting.<sup>18</sup> By contrast, MNCs are often portrayed as the victims of counterfeiting, but they actually contribute significantly to creating the problem that harms developing countries. MNCs are responsible because counterfeiting is a predictable result of moving manufacturing and production to developing countries in order to take advantage of low labor and manufacturing costs.<sup>19</sup> As part of establishing manufacturing facilities in developing countries, MNCs transfer commercially valuable intellectual property rights to developing countries with weak legal systems and corrupt governments.<sup>20</sup> By introducing commercially valuable intellectual property rights that are easily copied in countries where corruption and crime are rampant and enforcement is weak, MNCs are providing an opportunity for lucrative economic crimes that prove impossible to resist for many segments of the poor population in developing countries.<sup>21</sup> MNCs are also making the problem worse because their anti-counterfeiting strategies (which concentrate exclusively on enforcement) actually have the opposite effect of provoking a frenzy of even more counterfeiting at ever-increasing levels.<sup>22</sup> As long as MNCs benefit from low-cost manufacturing in developing countries that involve the transfer of technology to those countries, global trade in

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18. China has been popularly portrayed as the leading culprit in the rise in the global trade of counterfeit goods. See Daniel C.K. Chow, *Counterfeiting in the People's Republic of China*, 78 WASH. U. L.Q. 1, 1, 7 (2000). There is no doubt that China is the largest source of the global trade in counterfeit goods, but the discussion in this Article suggests that China may be harming itself most of all through various social and political harms from counterfeiting and that these harms outweigh those that fall on MNCs that do business in China.

19. See Mackenzie, *supra* note 14, at 26–28; see also discussion *infra* Part III.

20. See Mackenzie, *supra* note 14, at 26–28; see also discussion *infra* Part III.

21. See Mackenzie, *supra* note 14, at 26–28; see also discussion *infra* Part III.

22. For example, MNCs use an anti-counterfeiting strategy in China that is based primarily on enforcement: the use of raids and seizures designed to smash counterfeiters by the use of brute force and intimidation. When brand owners undertake enforcement actions against counterfeiters, there are no serious consequences for counterfeiters who get caught. Fines are so low as to be just the cost of doing business and counterfeiters rarely face incarceration. Many counterfeiters are back in business within several days or weeks. Enforcement actions have the effect of disrupting the business of counterfeiters, who become agitated and then return to work with a vengeance to produce even more counterfeits. Even counterfeiters who are not agitated by enforcement actions are motivated to produce even more counterfeits after a disruption since it is rational economic behavior to recoup losses. In China, there is plenty of enforcement, but little deterrence. The result is that the more enforcement that MNCs undertake, the more counterfeiting that results. For a fuller discussion, see Daniel Chow, *Anti-Counterfeiting Strategies of Multi-National Companies in China: How a Flawed Approach is Making the Problem Worse*, 41 GEO. J. INT'L L. 749, 765–67 (2010).

counterfeit goods will continue to grow because the bulk of the harms of counterfeiting are corporate externalities for MNCs.<sup>23</sup>

If MNCs are not harmed by counterfeiting, why do MNCs complain so vociferously that they are suffering economic losses at unprecedented levels?<sup>24</sup> In part, MNCs are accustomed, as part of their corporate culture, to frame all business problems in terms of financial losses and have done so with counterfeiting as well.<sup>25</sup> MNCs may also wish to divert attention from their significant role in creating the global counterfeiting problem and the harm that counterfeiting inflicts on developing countries. Media campaigns that highlight the massive losses that MNCs claim to suffer also help to engender public sympathy in favor of MNCs and to direct antipathy toward developing countries.<sup>26</sup> MNCs seek to do just enough in the way of enforcement against counterfeiting to demonstrate that they take the problem seriously.<sup>27</sup> However, when examined closely, the efforts of MNCs indicate that anti-counterfeiting is not a business priority for MNCs and reinforces the point that MNCs are not really harmed by counterfeiting.<sup>28</sup> An additional reason why MNCs continue to paint a dire and alarming picture of the global trade in counterfeit goods is to pass on the costs of enforcement against counterfeiting to national governments and their taxpayers.<sup>29</sup> If, on the one hand, as MNCs contend, counterfeiting is an economic crime perpetrated or supported by developing countries on a vast global scale, then counterfeiting becomes too large a problem for private parties (such as MNCs) to handle without the assistance of enforcement by the U.S. government and governments of other advanced industrialized countries.<sup>30</sup> If, on the other hand, MNCs are

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23. See Mackenzie, *supra* note 14, at 26–28.

24. I am not suggesting that MNCs have made conscious management decisions to exaggerate losses in order to mislead or deceive the public. The conduct can be explained as rational economic behavior to deal with a persistent business problem and, in particular, to avoid costs.

25. See Chow, *supra* note 22, at 751 (“However, as brand owners in China also know, enforcement does not result in any serious consequences for the counterfeiter; to the contrary, the consequences of being caught as a counterfeiter are usually so insignificant that such consequences can be considered just a cost of doing business.”).

26. See *The Spread of Counterfeiting: Knock-Offs Catch On*, *ECONOMIST*, Mar. 6, 2010, at 81–82, available at <http://tinyurl.com/yhbmtm5>; see also Sarah Boumphrey, *Fake Brands Recognising a Real Trend*, *EUROMONITOR*, July 27, 2007, [http://www.euromonitor.com/fake\\_brands\\_recognising\\_a\\_real\\_trend](http://www.euromonitor.com/fake_brands_recognising_a_real_trend); Kristi Heim, *Inside China’s Teeming World of Fake Goods*, *SEATTLE TIMES*, Feb. 12, 2006, at A1, available at <http://tiny.cc/pv5wu>; Louisa Lim, *Chinese Crackdown Fails to Stem Counterfeit Goods*, *NPR*, Aug. 23, 2006, <http://tinyurl.com/2u8wqe>.

27. See Chow, *supra* note 22, at 760–65.

28. See *infra* note 57 and Part I.C.

29. See Mackenzie, *supra* note 14, at 23–24, 26–28.

30. At the urging of U.S.-based multinational companies, the United States is now pressing for the conclusion and promulgation of the Anti-Counterfeiting Trade Act (ACTA), a multilateral treaty that will be implemented outside the scope of the World Trade Organization (WTO). Some

responsible in large measure for creating the global trade in counterfeit goods, then they should bear a greater share of the financial costs associated with international efforts at better enforcement. By casting counterfeiting as a public crime and positioning themselves as the victims, MNCs may also be able to avoid financial responsibility to those developing countries into which MNCs introduced the opportunity for economic crimes. Portraying themselves as the parties most harmed by counterfeiting, MNCs seek to avoid the argument that they bear ethical and financial responsibility for the unprecedented rise in the global trade in counterfeit goods and that they should bear some of the costs of compensating for the harms that are caused by them.<sup>31</sup>

This Article will develop the points introduced here by proceeding in three parts. Part I of this Article examines the claims by MNCs that they are suffering massive financial losses due to global counterfeiting and demonstrates why these claims are based upon spurious assumptions. This Part will also detail why most MNCs do not suffer any serious economic harms from counterfeiting, contrary to their assertions. Part II examines the harms that MNCs do suffer from counterfeiting, which are minor in comparison to their claims of severe financial losses, and also the harms that are inflicted upon developing countries. Part III examines

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observers believe that the United States is seeking to work outside of the WTO in order to be free of the legal constraints that would be imposed by the WTO. For example, because the ACTA is being negotiated outside of the WTO, the negotiations are cloaked in secrecy, leading many observers to believe that the ACTA, once revealed, will be a harsh and draconian super-weapon of enforcement. *See, e.g.*, Peter K. Yu, *Six Secret (and Now Open) Fears of ACTA*, 64 SMU L. REV. 1, 17–19 (forthcoming 2011), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1624813](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1624813). Observers also believe that the negotiations of the ACTA outside of the WTO might reflect the views of the United States and some other countries that the WTO has not adequately enforced intellectual property rights. *See id.* at 47 n.286. On the issue of funding, the ACTA is expected to call for extensive collaboration among the customs authorities of many different countries to coordinate efforts to stop the global trade in counterfeit goods. The costs of implementing the ACTA, if and when it is approved, will be extensive and will be funded by the governments of the implementing nations, not private industry. So far, only a small group of countries, home to many of the world's most powerful MNCs, are involved in the negotiations: the United States, Canada, the European Union, and Japan. Many observers suspect that once the ACTA is approved, the United States will likely begin to pressure its trading partners to join the ACTA and to share in the costs of implementing and enforcing the ACTA. *See id.* at 77–85. Many other efforts are underway in the WTO, the World Customs Organization, Interpol, and other international agencies to combat counterfeiting. *See, e.g.*, *Intellectual Property: Protection and Enforcement*, WORLD TRADE ORG., <http://tinyurl.com/2ol2ov> (last visited Mar. 26, 2011) (explaining the Agreement on Trade-Related Aspects of Intellectual Property Rights); *Intellectual Property Rights (IPR) Programme*, INTERPOL, <http://tinyurl.com/4okd9ff> (last visited Mar. 26, 2011); *The WCO and the Protection of Intellectual Property Rights (IPR)*, WORLD CUSTOMS ORG., <http://tinyurl.com/47vlpzc> (last visited Mar. 26, 2011). These operations are funded through public funds via annual contributions by member states.

31. For a discussion of the social responsibility of MNCs to pay for the costs of counterfeiting, see discussion *infra* Part IV.C.

the role of MNCs in contributing to the rise of global counterfeiting and draws some tentative conclusions about the ethical and financial responsibility of MNCs for the rise in the global trade in counterfeit goods.

#### I. MNCs' CLAIMS OF FINANCIAL LOSSES FROM COUNTERFEITING

In the past several decades, the global trade in counterfeit goods has surged at an unprecedented pace. In 1982, the U.S. International Trade Commission (USITC) estimated that commercial piracy caused annual worldwide losses of \$5.5 billion.<sup>32</sup> Just six years later, in 1988, the USITC revised its estimate to over \$60 billion in annual losses.<sup>33</sup> In 2009, the Organization for Economic Cooperation and Development (OECD) estimated that the global trade in counterfeit goods was over \$250 billion (almost two percent of world trade) and caused losses of \$150 billion to the G20 countries, the leading industrialized nations of the world, led by the United States.<sup>34</sup> Estimates that are circulated directly by industry groups are significantly higher. Some industry groups estimate that counterfeit goods comprise seven percent of total world trade and that the total annual losses on a global basis to counterfeiting are \$650 billion per year;<sup>35</sup> of this figure, the United States suffers between \$200–250 billion in annual losses.<sup>36</sup>

These statistics are impressive and present a daunting picture, but on what are these figures based? When one examines these statistics closely, it becomes clear that they are not based on any independent scientific or economic studies on the losses caused by counterfeiting. To

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32. See S. REP. NO. 104-177, at 3 (1995); see also USITC, USITC PUB. 1479, THE EFFECTS OF FOREIGN PRODUCT COUNTERFEITING ON U.S. INDUSTRY xiv, 24 (1984).

33. See USITC, USITC PUB. 2065, FOREIGN PROTECTION OF INTELLECTUAL PROPERTY RIGHTS AND THE EFFECT ON U.S. INDUSTRY AND TRADE app. H (1988).

34. See Press Release, World Intellectual Property Organization, Counterfeiting and Piracy Endangers Global Economic Recovery Say Global Congress Leaders, WIPO Press Release PR/2009/621 (Dec. 3, 2009), available at <http://tinyurl.com/yd9edmq>.

35. The Coalition for Intellectual Property Rights credits the World Customs Organization (WCO) and Interpol with this estimate. See *First Global Congress on Combating Counterfeiting*, COALITION FOR INTELLECTUAL PROPERTY RIGHTS (CIPR), <http://tinyurl.com/4nckel6> (last visited Mar. 26, 2011); *Putin Assures ICC That Global Business Concerns Will Be on G8 Agenda*, INTERNATIONAL CHAMBER OF COMMERCE [ICC] (July 5, 2006), <http://tinyurl.com/4fu5xug>.

36. INT'L ANTI-COUNTERFEITING COALITION, THE NEGATIVE CONSEQUENCES OF INTERNATIONAL INTELLECTUAL PROPERTY THEFT: ECONOMIC HARM, THREATS TO THE PUBLIC HEALTH AND SAFETY, AND LINKS TO ORGANIZED CRIME AND TERRORIST ORGANIZATIONS 3–4 (2005), available at <http://tinyurl.com/4p95qcj>; Press Release, Fed. Bureau of Investigation, The Federal Bureau of Investigation and the U.S. Customs Service Today Announced the National Intellectual Property Rights Coordination Center's First Conference for Members of Congress and Industry in Washington (July 16, 2002), <http://tinyurl.com/4rugjza>.

the contrary, all of these statistics, including the ones provided by the USITC and OECD, rely on information provided by MNCs and their industry groups.<sup>37</sup> What methods do MNCs use to arrive at these figures?

MNCs estimate the size of the counterfeiting trade and the losses suffered using the following methods or a variant thereof.<sup>38</sup> First, MNCs will determine the size of the counterfeit trade in any given location by conducting an on-the-ground market survey to determine the total amount of product in that location. The MNC then determines how many units of genuine product are shipped through the MNC's own distribution channels to the particular location. The difference between the amount of total product and the amount of product shipped by an MNC is treated as counterfeits. For example, suppose that a market survey indicates that there are 1000 units of total product in a given location and the MNC's own records indicate that 800 units were shipped by the MNC's factories and warehouse to the location. The MNC will conclude that the additional 200 units are counterfeits and that counterfeits comprise twenty percent of the market. The same approach, with some variations, is used for business or entertainment software. The MNC will conduct a survey to determine the number of applications in a given location and then review its records to determine how many applications were supplied to the location by the MNC. The difference between the number of total applications and the number supplied by the MNC equals the number of pirated applications in that location.

Once the amount of counterfeit product is determined, MNCs will determine the losses sustained from counterfeiting. Some MNCs seem to take the position that the existence of a counterfeit product on the market is the equivalent of a lost sale of the genuine product at the retail price. In our example above, if the size of the counterfeit trade is twenty percent of total trade, or 200 units in the location in question, MNCs will estimate the losses due to counterfeiting to be twenty percent of total trade or the revenue that would have been earned on sales of twenty percent, or 200 genuine products, at the retail price.<sup>39</sup> The gist of this approach is that the mere existence of a counterfeit — regardless of whether there is any evidence that the counterfeit was sold to a

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37. See USITC, *supra* note 3, at 76–77, 109–12, 118–19; see also Joe Kafchinski, Global Counterfeit Trade 8–10 (May 11, 2009) (unpublished manuscript), available at <http://tinyurl.com/4c5sy37>.

38. See *infra* note 56 (statement of Professor C. Fritz Foley); see also CHOW & SCHOENBAUM, *supra* note 1, at 563–64. The author was involved in determining both the volume of trade and losses while working as in-house counsel for an MNC with substantial counterfeiting problems.

39. See CHOW & SCHOENBAUM, *supra* note 1, at 564.

consumer — equals a loss of a sale of the genuine product at the retail price. There appears to be no defensible justification for this approach; one of the reasons given by MNCs for the use of this approach is the difficulty in tracking sales of counterfeits, which often occur out of plain sight and under clandestine circumstances. Other MNCs seem to take the approach that every sale of a counterfeit product blocks a sale of the genuine product; thus, each counterfeit that is sold results in a loss of a sale of the genuine product at the retail price.<sup>40</sup>

*A. Assumptions Used by MNCs in Determining Volume and Losses from Counterfeiting*

These methods for determining the size of the counterfeit trade and the resulting losses suffered are based upon several questionable assumptions. First, in determining the size of the counterfeit trade for a given location, the method described above makes the assumption that the only genuine goods in a particular location are those that were directly shipped by the MNC. This assumption ignores the possibility of the horizontal movement of goods, that is, genuine goods sold by the MNC in one location that are then resold or reshipped to another. For instance, in our example above, the market survey indicated that MNC supplied only 800 units, or eighty percent, of the genuine product to a particular location, so the other 200 units, or twenty percent, were deemed to be counterfeits. But suppose that the MNC had previously supplied a large number of genuine products to a different location and a wholesale distributor purchased those products and then resold them to retailers in the location in question.<sup>41</sup> It would also be possible for a retail chain that purchased goods for a store in one location to ship some of the goods to stores in other locations to meet increased demand in the other locations. In this instance, because of the horizontal movement of

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40. *See id.*; *see also* USITC, *supra* note 3, at 117–19, 121–22.

41. Under U.S. trademark law, the first sale in the domestic U.S. market results in an exhaustion of the trademark; the trademark owner is unable to control the distribution or movement of the product after the first sale occurs. *See* *Prestonettes, Inc. v. Coty*, 264 U.S. 359, 368 (1924); *see also* DANIEL C.K. CHOW & EDWARD LEE, *INTERNATIONAL INTELLECTUAL PROPERTY: PROBLEMS, CASES, AND MATERIALS* 523–32 (2006). The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) allows each country to determine its own exhaustion doctrine. *See* Agreement on Trade-Related Aspects of Intellectual Property Rights art. 6, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, 1869 U.N.T.S. 299 [hereinafter TRIPS]. Not all national exhaustion doctrines are the same, but most countries adopt some variation of the first-sale principle, leading to an exhaustion or termination of the right to control resale of the product. *See* CHOW & LEE, *supra*, at 523–32. It would be possible to have a contract clause that prohibits the resale of the product, but such a provision would then become an issue of contract law (and perhaps competition law) and, in any event, might be difficult to enforce even in the United States. In developing countries, effective enforcement of contract rights could prove to be elusive.

genuine goods from one location to another, it is quite possible that genuine goods were supplied to the location in question for legitimate business reasons by a business entity other than the MNC. In this case, the number of genuine products is higher than that supplied by the MNC and the number of counterfeits is correspondingly lower. The same result would hold true if parallel imports or gray-market goods were involved. Gray-market goods are genuine goods originally intended for sale in a location abroad that are then imported into the home market, such as the United States, often without the permission of the U.S. trademark owner.<sup>42</sup> If some of the MNC's products were manufactured in foreign factories for sale abroad but then purchased abroad by an unrelated distributor, who then exported them back to the United States (or another home market), genuine goods would also be available in markets that are unaccounted for by the MNC. These parallel imports or gray-market goods would be treated as counterfeits. The method used by MNCs to determine the volume of counterfeit goods in any location can lead to overestimates and inflated numbers.

The assumptions on which economic losses are calculated are also questionable. As noted earlier, some MNCs adopt the approach that every sale of a counterfeit results in the loss of the sale of a genuine product at the retail price. This approach seems to be based on the assumption that consumers who purchase counterfeits intended to purchase a genuine product but have mistakenly purchased a counterfeit instead. The mistake is caused by fraud or deception on the consumer; the counterfeiter has fooled the consumer into believing that the knock-off is a genuine product. However, several factors indicate that, today,

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42. Gray-market goods or parallel imports arise in a number of situations, but one of the most common occurs as follows: Suppose that an MNC has manufacturing facilities in the United States and also in several European countries. The MNC intends for its wholly-owned European factories to produce goods for sale in Europe; the goods have different packaging and are marketed to European consumers. The U.S. factories produce goods for sale in the United States. A European distributor, taking advantage of fluctuating exchange rates, buys a shipment of goods produced at the MNC's European factories and then exports them to the United States. These goods are "gray-market goods" or "parallel imports"; they are genuine, not counterfeit, goods but were originally intended for a different market. Under the facts set forth in this scenario, the U.S.-based MNC would be unable to exclude the importation of the goods; the goods must be allowed into the United States even against the wishes of the MNC because the European subsidiaries and the U.S. parent are deemed to be under a "common control." *See* 19 U.S.C. § 1526 (2006); 19 C.F.R. § 133.23(a)(2) (2010); *see also* CHOW & SCHOENBAUM, *supra* note 1, at 599–607 (discussing the common ownership or control exception that allows gray-market goods to be imported without the permission of the brand owner). In the United States, gray-market goods that are lawfully imported (sometimes against the wishes of the brand owner) can often be purchased at large discount department stores and specialty electronic stores. Gray-market goods usually cost less than branded goods that were intended for the domestic market and may have English-language packaging pasted on top of foreign-language labeling. Brand owners often disapprove of gray-market goods because such goods diminish their control of how their brands are presented to the public. *See id.* at 598.

many if not most consumers who purchase counterfeits make a knowing and rational choice to do so and are not deceived. Most counterfeits sell at prices that are significantly lower than prices for genuine products, sometimes many multiples lower. The wide and instant availability of information through the media and the Internet provide an easy source of information to consumers about prices of products that are being sold. Consumers now have much greater access to information and can easily determine the range of prices for just about any type of products being sold. In some cases, counterfeits sell for a fraction of the price of the original. For example, certain types of high-end luxury goods with prestigious brand names (such as handbags, purses, luggage, and carrying cases) might sell for one-tenth, or less, of the price of the original. An original brand-name luxury handbag might sell for \$700, whereas a counterfeit might sell for \$50. In the case of counterfeit tennis shoes or sneakers, a recent investigation indicates that a typical counterfeit might sell for \$12, whereas a genuine pair of a prestigious brand would sell at a retail price of \$85, or seven times the price of the fake.<sup>43</sup> It would be typical for a high-end basketball sneaker to sell at \$100 and for a counterfeit of the same shoe to sell at \$20. Even in the case of hygienic consumer products, such as shampoos, there is a significant price difference: High-quality counterfeits sell for about thirty to fifty percent less than the price of the original.<sup>44</sup> Given the significant price difference between counterfeits and genuine products, it is likely that consumers who pay significantly lower prices for branded goods know that they are purchasing a fake item, a smuggled product, or other contraband. A consumer who purchases a handbag for \$50 — knowing that the retail price of the genuine article is \$700 — knows that the item is a counterfeit.

Not only is the price difference a clear indication that the product is a counterfeit, but the place and circumstances of purchase provide another clear indication of the origin of the goods. MNCs have developed strong distribution networks consisting of qualified distributors who are contractually required to deal only in genuine goods upon the pain of penalties and loss of distribution rights. Counterfeiters find it difficult to penetrate an established high-quality distribution network system to mix

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43. Nicholas Schmidle, *Inside the Knockoff-Tennis-Shoe Factory*, N.Y. TIMES, Aug. 19, 2010, at MM38.

44. Why might a consumer knowingly purchase a counterfeit shampoo, because it is a product that is used on the scalp? Based on consumer surveys, the author has found that some consumers believe that the quality of a counterfeit shampoo is likely no worse than the quality of a lesser-known and less expensive brand than the one being counterfeited. The consumer therefore believes that he is paying a lower price and receiving a product of about the same quality as a lesser or inferior brand, but the counterfeit allows the consumer to enjoy the prestige of the famous brand.

fakes with real products. As a result, counterfeits are rarely, if ever, found in certain types of retail establishments that use qualified distributors. In the United States, counterfeits are almost never found in large department stores or well-known national chains or discount stores, such as Walmart, Target, or Costco. These companies have strong distribution networks that cannot usually be penetrated by counterfeits, smuggled goods, or other contraband. Counterfeiters must look to find soft spots, such as corrupt sub-jobbers (i.e., sub-distributors who purchase from distributors and who then directly sell to retailers) in less reputable distribution chains that deliver to smaller retail stores, individually-owned discount stores, as well as individual proprietorships (“mom and pop” stores), or transient street vendors.<sup>45</sup> These sub-jobbers or sub-distributors are more likely to be willing to accept goods of a dubious origin to mix in with genuine goods, and their retail customers are usually more willing to accept such goods in exchange for lower prices.

In China and other developing countries flooded with counterfeits, many or most consumers are well aware of locations where counterfeit goods are sold and where they are not. As with the case of the United States, in China, counterfeit goods are not found in large state-run or privately-owned department stores; rather, they are found in small retail shops, street stalls, and open-air kiosks. In some cases, there are well-known markets and parts of cities that are notorious for their dealing in counterfeit goods; in other parts of the city, such as central business district areas, counterfeits are rarely, if ever, available in large retail department stores.<sup>46</sup>

In the United States, consumers who purchase counterfeit goods do so from street vendors, private sellers who arrange to come to the homes of consumers,<sup>47</sup> or small retail stores in immigrant neighborhoods where the counterfeit products are hidden from plain sight but are available for the asking consumer. Some individual consumers can also purchase goods from the Internet from sellers in foreign locations, such as China,

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45. See CHOW & SCHOENBAUM, *supra* note 1, at 561.

46. This observation is based on several market surveys conducted by the author in China in July to August 2010. There is an extremely high level of consumer awareness of counterfeits in China because of the widespread availability of such goods. Most consumers in China are savvy enough to avoid counterfeits by shopping in stores known to stock genuine goods and by avoiding stores where counterfeits are widely known to be available.

47. Private “purse parties” are popular in many affluent areas in the United States. These parties are held in private homes by frequent international travelers who purchase counterfeits abroad and bring them back into the United States. No attempt is made to fool consumers at these purse parties. Everyone knows that the products are counterfeits. These parties are popular because many consumers consider buying counterfeits to be fun, exciting, and harmless. See, e.g., Jeffrey Sheban, *Bogus Goods Abound in Ohio*, COLUMBUS DISPATCH, Nov. 25, 2007, at A1, available at <http://tinyurl.com/4vjde6d>.

Thailand, and Vietnam, at steep discount prices. In other words, consumers who wish to purchase counterfeit goods make an active effort to find and locate vendors of such products. Conversely, consumers who shop in mainstream commerce, such as shopping malls and large department stores, rarely, if ever, encounter counterfeit goods. The price, location, and circumstances of the sale provide a highly reliable indication of whether goods are genuine or counterfeit. Rare is the case where consumers inadvertently or mistakenly purchase counterfeit goods; rather, they usually make a conscious choice to actively seek out counterfeit goods.

In fact, due to the differences in price, location, and circumstances of sale between real and counterfeit products, it appears that different groups of consumers are involved in purchasing real and counterfeit products. Consumers who purchase genuine products are willing to pay a premium for the goodwill and prestige associated with the genuine brand. By contrast, consumers who purchase counterfeit goods may, in general, be less affluent and may be willing to engage in riskier behavior by dealing with vendors of unknown reputations in less secure locations. Consumers who purchase counterfeit goods may not be a target market for the genuine product at all because of their different habits, tastes, and economic status. When counterfeits are not available, consumers who actively seek to purchase counterfeits either forgo purchasing any products or buy an alternative at a price point that is similar to the price of the counterfeit.<sup>48</sup> In other words, consumers who purchase counterfeits are not likely to purchase the genuine product, especially in cases where the price differentials between the genuine product and the fake are great.<sup>49</sup>

There is one sizeable group of consumers in the global market who are likely unaware that they are purchasing counterfeits. Recent evidence indicates that counterfeiters in China have exported counterfeit goods to many countries around the world.<sup>50</sup> Certain developing and least-developed countries in Africa, Eastern Europe, and parts of South America are territories in which MNCs may not have established

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48. This observation is based on the author's own experience as in-house counsel for an MNC with a major counterfeiting problem.

49. See USITC, *supra* note 3, at 121–22; see also Nancy D. Albers-Miller, *Consumer Misbehavior: Why People Buy Illicit Goods*, 16 J. CONSUMER MKTG. 273, 275 (1999); Nia Arghavan et al., *Do Counterfeits Devalue the Ownership of Luxury Brands?*, 9 J. PRODUCT & BRAND MGMT. 485, 494–95 (2000); Robert H. Dodge et al., *Consumer Transgressions in the Marketplace: Consumers' Perspectives*, 13 PSYCHOLOGY & MKTG. 821 (1996).

50. See U.N. OFFICE ON DRUGS & CRIME, *THE GLOBALIZATION OF CRIME: A TRANSNATIONAL ORGANIZED CRIME THREAT ASSESSMENT 171–90* (2010), available at <http://tinyurl.com/2b8r9qy>.

distribution networks of genuine products.<sup>51</sup> Some of these countries are too politically unstable for MNCs to make the sizeable foreign direct investment that is necessary to manufacture products locally. The lack of a local production facility and established distribution networks means that genuine products are not easily accessible or are not generally available in large quantities to consumers. In markets where genuine products do not exist, consumers find it much more difficult to identify counterfeits, as there is no basis of comparison between the fake and the genuine product. In these countries, consumers are purchasing branded products with little awareness that they are purchasing fakes and substandard products.<sup>52</sup>

However, even though these consumers are not aware they are purchasing counterfeit products, it is difficult for MNCs to argue that such sales directly block sales of genuine products because the reason for such consumer confusion is the lack of availability of such genuine products. Moreover, MNCs will privately admit that some counterfeiting is actually beneficial in developing countries where the genuine product is not yet sold. The counterfeit helps to create brand awareness, thus benefiting the MNC when genuine products are eventually sold or produced in the country.<sup>53</sup>

These unknowing counterfeit consumers are found in some of the poorest countries in the world with the lowest level of economic development; they also suffer some of the most serious harms from counterfeiting. Unsafe and hazardous products, including counterfeit and substandard foods and drugs, cause serious health and safety problems in these countries.<sup>54</sup>

### *B. Consumers and the Knowing Purchase of Counterfeits*

In countries where genuine products are available and where established distribution networks have been set up, the combination of two factors — the price of the good and the circumstances under which the good is purchased — gives a reliable indication to the consumer of whether the goods are genuine or counterfeit. Price and location of purchase are factors that involve a deliberate choice on the part of the consumer. The consumer has made a conscious decision to seek a low price and to go to certain types of sellers who provide counterfeits (as well as smuggled and substandard goods). These habits of consumers

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51. See *Intellectual Property Rights Issues and Imported Counterfeit Goods: Hearing Before the U.S.-China Econ. & Security Review Comm'n*, 109th Cong. 216 (2006) (statement of Daniel Chow, Professor of Law, The Ohio State University Moritz College of Law).

52. See CHOW & SCHOENBAUM, *supra* note 1, at 565.

53. See *id.*

54. See discussion *infra* Part II.B.3.

who seek counterfeits suggest that, contrary to the expressed views of many MNCs, many consumers do not mistakenly purchase counterfeits — they do so knowingly.

If many consumers do not mistakenly purchase counterfeit goods when they are really seeking to purchase a genuine product, then the removal of a counterfeit from the market will not necessarily result in the recovery of a sale of a genuine product. This point would seem to be especially applicable in all cases where there is a significant price difference of many multiples between the genuine product and the counterfeit. In the area of luxury goods, the claim that a consumer who purchases a counterfeit handbag for \$50 would pay \$700 for an original if the counterfeit is removed from the marketplace seems preposterous. Even in the case of computer business software, the major differences in price would indicate that there is no one-to-one correspondence between the sale of a counterfeit and the loss of the sale of a genuine application at the retail price.<sup>55</sup> The assumption that every sale of a counterfeit blocks the sale of a genuine product at the full retail price appears to be fictitious.<sup>56</sup>

This analysis indicates that the methods used by MNCs to calculate the volume of the global counterfeit trade and the resulting economic losses are not supported by reliable evidence. MNCs claim to be losing tens, even hundreds, of billions of dollars per year to counterfeiting and commercial piracy based on data that are derived from methods of simplistic and spurious assumptions. Until MNCs can provide reliable

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55. A recent case illustrates the price differences: A pirated version of business software was sold at \$45, but the retail price of the genuine software was \$3500. An investigation by a software industry group discovered that various packages of pirated software sold for a total of \$1000 while the genuine software applications had a retail price of \$45,000. See Chloe Albanesius, *BSA Sues iOffer Sellers over Pirated Software*, PC MAG., Oct. 28, 2008, available at <http://www.pcmag.com/article2/0,2817,2333463,00.asp>. Would someone who pays \$45 for pirated software pay \$3500 (about eighty times more) for the genuine application? Would someone who buys pirated movies or makes unlawful copies from the Internet be willing to pay ten times more for the genuine version? The author spoke to various industry experts and private investigation companies who expressed strong doubts. No one questions that there will be *some* losses, but the losses are likely to be a fraction of the massive amounts claimed. It should also be noted that the vast bulk of the losses being claimed by MNCs are from trademark counterfeiting, not from copyright piracy, which is the case for movies and software. The hundreds of billions of dollars of losses are mostly attributable to trademark counterfeiting while losses from copyright piracy are modest by comparison. For example, according to industry estimates, the total losses in 2008 from copyright piracy were \$15.9 billion in the business software industry, \$2.6 billion in the entertainment software industry, and \$35.8 billion in the motion picture industry. See CHOW & SCHOENBAUM, *supra* note 1, at 557.

56. See USITC, *supra* note 3, at 121 (testimony of Professor C. Fritz Foley) (“So I think it’s problematic, I’m not sure I’m aware of any academic papers that suggest a better way of doing this, but at the very least it seems a bit crazy to me to assume that someone who would pay some low amount for a pirated product would be the type of customer who would pay some amount that’s six or ten times that amount for a real one.”).

evidence of those losses, claims of billions of dollars of annual losses due to counterfeiting should be viewed by the public with skepticism and as unsubstantiated and fanciful claims.<sup>57</sup>

### C. *Resources Used in Anti-Counterfeiting*

One indication of the scope of the financial losses that MNCs truly consider themselves to suffer from counterfeiting is the resources that they use in suppressing counterfeiting. Many MNCs have now set up internal brand protection units headed by former enforcement officials. These MNCs often hire former FBI agents, military commandos, special forces agents, and police officers as part of a “get tough” approach to counterfeiting.<sup>58</sup> It is unsurprising, then, that these brand protection managers adopt an approach that primarily emphasizes enforcement: raids, seizures of counterfeit products, and destruction of equipment and machinery.<sup>59</sup> Within MNCs, these brand protection units are often part of the corporate security department, which are not viewed as prestigious units within MNCs.<sup>60</sup> Most MNCs are rigid hierarchal organizations; delegating enforcement against counterfeiting to the corporate security department sends a message to business managers within the company that counterfeiting is a type of petty crime that can be smashed by the use of brute force and is not a business priority of the company.<sup>61</sup> In addition, brand protection units have budgets of one to several million dollars per year.<sup>62</sup> While a budget of several million dollars per year may seem to be significant at first glance, these expended resources are only a tiny fraction of the claimed losses to counterfeiting. For example, MNCs in China claim that they lose fifteen to twenty percent of revenue per year to counterfeiting. For an MNC

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57. Even MNCs, when pressed and in unguarded moments, will admit that counterfeiting does not really result in lost sales of genuine products. *See* Schmidle, *supra* note 43 (“A senior employee at a major athletic-footwear company, speaking on condition of anonymity, reflected on counterfeiting as a simple fact of industrial life: ‘Does it cut into our business? Probably not. Is it frustrating? . . . Of course. But we put it as a form of flattery, I guess.’”).

58. *See* Chow, *supra* note 22, at 760–61.

59. This “get tough” approach is actually having the reverse effect of making the counterfeiting problem worse. In China, enforcement does not result in any meaningful deterrence but merely disrupts the business of the counterfeiter. The counterfeiter returns to producing fakes with a vengeance or is motivated by the desire to recoup losses by producing even more counterfeits, *see* Chow, *supra* note 22, at 765–66. The emphasis on enforcement results in lucrative financial rewards for all involved in anti-counterfeiting, so MNCs and enforcement industry groups have economic incentives to perpetuate counterfeiting and have no incentives to suppress it. *See id.* at 767.

60. *See id.* at 774.

61. *See id.* at Part III.B.

62. This observation is based on the author’s own experience as in-house counsel for an MNC.

with substantial business operations, these alleged losses could amount to hundreds of millions of dollars. A budget of one or two million dollars to combat counterfeiting is trivial if losses are actually in the hundreds of millions of dollars. MNCs' token budget allocations for combatting counterfeiting and their delegation of brand protection authority to corporate security departments are indications that suppressing counterfeiting is not, despite their claims to the contrary, a business priority for MNCs. Suppressing counterfeiting is not a priority because MNCs do not really suffer serious financial harm from counterfeiting. Rather, MNCs seem to wish to do just enough to show that they are taking the problem seriously.

## II. HARMS FROM COUNTERFEITING

If MNCs have not demonstrated that they suffer serious financial losses from counterfeiting and commercial piracy, what are the harms, if any, caused by the rising global trade in counterfeit goods and who suffers from them?

### A. *MNCs' Loss of Control of How Brands are Presented to the Public*

Many MNCs now view their brands as their most valuable business assets.<sup>63</sup> These MNCs have generally invested significant resources in creating brands that appeal to the public. In order to protect their investment, MNCs wish to exercise complete control over every facet of how that brand is presented to the public.<sup>64</sup> MNCs wish to control advertising in print and visual media, as well as the use of the Internet to display their brands to protect the goodwill of the brand.<sup>65</sup> An MNC views any attempt by unauthorized parties to present the brand in any light as a threat to one of the MNC's most valuable and core business assets.<sup>66</sup>

Although MNCs have not demonstrated that counterfeit goods directly preclude sales of genuine products, the use by counterfeiters of famous trademarks may diminish the image of the brand. Even though most consumers are not confused into thinking that inexpensive

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63. See discussion *infra* Part III.A.

64. Shane Berry, Vice President of Brand Protection, Abercrombie & Fitch, Presentation Before the Columbus Bar Association Intellectual Property Committee (Sept. 7, 2010). The author was in attendance at this event. Absolute control by the MNC over how the brand is presented to the public appears to be part of the branding movement. See discussion *infra* Part III.A.

65. See discussion *infra* Part III.A.

66. See *id.*

counterfeits are the famous branded product, the availability of knock-offs at a low price may impair the exclusivity of the brand. MNCs have invested considerable financial resources to create, in some cases, an image of exclusivity, glamour, and prestige, and for those reasons, they are able to charge consumers a considerable premium to obtain the brand. MNCs might consider the widespread availability of cheap knock-offs as a way of diminishing the value of the genuine product to the consumer who has paid a premium for the genuine product. A consumer who has paid a hefty premium (well above the cost of the materials of the product) might balk at seeing cheap knock-offs widely available on the street. The sale of counterfeits and smuggled products in discount stores, open street stalls, and small retail stores may also harm the image of the brand. Some brand owners might view the availability of knock-offs in disreputable locations as a tarnishment of the brand. Some counterfeiters also use a famous brand on a product that is not sold by the brand owner. For example, counterfeiters might use a trademark for a famous shampoo to sell skin cream or toothpaste, or a famous brand name of an automobile to sell furniture.<sup>67</sup> These uses may also create some blurring of the distinctiveness of the mark and cause consumer confusion, thereby damaging the goodwill of the brand.<sup>68</sup>

Even the harm to goodwill by counterfeits, however, might not be as damaging as it must first appear to the brand owner. The most serious harms caused to goodwill exist in cases where there is a passing off—that is, where fakes are presented as the genuine product and consumers are then fooled into purchasing counterfeits. However, as discussed earlier, this is unlikely to be true in most cases today. Most consumers are savvy enough to understand that branded goods that are sold at a fraction of their original cost in disreputable locations are not likely to be genuine and are not authorized for sale by the brand owner. The sale of knock-offs might even have commercial benefits for the brand owner since these sales help to increase the recognition by consumers of the brand name. However, for most brand owners, whether the counterfeits do any serious and actual harm to the goodwill of the brand is really beside the point. The harm is the presentation of the brand to the public

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67. For example, suppose X uses the trademark “Rolls-Royce” without authorization from the brand owner on furniture and sells the furniture using the slogan, “We sell the Rolls-Royce of Furniture.” This might be viewed as diluting the image of the trademark because it blurs the distinctiveness of the mark by causing consumers to associate the mark with furniture. Dilution claims, such as this one, are available only for certain “famous” marks that have achieved a certain level of recognition with the consuming public. *See* 15 U.S.C. § 1125(c) (2006); *see also* CHOW & LEE, *supra* note 41, at 608–09.

68. The type of harm caused by the counterfeiting discussed in the text above is similar to the doctrine of dilution that protects famous trademarks in the United States.

that has not been authorized by the brand owner and that is not under the control of the brand owner. This undermines the core business principle in many MNCs that they must have absolute and complete control over every facet of the presentation of their brands in any form and by any means to the public.

This type of harm is vastly different from the claims of brand owners that counterfeits preclude the sale of genuine products at full retail price, at least measured in terms of directly lost sales. So while counterfeiters do limit the ability of brand owners to exercise exclusive control over their brands, this type of harm might not be very significant in terms of monetary losses. MNCs have never attempted to place a monetary figure on the amount of loss from this type of harm, but it is likely to be trivial in comparison to the hundreds of billions of dollars that MNCs claim to lose from lost sales due to counterfeiting.

For MNCs, counterfeit goods today are viewed as an illegal and unauthorized, but often highly desirable, line of goods that are traded on the brand's prestige and that are intended to appeal to a certain sizeable group of consumers in both developing and developed countries who seek to purchase such goods with knowledge that they are counterfeits.<sup>69</sup> This second line of goods takes a free ride on the goodwill established by the original brand and threatens the control by MNCs of their brands. But these are different types of harm from the lost sales of the genuine product that has traditionally been viewed as the harm caused by counterfeiting. Consumer confusion — once the crux of counterfeiting — is no longer present in most cases in the modern age of globalization and wide availability of information. Most consumers who purchase counterfeit goods are not deceived into thinking that they are purchasing a genuine product; rather, they are seeking the prestige of the trademark or brand name at a lower price. Many consumers view counterfeits as goods that are less expensive (and of a lesser quality) than the original genuine product but still carry a similar level of prestige associated with the brand. Depending on the type of goods involved, many consumers are not concerned about the lower quality of the counterfeit since quality is of secondary or minor importance.

For instance, recent statistics indicate that clothing and shoes are among the most counterfeited products seized by the customs

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69. Although there are some similarities between gray-market goods and counterfeits, a fundamental distinction is that the former are genuine goods while the latter are not. *See supra* note 41 and accompanying text. The common element that brand owners find objectionable is the loss of control over how the brand is presented to the public. Counterfeit goods are unauthorized copies and gray-market goods may be unauthorized imports. For these reasons, some brand owners find gray-market goods to be just as objectionable as counterfeits.

authorities in the United States.<sup>70</sup> Consumers who purchase clothing with a famous designer logo displayed conspicuously on the item, sneakers with a distinctive trademark, or luxury designer handbags with a distinctive trademark and trade dress, seek the prestige of the brand name; this prestige is the most valuable asset of the original product, not the quality of the product. Consumers who purchase these goods are not concerned about the poor quality of the product: Although many of these counterfeits are of at least serviceable quality, they just want the goodwill of the brand name. MNCs feel threatened by counterfeits because they compromise the ability of MNCs to control every facet of how their brands are presented to the public and cause harms, including dilution of the exclusivity of their brands. This is the primary motivation of MNCs that seek to limit or control counterfeiting; it is less about the recovery of fictitious lost sales of the genuine product caused by the sale of counterfeits.<sup>71</sup>

## *B. Harm to Developing Countries*

Contrary to popular belief, developing countries, not MNCs, suffer the most harm from the global counterfeiting trade.

### *1. Organized Crime*

The introduction of famous brands into developing countries has provided an irresistible lure to criminal organizations to branch out into this lucrative area of crime. In East Asia—the hotbed of counterfeiting—criminal organizations involved in gambling, prostitution, smuggling, narcotics, and human trafficking have now migrated to counterfeiting because of its highly lucrative rewards and the low-risk nature of the crime.<sup>72</sup> Penalties for trafficking in narcotics

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70. In 2009, the largest categories of exports from China to the United States were computer equipment, manufactured commodities, and telecommunications equipment; apparel was the fifth most exported class of goods. See *U.S. Imports for Consumption at Customs Value from China*, USITC, <http://tinyurl.com/4wjpttq> (last visited Mar. 26, 2011). Furthermore, a joint publication by the U.S. Customs and Border Protection and U.S. Immigration and Customs Enforcement stated that “footwear” was the top commodity seized in 2009 for the fourth year in a row, which accounted for thirty-eight percent of all intellectual property rights seizures by value; “consumer electronics” and “handbags/wallets/backpacks” rounded out the top three seized counterfeited commodities entering the United States in 2009. See U.S. CUSTOMS AND BORDER PROTECTION & U.S. IMMIGRATION AND CUSTOMS ENFORCEMENT, INTELLECTUAL PROPERTY RIGHTS SEIZURE STATISTICS: FISCAL YEAR 2009, at 8 (2009), available at <http://tinyurl.com/4nzc9x2>.

71. Anti-counterfeiting thus becomes part of the larger effort of brand owners to exercise absolute and full control over every facet of how their brands are presented to the public. Preventing the unauthorized importation of gray market goods and the use of unauthorized websites set up by third parties that might confuse consumers are also part of the portfolio of the brand-protection unit.

72. Telephone Interview with Timothy P. Trainer, President, Global Intellectual Prop.

are notoriously severe in Asia: Long prison sentences and capital punishment are common for narcotics violations, but penalties for trading in counterfeit goods that do not result in injury or death are almost trivial by comparison.<sup>73</sup>

A comparison between the trade in illegal narcotics and the trade in counterfeit cigarettes illustrates why counterfeiting has become so attractive to organized crime in Asia. Criminal organizations in Asia are now largely responsible for the trade in counterfeit cigarettes.<sup>74</sup> Every day, large metal shipping containers of counterfeit cigarettes manufactured in China pass undetected through the port of Los Angeles in the United States.<sup>75</sup> The counterfeit cigarettes in these containers cost about \$80,000 to produce but have a street value of about \$1 million.<sup>76</sup> These profit margins rival those of the trade in illegal narcotics. Counterfeit cigarettes, unlike illegal drugs, can be shipped in daylight in plain sight using ordinary means of transport (such as trucks and rails) and can be stored in commercial warehouses. By contrast, illegal drugs must use clandestine means of transport and storage, thereby adding to the risk and the costs of the trade. Considerable organization is involved in this global trade in counterfeit cigarettes: Tobacco must be grown and procured, cigarettes must be produced and packaged in counterfeit packaging, export arrangements for shipment in containers must be arranged, import documents using false and stolen information must be produced in order for the products to pass through U.S. customs, and the counterfeits must then be distributed through weak links in distribution networks in the United States where they can finally reach the end-use consumer.<sup>77</sup> All of these steps require large-scale organization and resources, as well as many participants located in China and in the United States (sometimes referred to as “foot soldiers”). Only a highly efficient criminal organization has the resources to conduct this kind of trade, and reports indicate that these criminal organizations are as

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Strategy Ctr., Former Attorney Advisor, U.S. Customs Serv. and U.S. Patent & Trademark Office (Mar. 31, 2011) [hereinafter Trainer Interview].

73. In China, trafficking in narcotics is ruthlessly suppressed, but criminal punishment for counterfeiting is rare. *See, e.g.*, Chen Hong, *Nigerian Sentenced to Death for Drug Dealing*, CHINA DAILY, Mar. 11, 2010, <http://tinyurl.com/4dpxju9>; *Penalties for Drug-Related Crime in Asia*, CNN, May 5, 2009, <http://tinyurl.com/4j8q3tb>; *World Day Against Drugs, China Carries out Eight Death Sentences*, ASIA NEWS, June 24, 2010, <http://tinyurl.com/4p276bd>; *see also* Chow, *supra* note 22, at 754–60.

74. *See* U.S. CUSTOMS AND BORDER PROTECTION & U.S. IMMIGRATION AND CUSTOMS ENFORCEMENT, *supra* note 70, at 8, 10, 12.

75. *See* Chow, *supra* note 8, at 473, 475–76.

76. *See id.* at 475.

77. *See id.*

violent and ruthless as any of the organizations involved in drug trafficking.<sup>78</sup>

Given that several containers of counterfeit cigarettes worth \$1 million pass through the port of Los Angeles each day, the trade in such cigarettes is highly lucrative and can rival the profit that can be earned in narcotics.<sup>79</sup> The penalties for trafficking in counterfeit goods, however, are very low compared with the penalties for dealing in illegal drugs.<sup>80</sup> Because cigarettes are not viewed sympathetically by large segments of the consumer public in the United States, counterfeiters also have the advantage of working in an out-of-favor industrial sector that attracts little media attention or public sympathy.

Although the example discussed above concerns counterfeit cigarettes, the same type of organized operations occur with clothing, shoes, handbags, auto parts, and electronics. Generally, though, profit margins in these other industries are not as high as those for the trade in

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78. See Bill Gertz, *Organized-Crime Triads Targeted*, WASH. TIMES, Apr. 30, 2010, at A10, available at <http://tinyurl.com/3459eq3>; Kafchinski, *supra* note 37, at 1–7. See generally LAVERLE B. BERRY ET AL., FED. RESEARCH DIV., LIBRARY OF CONGRESS, TRANSNATIONAL ACTIVITIES OF CHINESE CRIME ORGANIZATIONS (2003), available at <http://tinyurl.com/5vnjjig> (surveying activity of Chinese organized crime groups around the world from 2000 to 2003).

79. See CHOW & SCHOENBAUM, *supra* note 1, at 573.

80. The Trademark Counterfeiting Act of 1984 criminalizes “trafficking” in counterfeit goods. Pub. L. No. 98-473, 98 Stat. 2178 (1984). The maximum term of imprisonment is ten years and the maximum fine is \$5 million. See 18 U.S.C. § 2320(a) (2006). Criminal penalties for trafficking in narcotics include imprisonment for not more than 10 years, fines in the amount provided in Title 18, or, in the case of an entity, fines of not more than \$10,000,000, or both. 21 U.S.C. § 1906(a) (2006). However, criminal penalties under other federal statutes may often double and triple sanctions for drug trafficking. For example, under the Racketeer Influenced and Corrupt Organizations Act (RICO), the term “racketeering activity” includes a broad assortment of state and federal crimes, including federal offenses that involve controlled drugs; defendants may receive prison sentences separate from, but in addition to, sentences for the individual acts that constitute a pattern of racketeering. 18 U.S.C. § 1961(1)(D) (2006); see also Bridget Allison et al., *Racketeer Influenced and Corrupt Organizations*, 35 AM. CRIM. L. REV. 1103, 1107, 1149–50 (1998). RICO violators can be fined, imprisoned, and subjected to mandatory asset forfeiture. See 18 U.S.C. § 1963(a) (2006); see also Anup Malani, *The Scope of Criminal Forfeiture Under RICO: The Appropriate Definition of “Proceeds,”* 66 U. CHI. L. REV. 1289, 1290 (1999). As long as the “racketeering activity” is “chargeable” or “indictable” under an applicable criminal statute, the substantive RICO charge is available. 18 U.S.C. § 1961(1)(E) (2006). RICO’s criminal penalties are as follows: “Whoever violates any provision of section 1962 of this chapter shall be fined under this title [ ] or imprisoned not more than 20 years (or for life if the violation is based on a racketeering activity for which the maximum penalty includes life imprisonment), or both . . .” *Id.* § 1963(a). Furthermore, Sections 952 and 953 of Title 21 prohibit importing and exporting controlled substances in and out of the United States, except for some specific scientific purposes with the authorization of the Attorney General. 21 U.S.C. §§ 952, 953 (2006). Depending on the type and amount of substance, penalties can be stiff. See *id.* § 960. In the course of advising brand owners on their counterfeiting problems, the author has found that brand owners often complain that enforcement against counterfeiting is not a priority for federal officials. The author has also heard frequent complaints by brand owners that in recent years, U.S. Customs authorities have focused their border patrol efforts on homeland security and the detection of terrorism.

counterfeit cigarettes.<sup>81</sup> However, many of the same organizations involved in smuggling counterfeit cigarettes also deal in counterfeit consumer goods for similar reasons: high profit margins and low risk of capture and punishment.

Penetration by counterfeits into the U.S. market is considered relatively difficult by international standards because of the many resources the United States has made available to police its borders. In many developing countries, such as those in Africa and South America, counterfeit goods can pass easily through customs without detection. In the global trade in counterfeit goods, the distribution of goods from the site of manufacture to the end-use consumer—often located in a foreign country—requires the type of organizational skills and resources that can only be provided by organized crime.

Organized crime is a serious global problem: It existed long before counterfeiting at its current levels emerged. But the emergence of the global trade in counterfeit goods has provided organized crime in developing countries a new and highly lucrative means to earn profits. An additional, lucrative source of profits strengthens these organizations, thereby allowing them to recruit new members, expand their reach, finance other dangerous criminal activities, and increasingly harm those societies in which they operate.<sup>82</sup>

## 2. *Government Corruption and Local Protectionism*

Organized crime often works hand in hand with corrupt government officials in developing countries. For example, in China (considered by most experts to be the source of most of the world's counterfeits<sup>83</sup>), corrupt government officials work actively to protect and support the trade in counterfeit goods. In fact, the role of local governments in supporting the trade in counterfeit goods often blurs the distinction between the criminal organizations involved in the trade and the government officials who support the trade.<sup>84</sup> In other words, corrupt local government officials themselves might be considered to be part of the criminal organization behind the trade in counterfeit goods.<sup>85</sup>

Local governments in China protect the trade in counterfeit goods in various ways. In many instances, local government administrative units invest in wholesale markets that distribute counterfeit goods, both

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81. Trainer Interview, *supra* note 72.

82. U.N. OFFICE ON DRUGS & CRIME, *supra* note 50, at 173–90.

83. *60 Minutes: The World's Greatest Fakes: Chinese Copies Are Making Their Way Back To U.S.* (CBS television broadcast Aug. 8, 2004), available at <http://tiny.cc/fxogm> (statement of Professor Daniel Chow).

84. See Chow, *supra* note 8, at 476.

85. See *id.*

within China and for sale in countries abroad.<sup>86</sup> The local Administration of Industry and Commerce, a bureau charged with developing trade and commerce, invests millions of dollars in establishing these markets and then rents out the stalls (each stall representing a wholesale distribution outlet for counterfeit goods) and charges a fee for business licenses.<sup>87</sup> These wholesale markets sell several tons of counterfeit and infringing goods to retail stores all over China for resale to consumers.<sup>88</sup> Many of these counterfeit goods will also be purchased by overseas buyers for export to countries around the world.<sup>89</sup> Some local governments have established management companies to operate these wholesale markets, and some have even privatized these companies so that they are free to keep their profits.<sup>90</sup>

These wholesale markets that deal in counterfeit and infringing goods can earn millions of dollars in sales revenue and can be vital to the local economy.<sup>91</sup> Not only do these markets generate substantial sales revenues, but the illegal trade in counterfeit goods also supports a host of businesses that are dependent on counterfeiting. For example, trucking and rail, warehouse and storage, restaurants, hotels, and nightclubs all depend on the trade in counterfeit goods to bring in business.<sup>92</sup> Moreover, despite the claims of MNCs to the contrary, counterfeiters also pay taxes to local governments. Clever counterfeiters often negotiate a flat tax rate in order to satisfy local tax authorities.<sup>93</sup> Because counterfeiting brings substantial benefits to the local economy, local governments are reluctant to shut down counterfeiting. In a country such as China, local government enforcement authorities, including judges and the police, are appointed by local mayors and other political officials. These officials put pressure on enforcement authorities to refrain from shutting down the counterfeiting trade.<sup>94</sup> In China and in many other parts of the developing world, enforcement against counterfeiting does not result in serious civil or criminal sanctions, but instead result in penalties that are so minor they may be considered part of the cost of doing business. Counterfeiters often pay a

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86. *See id.*

87. *Id.*

88. See Daniel Chow, *Counterfeiting in the People's Republic of China*, 78 WASH. U. L.Q. 1, 20 (2000).

89. See Chow, *supra* note 8, at 477–78.

90. *See id.* at 478–79. If the government entity does not privatize its operations, revenues must go to the government treasury for public use. Privatizing the management of these markets allows the new private entity to keep the profits for its own use.

91. *See id.* at 482.

92. *See id.* at 481.

93. *See id.* at 481–82.

94. *See id.* at 481.

minor fine and are back in business in a few weeks.<sup>95</sup> Few criminal prosecutions are brought, and imprisonment is rare.<sup>96</sup>

Developing countries have many systemic weaknesses, including organized crime and weak, corrupt governments. Counterfeiting has significantly exacerbated these problems by providing a highly lucrative and high-volume business that provides a significant source of revenue. To the extent that criminal organizations are financially strengthened through counterfeiting and that government corruption becomes even more serious and embedded, it is the country where counterfeiting occurs that suffers real social costs. Some international organizations have attempted to place a monetary figure on the costs of corruption and crime and have arrived at large and impressive figures.<sup>97</sup> But the real costs, as the citizens of China and many other developing countries know, are the social and human costs of a deep mistrust of government and a fear of organized crime that pervades daily life in these countries. Countries with corrupt governments and high levels of organized crime are not likely to make progress in important social institutions such as the rule of law, human rights, clean and transparent government, and control of crime. These are the real costs of counterfeiting that are imposed on developing countries by the MNCs.

### 3. *Health and Safety Risks*

Another type of externality suffered by developing countries is health and safety hazards caused by the proliferation of substandard counterfeit medicines. According to some recent media accounts, ten percent of the world's drugs are counterfeit; fake baby infant formula, cough syrup, and other medicines have led to serious illness or death.<sup>98</sup> However, almost all of these harms to human health and safety occur in developing and least developed countries, which have weak border control systems that allow counterfeits that are mostly manufactured in

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95. *See id.* at 483.

96. *See* Chow, *supra* note 22, at 755.

97. *See, e.g.*, Organisation for Economic Co-operation and Development [OECD], *Magnitude of Counterfeiting and Piracy of Tangible Products: An Update* (Nov. 2009), available at <http://tiny.cc/6be8s>; International Centre for the Prevention of Crime [ICPC], *International Report on Crime Prevention and Community Safety: Trends and Perspectives* (Apr. 2010), available at <http://tiny.cc/2x6xb>; International Chamber of Commerce [ICC], *The Fight Against Piracy and Counterfeiting of Intellectual Property*, ICC Doc. 450/986 (June 1, 2004), available at [https://www.uscib.org/docs/icc\\_counterfeiting.pdf](https://www.uscib.org/docs/icc_counterfeiting.pdf); *see also* Els De Temmerman, *Counterfeits Killing Regional Industries*, ALL AFRICA, July 15, 2009, <http://allafrica.com/stories/200907160095.html>; Richard Lapper & Adam Thomson, *Cash Starved City in Paraguay Fights War on Counterfeit Goods*, FIN. TIMES, Asia Ed. 1, Sept. 9, 2005, at 8.

98. *See* WORLD HEALTH ORGANIZATION [WHO], COUNTERFEIT MEDICINES: AN UPDATE ON ESTIMATES 1 (2006), available at <http://tinyurl.com/bed275>; *see also* Carl Bialik, *Much-Cited Count of Counterfeit Drugs Is Tough to Swallow*, WALL ST. J., Sept. 11, 2010, at A2.

China to pass through undetected.<sup>99</sup> Almost no serious health or safety incidents have occurred in advanced industrialized countries, such as the United States and many European countries.<sup>100</sup> Consumers in these countries are too savvy and distribution networks are too professional to allow low-quality medicines to penetrate distribution channels to reach consumers. As with the other harms associated with counterfeiting, developing countries, least-developed countries, and, in particular, the poorest countries in the world tend to suffer the most harm.<sup>101</sup>

### III. HOW MNCs CONTRIBUTE TO COUNTERFEITING

This Part now turns to a closer examination of how MNCs have contributed to the rise of the global trade in counterfeiting and why they may bear both ethical and financial responsibility for alleviating the problem.

#### A. Branding

In the past several decades, MNCs and many other business entities have invested enormous financial resources in trademarks or brands and have created intellectual property rights in brands themselves. Traditionally, trademarks served an origin function—that is, trademarks indicated the source of goods.<sup>102</sup> Historically, the law of trademarks developed when several businesses started using the same mark to sell goods, creating consumer confusion.<sup>103</sup> A trademark gives the owner of the mark a right to use the mark on certain types of goods to the exclusion of competing vendors, but it does not create any intellectual property rights in the trademark itself.<sup>104</sup> The trademark is to be used in commerce to avoid consumer confusion. A consumer who views a trademark will know that the product is from a particular

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99. See *Counterfeit Medicines: Some Frequently Asked Questions*, WHO (May 2005), <http://tinyurl.com/67gz6vg> (last visited Mar. 26, 2011).

100. See *Counterfeit Medicines*, Fact Sheet No. 275, WHO (Jan. 2010), <http://tinyurl.com/2akwna>.

101. See, e.g., U.N. OFFICE ON DRUGS & CRIME, *TRANSNATIONAL TRAFFICKING AND THE RULE OF LAW IN WEST AFRICA: A THREAT ASSESSMENT* 33–40 (2009), available at <http://tinyurl.com/kwvtd4>; Paul N. Newton et al., *Murder by Fake Drugs: Time for International Action*, 324 BRIT. MED. J. 800, 800–01 (2002); see also *9 Tons of Fake Medicine Seized in East Africa*, CNN, Aug. 26, 2010, <http://tinyurl.com/6zl8mz7>; *Fake Drugs: Poison Pills*, ECONOMIST, Sept. 4, 2010, at 65, available at <http://tinyurl.com/64o4u8o>; Charissa Sparks, *Counterfeit Drugs Kill Patients Desperate for Treatment*, ALL AFRICA, Aug. 6, 2010, <http://allafrica.com/stories/201008090998.html>; *A Third of the Medicine in Africa is Counterfeit*, PROG. POL'Y INST. (June 13, 2007), <http://tinyurl.com/6fhy4be>.

102. See CHOW & LEE, *supra* note 41, at 474.

103. See *id.* at 474–75.

104. See *id.*

manufacturer and will have the assurance that the product will be of the same quality as goods previously purchased from the same manufacturer.<sup>105</sup> Trademarks were once viewed as part of the law of tort and unfair competition, with the ultimate goal of protecting the consuming public from deception or confusion.<sup>106</sup> A breach of rights conferred by trademarks depended on showing consumer confusion; trademarks were not viewed as creating exclusive property rights in the owner similar to rights created under copyright or patent.

In recent decades, however, this view of trademarks has changed. MNCs are increasingly viewing trademarks or brands as property rights and their most valuable business assets. According to one recent report,

[b]randing used to be practiced by companies that sold packaged goods to consumers — and almost no one else. Developing a brand included advertising, package design, and maybe a few promotions and was seen as far less central to the corporate mission than serious stuff such as floating debentures, quickening inventory turns, or boosting capacity utilization.

That was in a different millennium. As the new one unfolds, brands have been taking center stage in a sweeping shift that some compare to the wave of mass marketing that occurred in the years following World War II. Pharmaceutical companies, which have been liberated to promote their products directly to consumers, have been spending hundreds of millions to create entirely new brands such as Viagra and Claritin. Branding efforts in the financial services sector have taken off as that industry has consolidated and as federal legislation has knocked down the walls that used to separate banks from brokerage houses. Professional services companies such as Andersen Consulting, rebranded as Accenture, have realized that conveying a sense of trust and shared mission is as important as technical competence in winning multimillion-dollar contracts. Universities, government agencies, entertainment properties, and even individuals — Michael Jordan, Martha Stewart, Madonna — have come to be regarded as brands: Their names stand for an implicit promise of quality, innovation, or reliability.<sup>107</sup>

The report goes on to explain that

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105. The trademark helps consumers make purchasing decisions based on prior purchases so consumers can avoid unnecessary market investigations or research. *See id.* at 474.

106. *See id.* at 475.

107. Gerry Khermouch et al., *The Best Global Brands*, BLOOMBERG BUSINESSWEEK, Aug. 6, 2001, at 53–54.

[a] strong brand acts as an ambassador when companies enter new markets or offer new products. It also shapes corporate strategy, helping to define which initiatives fit within the brand concept and which do not.

That's why companies that once measured their worth strictly in terms of tangibles such as factories, inventory, and cash have realized that a vibrant brand, with its implicit promise of quality, is an equally important asset. A brand has the power to command a premium price among customers and a premium stock price among investors. It can boost earnings and cushion cyclical downturns . . . .<sup>108</sup>

The world's most valuable brands, measured by the value of the brand alone as a revenue-producing business asset, are listed in Table 1. The enormous value of these brands is the result of the significant resources that MNCs have invested in creating property rights that result in a goodwill that in many cases is far beyond the cost of the materials of the product. The role of the brand is no longer just to indicate the origin of the goods but to create goodwill: an image of prestige, glamour, innovation, a certain lifestyle, a youthful and energetic attitude, and exclusivity. Branding creates a premium that allows brand owners to recoup their advertising costs and earn even higher profits because it allows brand owners to charge much higher prices for some types of goods than would be justified by the cost of the materials alone. This premium is created by a significant investment in advertising, promotion, and media, thereby creating a brand image that now has taken on a business asset value apart from its traditional origin function.<sup>109</sup> The premium created by the goodwill of the brand through significant investments has created a valuable asset that also creates an incentive to copy.<sup>110</sup> In most cases, consumers, fueled by advertising and promotion, want the prestige of the brand even more than they want the product itself. The branding phenomenon has created vast new financial incentives to produce counterfeited and pirated goods.

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108. *Id.* at 50–52.

109. See, e.g., David A. Aaker, *A Measure of Brand Acceptance*, 9 J. MKTG. RES. 160 (1972); Robert Jacobson & David A. Aaker, *The Strategic Role of Product Quality*, 51 J. MKTG. 31 (1987); David Willey, *Brand Management: Only the Strong Survive*, 14 J. BUS. STRATEGY 30, 30–31 (1993); see also Rik Myslewski, *Google Name 'Worth \$100 Billion,' Says Strategy Boutique*, REGISTER (London), May 1, 2009, available at <http://tinyurl.com/63x3uh9>.

110. One could also argue that the premium created by the brand includes a markup to recoup any of the costs of unauthorized copies. For example, producers of movies, music, and computer software might mark up their products anticipating unauthorized copies. If that is the case, then any costs from counterfeiting are already included in the price of the product. In the author's own experience, no MNC has been willing to discuss this issue.

TABLE 1: THE WORLD'S TEN MOST VALUABLE BRANDS IN 2006<sup>111</sup>

Rank	Brand	2006 Brand Value (\$Billions)
1	Coca-Cola	67.0
2	Microsoft	56.9
3	IBM	56.2
4	GE	48.9
5	Intel	32.3
6	Nokia	30.1
7	Toyota	27.9
8	Disney	27.8
9	McDonald's	27.5
10	Mercedes-Benz	21.7

### B. Globalization and Foreign Direct Investment

In the past several decades, MNCs have begun an unprecedented wave of foreign direct investment (FDI) as part of the globalization movement<sup>112</sup> that has revolutionized the way business (and many other aspects of life) is now conducted in the modern world.<sup>113</sup> FDI occurs when MNCs acquire a permanent ownership interest in a business entity located in a foreign country.<sup>114</sup> The clearest example of FDI is when a

111. *Top 100 Global Brands Scoreboard*, BLOOMBERG BUSINESSWEEK, [http://www.businessweek.com/interactive\\_reports/top\\_brands.html](http://www.businessweek.com/interactive_reports/top_brands.html) (last visited Mar. 26, 2011).

112. Globalization refers to the relatively free movements of goods, services, technology, capital, and information over the world. Only a few decades ago, the world was separated by barriers created by vast distances and differences in time zones. Globalization has reduced or eliminated many of these barriers. The process has occurred within about one generation and has completely changed how business is conducted in the modern world. Globalization is controversial; it has both benefits and harms and a debate rages on whether the benefits outweigh the harms. *See, e.g.*, CHOW & SCHOENBAUM, *supra* note 1, at 20–21.

113. FDI has significantly outpaced other channels of trade (goods, services, and technology) with a growth rate of 9.5% from 1973 to 1997 — a rate that is more than double the growth in the trade in goods for the same period. *See id.* at 17. FDI began to grow significantly in the decade of the 1980s and then accelerated significantly through the decade of the 1990s. *See id.* Counterfeiting and other forms of commercial piracy first began to appear as serious problems in the decade of the 1990s, coinciding with the surge in FDI, and reached critical levels after 2000. The surge in FDI led directly to the rise of counterfeiting and commercial piracy.

114. CHOW & SCHOENBAUM, *supra* note 1, at 366.

hypothetical MNC, with its headquarters in the United States, establishes a wholly-owned subsidiary in France, India, Brazil, or China.<sup>115</sup> When the MNC establishes the wholly-owned subsidiary in France, the subsidiary is a French business entity under French law. The MNC, a U.S. corporation, is the foreign owner of all of the stock or assets of the domestic French company. FDI would also exist if the MNC established a joint venture instead of a wholly-owned foreign subsidiary. A joint venture is a partnership between the MNC and a local (in this example, French) company.<sup>116</sup> Both the MNC and the local company are co-owners of the joint venture, each with an equity interest.<sup>117</sup> The joint venture, however, is a creature of local law and the MNC is considered to be a foreign owner.<sup>118</sup>

During the wave of globalization that occurred in the past several decades, the amount of new FDI exceeded all of the other channels of trade in the modern world.<sup>119</sup> Many MNCs have established foreign subsidiaries or joint ventures in developing countries, such as China, Vietnam, and India, in order to take advantage of low manufacturing and labor costs and lenient regulatory regimes. In FDI, a crucial component is the transfer of technology from the parent MNC to the foreign business entity.<sup>120</sup> For example, if an MNC engaged in the manufacture of pharmaceuticals were to establish a foreign subsidiary to manufacture drugs in a foreign country, the MNC must transfer technology — that is, knowledge and know-how often protected by forms of intellectual property such as patents, copyrights, trademarks, and trade secrets — to the foreign subsidiary.<sup>121</sup> Without access to such technology, the foreign subsidiary will be unable to manufacture the products for sale. Indeed, the technology or intellectual property component of the foreign investment is usually the most critical element of the foreign subsidiary's eventual success or failure. In the modern global marketplace, competitiveness of products and services is directly linked to the level of technology involved and, in general, the higher and more advanced the level of technology, the more competitive the product will be.<sup>122</sup> MNCs, in order to take advantage of low manufacturing costs, set up foreign subsidiaries and then transfer

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115. *See id.*; *see also id.* at 489–90 (discussing the difference between a wholly-owned subsidiary and a joint venture in China).

116. *See id.* at 492–518 (explaining how to establish a joint venture in China).

117. *See id.* at 489 (discussing the example of a joint venture in China).

118. *See id.* at 492–93 (using a joint venture in China as an example).

119. *See id.* at 17.

120. *See* DANIEL C.K. CHOW & THOMAS J. SCHOENBAUM, INTERNATIONAL TRADE LAW: PROBLEMS, CASES, AND MATERIALS 201–02 (2008).

121. *See id.*

122. *See id.* at 200.

technology to those subsidiaries so that they can effectively produce goods for sale in the foreign markets or import them back to the United States. The above example concerned a pharmaceutical company, but the same process of technology transfer would exist in the case of other goods, such as computers, electronics, and consumer goods.

The globalization of manufacturing operations by MNCs has been a hallmark of the modern age and has allowed MNCs to greatly increase their power and influence.<sup>123</sup> Using sophisticated corporate structures often involving a parent holding corporation and various overseas manufacturing subsidiaries, MNCs have been able to set up transnational production chains that can bypass or evade national laws on labor and the environment.<sup>124</sup> MNCs play a central role in the movement of capital and technology from developed countries to developing countries and thus have become major players in determining the economic, political, and social welfare of nations, particularly in developing nations that have a strong hunger for foreign capital and technology.<sup>125</sup>

When MNCs take advantage of lower manufacturing costs in developing countries, they introduce technology in environments that often have weak legal systems and inept and corrupt governments. The rudimentary nature of legal systems in developing countries is one of the main reasons why costs are lower than in developed countries, which have more sophisticated legal systems with more stringent legal standards imposing higher costs of compliance. A sophisticated legal system, however, is not likely to be found in developing countries because such systems require a significant investment of resources that these countries usually lack.<sup>126</sup> A legal system similar to that in the United States is supported by significant resources such as law schools, a system of courts, government lawyers, and private attorneys, as well

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123. See MANFRED B. STEGER, *GLOBALISM: THE NEW MARKET IDEOLOGY* 27–28 (2002).

124. *See id.* at 28. For example, some MNCs take advantage of lax environmental laws to set up dangerous operations overseas. Union Carbide, a U.S.-based multinational company, was able to set up a manufacturing facility in Bhopal, India. A gas leak from the Bhopal plant led to the deaths of more than 2,000 people and injured many more. Although Union Carbide settled the case at a cost of about \$470 million, the costs of such an accident, if it had occurred in the United States, would have likely been much higher. *See* CHOW & SCHOENBAUM, *supra* note 1, at 772–80.

125. *See* STEGER, *supra* note 123.

126. Do developing countries have an obligation under international law to invest additional resources to improve their legal systems in order to create greater protections for intellectual property rights? The answer is no, according to the WTO. *See* TRIPS, *supra* note 41, art. 41, ¶ 5 (“It is understood that this Part does not create any obligation to put in place a judicial system for the enforcement of intellectual property rights distinct from that for the enforcement of law in general, nor does it affect the capacity of Members to enforce their law in general. Nothing in this Part creates any obligation with respect to the distribution of resources as between enforcement of intellectual property rights and the enforcement of law in general.”).

as enforcement officials such as federal prosecutors, federal marshals, customs officials, the FBI, and the police. The costs of such a legal system are significant and are far beyond the capability of many developing countries, which often have, by comparison, a rudimentary system that cannot be compared with those in advanced industrialized countries such as the United States, Japan, and many European countries. In addition, many developing countries have governments that are inept and seriously corrupt, who tolerate or work hand in hand with criminal organizations.<sup>127</sup>

In such an environment, it is predictable that the transfer of technology by an MNC to a foreign subsidiary in a developing country will lead to counterfeiting and piracy on a scale that would not occur if the FDI did not take place.<sup>128</sup> Because MNCs are not really harmed by counterfeiting and piracy and because they enjoy many advantages when investing in developing countries, they make these decisions to invest without considering the external harms and costs of counterfeiting, which fall primarily on the host country.

### C. *Why MNCs Exaggerate Losses*

If MNCs cannot substantiate their claims of severe financial losses and if the losses appear to be only a tiny fraction of the amounts claimed, why do MNCs vehemently assert these claims? First, many MNCs have a corporate culture in which it is necessary to frame a business problem in terms of hard financial numbers in order for the

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127. According to Transparency International, a global civil society organization, the top ten most corrupt countries are all developing or least developed countries: Somalia, Afghanistan, Myanmar, Sudan, Iraq, Chad, Uzbekistan, Turkmenistan, Iran, and Haiti. See *Corruption Perceptions Index 2009*, TRANSPARENCY INT'L, available at <http://tinyurl.com/yf42b83>; see also Daniel Fisher, *The World's Most Corrupt Countries*, FORBES, Feb. 17, 2010, <http://tinyurl.com/6drs7kv>.

128. If MNCs did not establish subsidiaries in developing countries and instead confined their manufacturing operations to their home countries, would leakage of intellectual property occur in the developed-country home of the MNC anyway, thus leading to counterfeiting in developing countries? In other words, is the rise of FDI and globalization really to blame for the spectacular rise in counterfeiting? Evidence indicates that counterfeiting occurs where legitimate manufacturing first occurs. In China, for example, the hotbeds of counterfeiting are in southeastern China, the first areas opened to FDI and the locations of the first manufacturing sites. In a pattern in China that seems to be repeated everywhere in the world, factories making counterfeits spring up near factories established to manufacture the genuine product. Someone inside the legitimate factory learns the inner workings of how the goods are made — how the equipment is set up and used, where to obtain raw materials, how ingredients are mixed and combined, and how the product is designed and packaged — and sets up an illegal operation on his own or through associates. The same or similar materials used in making the genuine product are now sourced from the same providers and used to make fakes. If FDI did not occur in foreign countries it is doubtful that counterfeiters would be able to obtain this level of knowledge, access to materials, and begin manufacturing on such a massive scale.

problem to be viewed seriously within the company. Even though brand managers may not consider counterfeiting to really cause losses, brand managers have incentives to characterize the sale of counterfeits as “lost sales” because these lost sales are ostensibly reducing what would be even higher revenue numbers for the brand managers which would merit a higher performance rating and annual evaluation for the brand manager. Brand managers have an incentive to argue that but for counterfeits, their revenue numbers would be even higher, and that they should not be penalized by way of a reduction in salary increases or promotions for a problem that they did not cause. Many brand managers will therefore argue that counterfeits are lost sales and report seizures of counterfeit products as “recovered sales,” thereby adding to the bottom line of the company and enhancing their individual performance.<sup>129</sup> Sales and brand managers within MNCs have long been accustomed to a corporate culture in which serious business problems must be framed in terms of losses to the bottom line and, of course, also have incentives to portray their own performance in as positive a light as possible.<sup>130</sup> A second reason is that decrying huge losses engenders public sympathy and portrays MNCs as the victim of a global crime wave that is causing serious financial losses to MNCs, their host countries, consumers, and taxpayers. Portraying themselves as incurring massive financial losses to counterfeiting might help bolster claims by MNCs that they need to charge premium prices in order to recoup research, development, and promotional costs. Claiming huge losses also helps to divert public attention from the role that MNCs have played in creating the global trade in counterfeit goods and inflicting serious harms upon developing countries that suffer the brunt of the costs of counterfeiting. A third reason for portraying counterfeiting as a massive and costly global crime wave is that it helps MNCs argue that national governments must share the costs of combating counterfeiting. By depicting themselves as the victims of counterfeiting, MNCs can shift some, or even the bulk, of the costs of enforcement to the public, rather than bearing the entire costs themselves.<sup>131</sup> Some MNCs have even suggested that revenues

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129. Some MNCs treat every counterfeit product that is seized in raids on factories and warehouses as a recovered sale, adding to the revenue of the company. Treating seizures as recovered sales is consistent with the approach that the sale of every counterfeit blocks the sale of a genuine product at the retail price. See Chow, *supra* note 22, at 768–69. Based on the author’s own experience working in the anti-counterfeiting unit of an MNC, no one in an MNC, not even those working in anti-counterfeiting departments, seriously believes that the sale of a counterfeit blocks a sale of a genuine product, and that every seizure of a counterfeit represents a recovered sale.

130. See *id.*

131. See Mackenzie, *supra* note 14, at 23–24, 29.

earned from counterfeiting support terrorism, but this connection appears to be tenuous and unsubstantiated.<sup>132</sup>

When counterfeiting is seen as a corporate externality for MNCs and it is understood that the harms of counterfeiting fall disproportionately on developing countries, then the proper responsibility for creating those harms and bearing the financial costs of addressing those harms changes significantly. MNCs — once cast as the victims of counterfeiting — now may bear an ethical and financial responsibility to compensate for the harms caused by counterfeiting.<sup>133</sup> Developing countries, which were once viewed as the major perpetrators of counterfeiting, may now have legitimate claims against MNCs for introducing and spreading the counterfeit system (a serious economic crime with many social costs) into their economies. National governments and taxpayers, once viewed as having to bear the costs of enforcement against global counterfeiting, may have a claim against MNCs for contributions to the costs of enforcement. To some extent, similar issues arose in connection with industrial pollution several decades ago. Pollution to the environment — a byproduct of industrialization — was an externality to MNCs since the harms to the environment were cast upon others.<sup>134</sup> Only when these costs were internalized and imposed on MNCs through government requirements did real progress in pollution reduction occur.<sup>135</sup> A similar process of imposing some of the costs of spreading and creating counterfeiting may need to occur in order to internalize some of the costs associated with counterfeiting. Internalizing some of these costs will force MNCs to consider these costs as they make decisions to expand low-cost manufacturing operations into countries where counterfeiting is a predictable consequence of FDI. Undoubtedly, developing countries will need to develop a strategy to make these demands known in an international forum such as the World Trade Organization (WTO)

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132. Although this assertion has been made repeatedly in recent years, MNCs have provided no reliable evidence of a real and substantial connection. According to some accounts, China accounts for eighty percent of the global trade in counterfeit goods, and there has been no evidence at all of a link between counterfeiters in China and terrorism. China is an authoritarian, one-party state that can act swiftly and ruthlessly when it finds that its interests are threatened. Any link between counterfeiting and terrorism would have been quickly uncovered and mercilessly suppressed.

133. See Mackenzie, *supra* note 14, at 22–23.

134. See Francis O. Adeola, *Environmental Injustice and Human Rights Abuse: The States, MNCs, and Repression of Minority Groups in the World System*, 8 HUM. ECOLOGY REV. 39, 43–44 (2001).

135. See WORLD TRADE ORGANIZATION, WORLD TRADE REPORT 2004, at 166–69 (2004), available at <http://tiny.cc/1wv2y>.

because they are the ones who suffer the brunt of the harms from counterfeiting.<sup>136</sup>

In this light, counterfeiting and other forms of commercial piracy can be viewed as a harmful byproduct or side effect of the process of globalization of business and trade. MNCs profit from the globalization of their manufacturing operations, but this globalization process also has costs. No one suggests that the solution to the harms caused by globalization is the reversal of the process. It is impossible to argue that MNCs should curtail or reverse FDI in foreign countries or to withhold technology transfer. Even its harshest critics acknowledge that globalization is irreversible and the further deepening of the process is inexorable. The real issue is this: Who must pay for the costly side effects of globalization? Do MNCs have a reciprocal social and ethical responsibility to ameliorate the harmful side effects of the globalization of manufacturing from which they derive enormous financial benefits?<sup>137</sup> A full examination of this question is beyond the scope of this article, but the question of which parties, other than the developing nations, should bear the financial costs of counterfeiting has not received sufficient attention and needs to be examined. On this subject, there is a growing literature on the concept of corporate social responsibility.<sup>138</sup> Bill Gates, the founder of Microsoft, has argued that MNCs have a social responsibility to undertake projects to ameliorate the problems of globalization such as health epidemics, environment degradation, and world poverty. Gates calls this “creative capitalism.”<sup>139</sup> This idea is based on the concept of social compact: Because MNCs wield enormous power and enjoy special privileges, such as limited liability, they have a responsibility to act in a socially responsible manner, including compensating for harms caused by their profit-seeking behavior. There is also evidence that MNCs may have

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136. The author is assuming that there are national leaders within developing countries who are sincerely interested in the long-term welfare of their countries and are not prone to the temptations of greed, self-interest, and corruption. Developing countries, particularly Brazil and China, have recently demonstrated great skill in using the WTO to argue claims on behalf of themselves and other developing countries in the area of intellectual property, particular involving access to medicines. *See* CHOW & SCHOENBAUM, *supra* note 120, at 214–20.

137. For example, while developing countries do not have an obligation to invest additional resources into their legal systems to protect intellectual property, might MNCs have such an obligation to help developing countries if MNCs plan to introduce commercially valuable intellectual property that will create a tempting opportunity for crime? *See supra* note 113.

138. *See* CHOW & SCHOENBAUM, *supra* note 1, at 737–94.

139. The debate over who must bear the costs of the harms from globalization is vigorous and ongoing. Creative capitalism and corporate social responsibility is one part of this debate. For a fuller discussion of Gates’s concept of creative capitalism, see generally MICHAEL KINSLEY, *CREATIVE CAPITALISM: A CONVERSATION WITH BILL GATES, WARREN BUFFETT, AND OTHER ECONOMIC LEADERS* (2008).

acquired a legal personality under international law, thereby becoming subjects of international law on par with nation-states with the resulting legal responsibility to not act in ways that would harm other states.<sup>140</sup> If that is the case, one might argue that MNCs, which derive significant financial benefits from the branding movement and the globalization of their manufacturing operations, have an ethical, social, and perhaps even legal responsibility to pay for the costs of ameliorating the predictable harmful side effects of counterfeiting in developing countries.<sup>141</sup> These are questions that merit a further extended study.

### CONCLUSION

Within the past decade, counterfeiting and other forms of commercial piracy have been portrayed in the media as an illegal global trade that is reaching crisis levels, leading to financial losses of unprecedented proportions. MNCs often portray themselves as the victims of these economic crimes and claim that they are losing billions, or even hundreds of billions, of dollars on an annual basis, with many of these losses passed on to their governments and their consumers. A closer examination, however, indicates that these claims of severe financial losses are unsubstantiated and are based on spurious and dubious assumptions, resulting in reports of losses that are grossly exaggerated. Rather than suffering massive financial losses due to counterfeiting, many MNCs view counterfeiting and piracy as undermining the fundamental principle that MNCs must exercise complete control over every facet of how their brands are presented to the public. This appears to be the core harm caused by counterfeiting, and not the alleged billions of dollars in lost sales. No doubt the loss of control of brand image and goodwill results in some financial loss, but no MNC has yet attempted to quantify these losses in financial terms. The costs of lost control of brand image would seem different in kind from the current claim that there is a one-to-one correspondence between the sale of a counterfeit and the lost sale of a genuine product at the retail price.

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140. See CHOW & SCHOENBAUM, *supra* note 1, at 738–39.

141. Based on the author's own experience, some of the measures that MNCs can undertake are simple and inexpensive. MNCs are currently often casual in their approach to protecting their nonessential intellectual property. For example, MNCs can certainly take much stronger prophylactic measures within their own foreign subsidiaries to avoid the leakage or theft of intellectual property. Currently, some MNCs seem rather cavalier about some of their intellectual property rights, allowing employees to leave confidential files on desks and other public places, allowing employees to have access to computer files that are easily copied, and working with third-party contractors of dubious reputations. MNCs are concerned about "core" technologies but are much more lax about secondary technologies that they view as less commercially valuable. The leakage of these technologies, while not harmful to MNCs, creates new opportunities for crime in developing countries.

Not only are the claims of MNCs of severe financial losses unsubstantiated, but MNCs themselves have contributed in crucial ways to the rise of counterfeiting, such as by making deliberate business decisions to transfer their technology and intellectual property to their manufacturing facilities in developing countries in order to take advantage of low production costs and lax regulations. Many of these countries have notoriously weak, ineffective, and corrupt governments that often tolerate or work cooperatively with criminal elements in their countries. In such an environment, it is predictable that the introduction of intellectual property that are easily copied will create inducements for counterfeiting on a vast scale, and such inducements will prove impossible for criminal entities in these countries to resist. MNCs ignore the harms that such counterfeiting imposes on developing countries because these costs are externalities. Until the costs of counterfeiting are internalized and brought to bear on their business decisions, MNCs will not have pressing incentives to change their conduct that feeds the steady rise of the global trade in counterfeit goods, thereby resulting in harms that fall primarily on developing countries.