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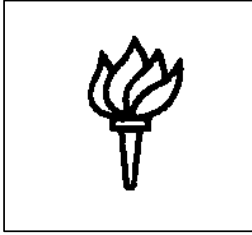
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LET THEM EAT FAKE CAKE:
THE RATIONAL WEAKNESS OF CHINA'S ANTI-COUNTERFEITING POLICY

BY

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LET THEM EAT FAKE CAKE:
THE RATIONAL WEAKNESS OF CHINA'S ANTI-COUNTERFEITING POLICY

DRAFT November 24, 2014

Kal Raustiala¹ and Christopher Sprigman²

The luxury jeweler and watchmaker Cartier has four boutiques in New York City. Given New York's great concentration of wealth, and its position at the center of the world's fashion industry, this is unsurprising. What may be surprising is that in Beijing, Cartier has six boutiques. And in Hong Kong, Cartier has eleven. Cartier's sizeable presence in China is not anomalous. Luxury brands abound in China today; American and European luxury goods firms are vigorously pursuing Chinese customers, with more and grander stores and boutiques opening every year. By many measures China is now the world's largest market for luxury goods.³

At the same time, however, the Middle Kingdom remains the Knockoff Kingdom. The Chinese are great producers and consumers of counterfeit and copied goods, and efforts to curtail counterfeiting are a central focus of many Western firms and governments. In the United States, for example, the 2013 report of the blue-ribbon Commission on the Theft of American Intellectual Property, co-chaired by former American Ambassador to China Jon Huntsman, focused extensively on China. The Commission's declared that "China is the world's largest source of IP [intellectual property] theft."⁴ According to the Commission, China's share of world IP theft reaches nearly 80%.⁵

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² Professor, New York University School of Law and Co-Director, Engelberg Center on Innovation Law and Policy. Thanks to Orly Lobel for suggesting the title of this chapter. We thank Tom Plate, Haochen Sun, Alex Wang, and Peter Yu for excellent comments on earlier drafts, and Isabella Hsu for very able research assistance.

³ *Beyond Bling*, ECONOMIST, June 8, 2013, available at <http://www.economist.com/NEWS/BUSINESS/21579015-LIFE-GETTING-HARDER-PURVEYORS-LUXURY-CHINA-GROWTH-PROSPECTS-ARE-STILL>.

⁴ NATIONAL BUREAU OF ASIAN RESEARCH, THE REPORT OF THE COMMISSION ON THE THEFT OF AMERICAN INTELLECTUAL PROPERTY 2 (2013).

⁵ See *id.* at 3.

How did China become the world's leader in luxury goods sales—a category that relies heavily on IP rights for its market value—while at the same time achieving unchallenged global dominance in “IP theft”? How can authentic luxury products, with their often-stratospheric prices, have such astonishing market success in China when knockoff versions are so easily produced and so widely available?⁶

In this chapter we explore these questions. We begin by describing China's approach to IP and its thriving luxury goods market. We then examine China's equally robust knockoff economy, and explore how copying and counterfeiting occur in China. Finally, we speculate about how the success in China of both legitimate branded luxury goods and counterfeits can be reconciled. We argue that much of the harm assumed to flow from counterfeits is difficult to demonstrate empirically in the luxury goods sector, and there are good theoretical reasons to doubt its magnitude. Indeed, the conventional wisdom about the harm caused by counterfeits is more a matter of inference than evidence. And there is some evidence, including evidence from China itself, that counterfeits can *strengthen* brands as well as undercut them.

To be clear, we do not argue that counterfeits are harmless—only that the standard case against them is surprisingly weak. As a result, the case for vigorous public enforcement of trademark law to stem the tide of luxury goods counterfeits is also weak, and especially so in China. More (politically) important, than whether Chinese counterfeits harm foreign luxury goods makers, from a Chinese perspective counterfeits have many virtues. China is a country where both the economy and income inequality are expanding rapidly, and where the growing gap between rich and poor contributes to social unrest that troubles the country's leadership. In this context, a tolerance for counterfeits and what are sometimes known as “shanzhai” goods can serve important social and political goals.⁷ These social and political effects may outweigh whatever harms may stem from counterfeits – especially considering that most of that harm, at present and for the foreseeable future, falls on foreign manufacturers. China's tolerance for knockoffs, in short, is a rational policy.

Intellectual Property in China

⁶ We primarily look at luxury apparel and accessories, but at times we consider other luxury products, such as fine wines or automobiles. These markets are often so distinct, however, that it can be difficult to generalize across them.

⁷ We say more about *shanzhai* below.

China's comparatively weak enforcement of its intellectual property laws, and the widespread copying and counterfeiting that takes place in China, have long confounded the United States and other Western governments. China has a storied history of innovation—including truly groundbreaking technologies such as gunpowder and printing—but contemporary China is much better known for knockoffs than breakthroughs. This impression is not entirely fair or accurate; many contemporary Chinese firms are quite inventive.⁸ But China has not been a major source of truly transformative technologies in many centuries, nor do more than a handful of Chinese brands command attention in the global marketplace.

While China has joined the World Trade Organization and is party to more than a dozen multilateral IP treaties, copying remains a common activity largely untouched by the central government.⁹ It's not because of any lack of formal law against copying and counterfeiting. China has complied with World Trade Organization rules requiring member states to adopt the “minimum standards” contained in the Trade-Related Aspects of Intellectual Property Rights agreement, or TRIPs. These standards largely reflect the stringent Western approach to IP protection. But China's *implementation* of these treaty rules has hardly satisfied American officials. The country's enforcement effort pales in comparison to the scope of IP infringement taking place. This gap has received attention at the highest levels in the United States. Briefing reporters at the White House in February 2013, Undersecretary of State Robert Hormats called China's treatment of IP “a serious and highly troubling issue.”¹⁰

American concern is tied to the scale and scope of copying in China, but also to a specific Chinese policy of “indigenous innovation”—a policy that American business has seen as a green light for copying. According to past statements of the Chinese government, indigenous innovation can include “enhancing original innovation through co-innovation and re-innovation based on the assimilation of imported technologies” – in other words, innovation through copying.¹¹ Combined with Beijing's relatively unsuccessful efforts to enforce existing rules, indigenous innovation is seen

⁸ Kal Raustiala & Christopher Sprigman, *Fake It Till You Make It*, FOREIGN AFFAIRS, (July/Aug. 2013), available at <http://www.foreignaffairs.com/articles/139452/kal-raustiala-and-christopher-sprigman/fake-it-till-you-make-it>

⁹ See, e.g., *Summary Table of Membership of the World Intellectual Property Organization (WIPO) and the Treaties Administered by WIPO, plus UPOV, WTO, and UN*, WORLD INTELLECTUAL PROPERTY ORGANIZATION, <http://www.wipo.int/treaties/en/summary.jsp> (last visited Jan. 28, 2014, 10:46 PM).

¹⁰ Raustiala & Sprigman, *supra* note 6

¹¹ *Id.* at X

as one more indicator that China is in fact committed to obtaining Western IP without paying for it. Given the vast scale of the Chinese market, the United States government considers it vital to rein in Chinese copying, and it has exhorted China — and sued it before the WTO— to change its ways. Other nations have acted similarly.¹²

What is the source of China's ambivalence toward (or, as some would say, flouting of) IP rights? Many analysts point to cultural factors, in particular the powerful legacy of Confucian thinking. According to this view, China has a distinctive historical relationship to copying that puts it at odds with the model of private ownership of creative goods that is deeply embedded in contemporary Western, and by extension international, IP law. Analyses of China's uneasy relationship to IP often quote Confucius' famous dictum that "I transmit rather than create." This statement became, it is sometimes suggested, an influential guiding principle in later centuries; as one scholar of China has argued, "the incorporation of elements of past works in one's own was not undertaken with the intent to steal another author's ideas. Rather, *imitation was the means for authors to demonstrate their knowledge and mastery of history*; it was a form of tribute to their predecessors."¹³ A similar analysis states flatly that IP law as it has been conceived in the West "goes firmly against the grain of Asian culture, which supports the concept of sharing, not protecting, individual creative work."¹⁴ In short, according to some commentators, IP is a "cultural phenomenon as well as an economic one." Countries (such as China) with a "collective" culture—"one that emphasizes sharing over individual ownership rights" — have significantly higher rates of copying and counterfeiting than do countries with "individualist" cultures.¹⁵ Copying in these contexts is as much sharing as it is stealing.

William Alford, in his influential *To Steal a Book is an Elegant Offense*, suggests that this relativist argument is oversimplified. But he broadly agrees that the past was and remains a very important source of legitimacy in traditional China, and that this reverence for the past has important implications for how copying is perceived and valued today. "The indispensability of the

¹² See *Dispute DS362: China-Measures Affecting the Protection and Enforcement of Intellectual Property Rights*, WTO, http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds362_e.htm (last visited Jan. 28, 2014). Among others, Argentina, Australia, Canada, the European Communities, India, Taiwan, Turkey, and Thailand all joined the suit against China as third parties.

¹³ Thomas Tze-Hun Chou, *Private Copyright Investment in China*, 1 J. SMALL & EMERGING BUS. L. 375, 393 (1997)(emphasis added).

¹⁴ W.R. Swinyard et al., *The Morality of Software Piracy: A Cross-Cultural Analysis*, 9 J. BUS. ETHICS 655, 662 (1990).

¹⁵ Donald B. Marron & David G. Steel, *Which Countries Protect Intellectual Property? The Case of Software Piracy*, 38 ECON. INQUIRY 159, 172 (2000).

past, for personal moral growth,” Alford writes, “dictated that there be broad access to the common heritage of all Chinese.” This, and other factors, “militated against thinking of the fruits of intellectual endeavor as private property.”¹⁶ Like other analysts of China, Alford contrasts this perspective with the West, where the seventeenth and eighteenth centuries “witnessed the development of an approach toward intellectual property in Europe that had no counterpart in imperial Chinese history.”¹⁷ He notes as well that many great Chinese painters tolerated or even welcomed forgery of their work “because such copying, in effect, bore witness to the quality of the work copied and to its creator’s degree of understanding and civility.”¹⁸ This notion—that a copy is a form of homage, one that actually raises the value and importance of the original—is critically important, as we will discuss further below, though not only for the reasons that Alford and others have proposed.

China’s reverence for the past has not always been consistently felt, of course, and this makes easy linkages between Confucian precepts and contemporary policy and practice suspect. After 1949, Mao expressly sought to discredit the past as a source of legitimacy, seeing China’s ancient cultural legacy as a source of oppression and backwardness. Confucius himself even fell into disfavor. During the Cultural Revolution that followed, the “Four Olds”—Old Customs, Old Habits, Old Culture, and Old Ideas—were vilified. But this wholesale rejection of the old wisdom and ways did not mean the end of copying in China. Nor did it entail the embrace of Western individualist notions of intellectual property—indeed, property of all kinds was viewed as anathema in Maoist China. Indeed, it was only in the aftermath of the Cultural Revolution, as Mao’s influence waned and China began to open up again to the West, that Chinese leaders began slowly to embrace Western approaches to IP, at least on paper. China passed its first post-revolutionary patent and trademark laws in the 1980s; its first copyright law in 1990. Simultaneously, the Chinese leadership laid the groundwork for the country’s extraordinary economic growth. And this economic growth in turn fueled China’s vibrant—many would say rampant—contemporary culture of copying.¹⁹

¹⁶ WILLIAM P. ALFORD, *TO STEAL A BOOK IS AN ELEGANT OFFENSE* 20 (1995).

¹⁷ *Id.* at 18.

¹⁸ *Id.* at 29.

¹⁹ Today China’s past is again a source of pride. Even Confucius is back as a favored sage; in 2011 his statue was placed in Tiananmen Square. Confucius’ statue was apparently removed, for reasons that are unclear, four months later. But the sage remains largely in favor among Chinese leaders. *See, e.g.,* Chris Buckley, *Xi Pays Homage to Confucius, a Figure Back in Favor*, N.Y. TIMES (Nov. 26, 2013, 11:34 PM), <http://sinosphere.blogs.nytimes.com/2013/11/26/xi-pays-homage-to-confucius-a-figure-back-in-favor/>.

Deng Xiaoping may not have actually said it, but the phrase often associated with him—“to get rich is glorious”—signaled to post-Maoist China that things had changed markedly, and that an unleashing of the entrepreneurial and acquisitive talent that had long marked diasporic China was about to unfold in the motherland.²⁰ In the decades since Deng’s supposed dictum China has experienced unprecedentedly rapid development. China’s per-capita GDP in 1993 was \$410. Two decades years later it was nearly \$6000.²¹ That astonishing rise explains something about China’s embrace of luxury goods; a nation as poor as China was in 1993 had little capacity for luxury goods consumption.

Yet supplying the means is not the same as supplying the motive. Scandinavia is very wealthy—much more so than China on a per capita basis—but lacks a single Cartier boutique. Luxury goods appear to have greater cultural salience in China than in many other places with more longstanding wealth. At one level this is surprising: China is a nominally-communist country where in the not too distant past the dour Mao jacket ruled. At another level, however, it is not just the economy that is changing: mores about wealth and its display have also changed markedly. As the Chinese economy has grown at unprecedented rates, and many but by no means all Chinese have become wealthy, interest in signifiers of luxury and markers of class distinction has grown.

Still, some observers believe the Chinese love of luxury, much like its proclivity for copying, is driven by distinctive cultural factors. For example, Gao et al argue that “consumers in Asia purchase luxury goods to secure social recognition and to show their status because the culture emphasizes hierarchy and status.”²² The concept of “face” or *mianzi* looms large in many of these culturally-based analyses. As another observer argues, “Due to the heavy influence of face, Asian consumers must purchase luxury products to enhance, maintain or save their face. Therefore, the conceptualisation of face and face consumption provides a useful way to understand why Asian

²⁰ On the likely-spuriousness of Deng’s famous dictum, see Evelyn Iritani, Great Idea But Don’t Quote Him, L.A. TIMES (Sep. 9, 2004), <http://articles.latimes.com/2004/sep/09/business/fi-deng9>

²¹ *Data-China*, THE WORLD BANK, <http://data.worldbank.org/country/china> (last visited Jan. 30, 2014). Even at \$6000, China is poorer per capita than Iraq, a place rarely associated with vibrant luxury goods markets. In short, there clearly is more than sheer economics at play.

²² Bopeng Zhang & Jung-Hwan Kim, *Luxury Fashion Consumption in China: Factors Affecting Attitude and Purchase Intent*, 20 J. RETAILING & CONSUMER SERVICES 68, 70 (2013) (citing Norton L. Gao et al., *Potential Niche Markets for Luxury Fashion Goods in China*, 13 J. FASHION MARKETING & MANAGEMENT 514, 514-26 (2009)).

consumers, on the one hand, are very thrifty in their everyday life and consumption but, on the other hand, spend (and sometimes waste) a large amount of money on luxury consumption.”²³ From this perspective a culturally-determined obsession with saving face and building face pushes the Chinese to seek out luxury goods that are visible and recognizable to others—making the cash registers ring at Chanel and Armani.

Obviously buying luxury goods requires means, but does the concept of *mianzi* provide a distinctly Chinese motive? In other words, is it true that there is an exceptional Chinese, or Asian, obsession with face—or in more familiar Western terms, with status? The argument that there is something special in Chinese culture, rather than China’s stage of economic development, that focuses the attention of Chinese consumers on luxury goods can, as with cultural explanations of the Chinese embrace of copying, easily be taken too far. China has no lock on status-seeking; indeed, one can go back to Thorstein Veblen’s landmark 1899 analysis of new wealth in Gilded Age America and find many similarities with contemporary analyses of China, even though the cultures are extremely different. Veblen, who coined the term “conspicuous consumption,” did not ground the acquisitive and showboating behavior he observed at that time in particularistic American cultural traits. Rather, Veblen stressed seemingly-universal desires to signal wealth and status in a social context (the roiling, rapidly urbanizing and industrializing post-Civil War United States) in which traditional markers of status were in decline.

Veblen’s insights—and the recent history of Russia, Brazil, and other societies in which great wealth and great inequality have gone hand in hand—suggests that perhaps culturally-specific concepts such as *mianzi*, while surely relevant, are not sufficient to explain China’s remarkable appetite for luxury. Just as important or perhaps more so is China’s dislocatingly-rapid economic growth—growth that produces a new and socially insecure upper class that in turn seeks to mark and cement its rising status through readily-identifiable luxury brands. China today does share many features with these other rapidly developing countries. Perhaps the brash desire to show off newfound wealth is simply be part and parcel of acquiring great wealth—and differentiating oneself from those who haven’t. In short, *mianzi* may well reflect distinctively Chinese, or East Asian, cultural concerns, but it may also largely be a regional gloss on the broader concept of status, which seems to be an almost universally-human obsession. Either way, what is clear is that for China’s

²³ Julie J. Li & Chenting Su, *How Face Influences Consumption: A Comparative Study of American and Chinese Consumers*, 49 INT’L J. MARKET RES. 237, 251-52 (2007).

huge numbers of newly-rich, or newly-middle class, Western brands often serve as instant and very desirable social signifiers of success.

Still, contemporary China does have some distinctive features that merit attention – including one that Veblen’s late 19th century America, for all its parallels, lacked: a very low birthrate. The result is what is sometimes called the “one child generation.” As one study notes, “Between 1979 and 1990, 227 million Chinese” were born into the one child generation. One of the consequences of China’s legally-enforced one-child policy is the “‘little emperors family structure,’ in which every child born is indulged by ‘six-pockets’ (two parents and four grandparents). In the view of some commentators, this phenomenon has created ‘little emperors’ who are more concerned with materialism, brands, and self-gratification.”²⁴ While its impact is hard to measure, it is at least plausible that China’s one-child policy, which is most strictly enforced in major cities, has exacerbated trends toward materialism and conspicuous consumption in the younger generations, especially in a context of increasing affluence.

A second special, though hardly unique, feature of China is the very high rate of income inequality. According to a recent report from *Reuters*, China has 2.7 million (U.S. dollar) millionaires and an astounding 251 billionaires.²⁵ By comparison, according to *Forbes* magazine, the US, which itself is quite unequal, and which enjoys per capita GDP more than eight times larger than China’s,²⁶ has 442 billionaires.²⁷ Yet despite the large number of billionaires and millionaires, 13 percent of China’s people live on less than \$1.25 per day.²⁸ And China’s per capita disposable income is approximately \$3000 per year, compared with approximately \$39,000 per year in the U.S. So while China’s vast size and burgeoning class of wealthy citizens makes it a remarkably lucrative market for luxury retailers, in fact most of the country is still very poor by any standard. For the majority of Chinese, luxury goods are fantastical items that are simply unattainable at anything like market prices.

²⁴ Ashmun Lalida, *Identity and Branding: Consumer Behavior and the Shaping of the Self—A Cross-cultural Analysis of East Asian and American Luxury Consumers* (June 2012) (Master of Arts in Liberal Studies thesis, Dartmouth College).

²⁵ Kevin Yao & Aileen Wang, *China Lets Gini Out of the Bottle; Wide Wealth Gap*, *Reuters*, (Jan. 18, 2013, 3:30 AM), <http://www.reuters.com/article/2013/01/18/us-china-economy-income-gap-idUSBRE90H06L20130118>

²⁶ *Data-GDP Per Capita (Current US\$)*, THE WORLD BANK, <http://data.worldbank.org/indicator/NY.GDP.PCAP.CD>, (last visited Jan. 30, 2014).

²⁷ Erin Carlyle, *Full List: U.S. Billionaires of 2013*, *FORBES* (Mar. 6, 2013, 8:58 AM), <http://www.forbes.com/sites/erincarlyle/2013/03/06/full-list-u-s-billionaires-of-2013/>

²⁸ *Data- Poverty Headcount Ratio at \$1.25 a Day (PPP)(% of population)*, THE WORLD BANK, <http://data.worldbank.org/indicator/SI.POV.DDAY>, (last visited Jan. 30, 2014).

Corruption is a third feature of contemporary China that may have implications for luxury goods markets, though again it is not factor that it is unique to China. Nor is China especially corrupt—Transparency International’s index ranks China at 80 out of 177 ranked nations for 2013; better than average, certainly better than neighboring Asian giant India, and only about 10 places behind iconic luxury-good source Italy.²⁹ Still, China-watchers often note that China’s political class is widely corrupt and that gift-giving in the guise of payoffs and bribes is a regular feature of Chinese business life.³⁰ Luxury goods form, it is said, a large fraction of these gifts—though it is obviously difficult to distinguish legitimate gifts from disguised bribes. *The Economist* recently reported that President Xi Jinping’s anti-graft campaign has been showing results, and speculated that luxury goods sales may be a victim. “A number of luxury brands have reported sharp falls in revenues,” wrote the *The Economist*. “Rémy Cointreau saw sales of its flagship cognac fall by more than 30% in the last three months of 2013 over the previous year, mostly owing to falling Chinese demand.”³¹

A fourth noteworthy feature about contemporary China is that it is rapidly and dramatically urbanizing. Again, urbanization is not unique to China; many developing and middle-income countries are rapidly urbanizing as well. But more than half of Chinese live in cities today, whereas less than 1 in 5 did in the 1970s.³² Beijing, Shanghai, and the greater Hong Kong/Guangzhou conurbation are vast cities well known in the West. Yet equally large, if not larger, are Chongqing, Tianjin, and Wuhan. Indeed, China has ten cities with urban populations over 6 million. Large, dense cities, with their associated markets, multilayered connections both locally and to the outside world, and endless scope for individuals to watch and be watched by throngs of strangers, are perfect petri dishes for status competition, *mianzi*-obsession, and brand-building. The juxtaposition of urban life, new wealth, and conspicuous consumption in contemporary China are amply illustrated by two of the hit films of the summer of 2013: *Tiny Times 1* and 2, both of which chronicle the lives of four girls, *Sex in the City*-style, as they engage in an “overt celebration of

²⁹ *Corruption Perceptions Index 2013*, TRANSPARENCY INT’L, <http://cpi.transparency.org/cpi2013/results/> (last visited Feb. 18, 2014).

³⁰ We thank Haochen Sun for stressing this point to us.

³¹ *Less Party Time*, ECONOMIST, Jan. 25, 2014, available at <http://www.economist.com/news/china/21595029-communist-partys-anti-graft-campaign-has-had-surprising-impact-new-report-shows-how>. If this is broadly accurate, China’s luxury goods market has been somewhat bolstered by the need to supply readily-identifiable and coveted gifts, and if President Xi’s efforts are successful, perhaps this market may slump or at least show much slower growth.

We haven’t seen broad-based data to bear out this hypothesis, but it is worthy of further study.

³² John Pomfret, In *Search of the Real China: Outsiders Still See What They Want to See*, FOREIGN AFFAIRS, Nov./Dec. 2013, at 152.

materialism” in fast-paced Shanghai. As one reviewer explained, the books upon which the popular films are based

are stuffed with English-language brand names like Chanel and Gucci and choice phrases. (“Economy class kills me!” and “I hate Beijing!”) [The] films show the actual designer goods and include dialogue that has also riled commentators, like this exchange in “Tiny Times 1” between two star-crossed young lovers: “I like you,” the young man says, “not because you’ve had a driver since you were little, and not because you have designer bags, and definitely not because you gave me expensive boots. Even if you didn’t have a cent, I would still like you.” The woman then turns on him: “Let me tell you, love without materialism is just a pile of sand!”³³

Shanzhai

There is one additional distinctive aspect of contemporary China that deserves more extensive attention: the singular Chinese concept of *shanzhai*. *Shanzhai* literally translates as “mountain stronghold” or “bandit stronghold.” In contemporary usage, however, it refers to low-cost knockoffs, such as buildings (including those of the ersatz central European villages that have cropped up in Chinese suburbs), stores (such as the fake Apple store in Kunming that sold real but refurbished Apple products), and even events (such as the imitation Olympic torch relay that rural villagers in China organized when the official relay passed over their regions).³⁴ *Shanzhai* is significant for understanding both luxury goods and counterfeits in China because *shanzhai* culture links the desire for wealth to copying of luxury goods, and makes production and consumption of counterfeits more socially legitimate than they might be otherwise. *Shanzhai* once connoted shoddy imitations of desirable originals. But like so much else in China, the term’s meaning has undergone change as China itself changes. As *The Wall Street Journal* recently noted, “Once a term used to suggest something cheap or inferior, *shanzhai* now suggests to many a certain Chinese cleverness and ingenuity.” *Shanzhai* cellphones, consumer household products, fashion items, and even fast food restaurants abound in China, and today are often pointed to with pride.

The popular appreciation of *shanzhai* products poses a challenge for anti-counterfeiting efforts. And indeed, far from cracking down on the phenomenon, the Chinese government seems to

³³ Sheila Melvin, *A Film-Fueled Culture Clash Over Values in China*, N.Y. TIMES, Sep. 3, 2013, http://www.nytimes.com/2013/09/04/movies/in-tiny-times-movies-material-girls-have-a-nation-tsking.html?_r=0

³⁴ See, e.g., BIANCA BOSKER, ORIGINAL COPIES: ARCHITECTURAL MIMICRY IN CONTEMPORARY CHINA (2013); Haochen Sun {article}

believe that *shanzhai*-style creativity is something to cultivate. In 2009, an official from China's National Copyright Administration declared that "*shanzhai* shows the cultural creativity of the common people." He added, "It fits a market need and people like it." There is a certain convenience to this realization: Chinese authorities seem to recognize that *shanzhai* is socially-embedded and unlikely to disappear. But *shanzhai* offers some additional benefits to Beijing. A vibrant culture of copying has social value in a highly unequal society such as China's; by allowing the less well off to access versions of the products that only the wealthy can afford in their original form, the widespread availability of *shanzhai* products may be useful as a brake on the social unrest that contemporary China's high level of social inequality tends to create. In short, the relative freedom to copy may help ease or at least mask the nation's yawning economic divide.

Yet like so much in China, *shanzhai* is not simply an economic phenomenon. It also functions as an unusual form of cultural resistance to authority – albeit one that, unlike the popular political uprisings that led to the massacre in Tiananmen, or are occurring currently in Hong Kong, appears to pose little direct threat to the hegemony of the Communist Party. Yu Hua, the Chinese writer, describes this in his best-selling book *China in Ten Words*. He details the copycat Internet news show that parodies the government's official evening news broadcast, copycat entertainment shows that ape the government's televised Spring Festival gala, and the copycat songs, copycat announcers and copycat stars and starlets that populate them. "From this," Yu writes, "we can see that the copycat phenomenon has a certain positive significance in China today. Seen in this way, it represents a challenge of the grassroots to the elite, of the popular to the official, or the weak to the strong."³⁵

This may be one reason the Chinese government has chosen to tolerate and at times even embrace, *shanzhai*. To oppose it too overtly might only reinforce the sense that it is a challenge to established hierarchies. Another reason Chinese leaders may tolerate *shanzhai* is that they are not the only or even primary target. *Shanzhai* can also be a way for ordinary Chinese to challenge global authority, in particular the continuing (and often irritating, to Chinese eyes) economic dominance of the West.

Xiaomi, for instance, is one of China's fastest-growing technology companies. Less than four years old, Xiaomi has sold nearly seven million smartphones and raked in more than ten billion yuan

³⁵ YU HUA, CHINA IN TEN WORDS pg. number (Allan H. Barr trans., 2012)

(\$1.6 billion)—impressive numbers for a company that sold its first smartphone in August 2011. Xiaomi's phones look familiar to Westerners because many of the company's designs are *shanzhai* versions of Apple's coveted iPhone. And design is not the only cue that Xiaomi takes from Apple. At a recent product launch, Lei Jun, the head of Xiaomi, stood alone onstage in a black shirt, jeans, and black Converse sneakers—*déjà vu* for anyone who ever saw the late Steve Jobs, the founder and former CEO of Apple, introduce new products at a Macworld convention. Lei's message was clear: Xiaomi, and its products, are just as cool as Apple. And Chinese consumers have happily embraced Xiaomi's products without any illusions about their provenance. In a telling turn of phrase, a Shanghai university student recently told *The New York Times* "Xiaomi is the real fake."³⁶ With its *shanzhai* smartphones and *shanzhai* Steve Jobs, firms like Xiaomi not only serve to highlight contemporary Chinese ingenuity, but also to show that China can be just as good at creating cutting-edge consumer products as America.³⁷

Shanzhai is not without its critics, of course, and not only in the offices of the US Chamber of Commerce. *Shanzhai* culture in China, Yu Hua argues, may demonstrate resilience and resistance. Yet it is, also a symptom of a sort of nationwide nervous breakdown, brought on by the enormous tensions created by a society that simultaneously practices economic openness and political repression:

It seems to me that the emergence – and the unstoppable momentum – of the copycat phenomenon is an inevitable consequence of this lopsided development. The ubiquity and sharpness of social contradictions have provoked a confusion in people's value systems and worldview, thus giving birth to the copycat effect, when all kinds of social emotions accumulate over time and find only limited channels of release, transmuted constantly into seemingly farcical acts of rebellion that have certain anti-authoritarian, anti-mainstream, and anti-monopoly elements. The force and scale of copycatting demonstrate that the whole nation has taken to it as a form of performance art.³⁸

For all of *shanzhai*'s political roots and reverberations, however, its most overt consequences

³⁶ Sue-Lin Wong, *Challenging Apple by Imitation*, N.Y. TIMES, Oct. 29, 2012, <http://www.nytimes.com/2012/10/29/technology/challenging-apple-by-imitation.html>

³⁷ We thank Peter Yu for stressing this point to us.

³⁸ *Id.* at Pg needed

are found in the country's consumer economy. Many *shanzhai* products are, not surprisingly, purely imitative. But we also see Chinese firms that mix imitation with innovation, and these products are the ones that often elicit pride in the ingenuity embedded in *shanzhai* offerings. Xiaomi's phones are an excellent example. Xiaomi is clearly riffing on Apple in many aspects of its product and image. Yet it is not just a simple knockoff of Apple. Xiaomi's success, in fact, hinges on the company being quite *unlike* Apple in some important respects.

For one, Xiaomi's phones typically cost about half that of its rival's. Even more important, Xiaomi has a very different attitude toward innovation. Apple is known for its closed approach to product development. The company believes that it knows what its customers want before they do, so Apple's design process is essentially dictatorial. Xiaomi's design process, by contrast, is quite democratic. Every Friday, Xiaomi releases a new round of software updates for its mobile operating system, which is based on Google's open-source Android software. Within hours, thousands of users flock to Xiaomi's online forums to suggest new features, functions, and designs and to identify and resolve software bugs. Xiaomi has relied on user input to determine how much memory to install on its phones, how important the phone's thickness is to users, and whether its phones should allow users to take photos without pushing a button. Lei might dress like Jobs, but he runs his company very differently.

Xiaomi is hardly China's only *shanzhai*-style innovator. Weibo, the country's most popular social networking service, boasts hundreds of millions of users. Launched in 2009, three years after Twitter, Weibo is widely viewed as a Twitter clone. Since its launch, however, it has added a clutch of features that distinguish it from Twitter, including a more interactive system for commenting. Such improvements make Weibo arguably more functional, and more fun, than the service it copied. Another Chinese value-adding knockoff is Youku, which is just one of a number of Chinese copies of YouTube. (*Youku* translates as "excellent" or "cool.") Unlike YouTube, Youku allows users to upload videos of any length without copyright verification. That means that Youku hosts hundreds of thousands of hours of unauthorized programming. But the service has also partnered with more than 1,500 professional content providers to deliver authorized videos, and the Chinese service is much further along than its U.S. rival in delivering original content. Indeed, Youku has emerged as a serious competitor to traditional broadcast TV in China—a feat that YouTube must envy.

In sum, China's vibrant *shanzhai* culture spans a range of activities from the homemade to

the high tech to the (literal) high-rise. Copying is celebrated as much, or perhaps more, than it is condemned, and China continues to innovate even as it imitates. Much of this *shanzhai* activity is unrelated to luxury goods. But it has resonance for luxury products, because it taps into the larger social and economic and even political context in which copying and counterfeiting occur in contemporary China.

The Chinese Challenge to the Conventional Wisdom on Counterfeits

Embedded in many domestic legal systems around the world, in international IP agreements, and in international trade accords alike is a simple notion: counterfeits undercut, outcompete, and ultimately harm originals.³⁹ We will call this the *substitution effect*. Counterfeits are usually far cheaper than originals. And while quality differences between originals and copies may be equally large, those quality differences may not matter to, or even be observable to, many consumers or onlookers. For some, the knockoff is a serviceable and even attractive substitute for the high-priced original. And so, the conventional wisdom maintains, by offering a cheaper alternative that may be hard to distinguish from the original (at least to the untrained eye—or at a distance), counterfeits substitute for sales from originals, cause consumer confusion, and degrade the value of a brand.⁴⁰

This, in a nutshell, is why counterfeits are thought to be bad, and why strong enforcement of IP law is thought to be essential. When American officials berate China over copying, this basic set of arguments undergirds their critique. To be sure, the conventional story about copying's dangers is intuitive and widely accepted. Yet there is good reason to doubt important parts of it, both with regard to copying in the West and, perhaps even more so, for copying in China. This is not to say the conventional wisdom is wholly wrong—only that it is largely unproven, and that there is significant reason to question whether the negative effects of counterfeits are as severe or as widespread as it assumes.⁴¹

³⁹ By conventional we mean conventional in both Western legal systems and in international IP law, which largely tracks American and European approaches to IP.

⁴⁰ In the context of copyright and patent excessive copying in turn is said to lead to reduced innovation, because who will innovate if others will steal the fruits of their innovation? In the trademark context, however, even the conventional wisdom rarely accords great weight to innovation as a harm from counterfeiting. Indeed, as we will discuss further below, articulating the precise social harm from counterfeiting trademarks is more difficult than many recognize.

⁴¹ For a longer exposition of this basic argument see KAL RAUSTIALA & CHRISTOPHER SPRIGMAN, *THE KNOCKOFF ECONOMY: HOW IMITATION SPARKS INNOVATION* (2012)

Our skepticism is grounded in several difficulties with this conventional wisdom. Whether, and if so, how much, counterfeits substitute for sales from originals is an empirical question. Yet there is surprisingly little rigorous research into its scale. And there is good reason to doubt that the scale of the substitution effect is very great. As we explain below, genuine luxury goods and counterfeits often occupy different markets altogether, with the market for counterfeits populated by buyers who lack the resources (for now, if not forever) to purchase the original. Counterfeit sales in this setting are not “lost sales;” they are simply different sales.

Nor, in most instances, are counterfeit luxury goods likely to confuse consumers into thinking they are buying originals. This is true whether at the critical point of sale or at the murkier and more controversial “post-sale” stage. Given the many ways in which counterfeit purchases differ from purchases of originals, there is little reason to think that many consumers who purchase counterfeit luxury goods are unsure about what they’re buying. It is more likely that most counterfeit buyers want counterfeits and can’t afford, or would never pay for, originals.

Taken together, these factors cast doubt on the magnitude of the substitution effect, as well as on the scale of consumer confusion that counterfeits create. Equally significant, there is suggestive evidence that counterfeits sometimes create *benefits* for producers of originals.⁴² Counterfeits can serve as advertisements for originals, helping to grow sales, and they can serve as trial versions for those who do have the means, or who are likely to have the means in the future, to purchase original products. We say more about how counterfeits can actually help originals below. But if the potential benefits to producers from counterfeiting are not trivial, and if the harm from counterfeits to consumers and producers is more limited than commonly supposed, we ought to question whether counterfeits have a significant negative impact overall on originals. And when the social welfare effects for poorer consumers are taken into account—that is, the value they receive from being able to purchase inexpensive copies of items they desire—the effect of counterfeits may at times be, on net, positive.

A more definitive answer to the seeming puzzle of China’s place both as the world’s leading luxury goods market and the world’s leading counterfeiter will have to await further study. But at the very least, it is clear that the case for strict enforcement of anti-counterfeiting law is not

⁴² For an early and particularly insightful version of this argument, see Jonathan Barnett, *Shopping for Gucci on Canal Street: Reflections on Status Consumption, Intellectual Property and the Incentive Thesis*, 91 VA. L. REV. 1381 (2005).

overwhelming -- nor close to being proven. All this makes China's relaxed approach to IP enforcement a plausibly rational strategy—especially with regard to luxury goods. Even as Chinese producers increasingly move into higher value goods and begin, perhaps, to create luxury marks that resonate for wider audiences, we expect China to resist the West's call to impose very strict enforcement of IP rights. Moreover, these arguments suggest why and how a robust market in counterfeits can comfortably coexist with a robust market in originals.⁴³

Do Counterfeits Outcompete Originals?

It is a bedrock assumption of the conventional wisdom about IP that counterfeits, which are virtually always cheaper, outcompete originals. If two items are the same but for price, it follows from basic economic theory that the cheaper one will prevail in the marketplace. Yet upon closer inspection, this simple logic doesn't always hold in the real world. (And of course in the luxury goods market, the logic sometimes fails altogether. Economists use the phrase "Veblen goods" for those items, such as luxury perfumes, that exhibit *increased demand* as price rises.)⁴⁴

One key question in this inquiry is whether consumers who purchase copies have the means to purchase the original. The more this is true, the more the counterfeit is likely to actually substitute for the original. And the more the counterfeit is a substitute, the more (given conventional economic assumptions) sales are likely to be diverted. While this seems like common sense, the evidence in favor of this proposition is surprisingly meager. Even in markets where the originals are quite inexpensive, and copies are very similar—and perhaps even identical—to the original, the impact of counterfeits on sales of originals is not unequivocally negative. Perhaps the most striking example is digital music downloads, an industry that has faced very large-scale piracy. One recent study indeed found harm to original music sales from pirated downloads,⁴⁵ while another study (conducted by the EU's research arm and using Internet clickstream data) found no harm to originals. Indeed, this study found a slight *increase* in legal sales associated with online music piracy.⁴⁶ In short, even though

⁴³ See also Raustiala & Sprigman, *supra* note 6.

⁴⁴ H. Leibenstein, *Bandwagon, Snob, and Veblen Effects in the Theory of Consumers' Demand*, 64 Q.J. ECON. 183, (1950).

⁴⁵ Rafael Rob & Joel Waldfogel, *Piracy on the High C's: Music Downloading, Sales Displacement, and Social Welfare in a Sample of College Students*, 49 J.L. & ECON. 29, 29-62 (2006), available at <http://www.nber.org/papers/w10874>.

⁴⁶ LUIS AGUIAR & BERTIN MARTENS, *DIGITAL MUSIC CONSUMPTION ON THE INTERNET: EVIDENCE FROM CLICKSTREAM DATA*, EU Joint Research Centre, Institute for Prospective Technological Studies (2013), available at <http://ftp.jrc.es/EURdoc/JRC79605.pdf>

digital copies are excellent substitutes for originals, it is not clear that there is empirical support for the notion that copies negatively impact the sales of originals.

For luxury goods, there is even more reason for skepticism about the magnitude of the substitution effect. By definition, luxury goods are expensive—sometimes astonishingly so.⁴⁷ Even in the United States the vast majority of consumers cannot afford them, unless they devote very large fractions of their income to these purchases (necessarily foregoing a host of other, more quotidian purchases). So for many consumers, the choice between original and counterfeit is no choice at all. This is all the more true in China. Given the widespread poverty and extremely high levels of income inequality, many Chinese consumers who purchase counterfeits will lack the resources to purchase original luxury goods. This is true even though counterfeits typically feature markedly inferior materials and workmanship that even the untutored consumer can readily discern. For most consumers, in short, counterfeits are an obtainable *alternative* for the genuine branded article. They are not, however, a *substitute*.⁴⁸ These consumers could never buy the original in the first place.

In other words, in China, as elsewhere, originals and counterfeit luxury goods may largely occupy different market niches. The more this is true, the more the presence of counterfeits will have little direct effect on sales of legitimate branded luxury goods. Just like a fast food restaurant that opens down the street from a temple of expensive cuisine, the consumer bases are completely different. One hardly impacts the market of the other.⁴⁹

Do Counterfeits Confuse Consumers?

The main goal of trademark law, in both the U.S. and China, is to prohibit uses of a mark that are likely to *confuse consumers* about the source of a particular branded product or service. In other words, we protect marks not primarily to protect the interests of the mark holders (though that is undeniably often a factor in practice) but to protect the consumer. The consumer who wants to buy

⁴⁷ Hermes' iconic Birkin handbag, for instance, can cost well over \$20,000 for some models; a Kiton men's cashmere blazer currently sold at Neiman Marcus costs \$6495.

⁴⁸ Barnett, *supra* note 43.

⁴⁹ A harder question is whether, and if so much, of those very privileged few who can afford the original choose instead to buy counterfeits. This is an empirical question that surely varies market by market. We will say more on this below.

a Birkin bag can use the Hermès' mark as a guide; those products displaying the mark are the real thing and those that simply look like the Birkin bag but have a different mark are a copy. The policing of trademarks helps consumers find the products they want faster and easier. Hence trademark law's fundamental purpose is consumer protection.⁵⁰

By definition, luxury goods counterfeits use others' marks without authorization. But do they cause consumer confusion? In other words, do consumers know that fakes are fakes when they purchase them? This issue is a critical aspect of any inquiry into the substitution effect, since the more consumers believe—mistakenly—that a counterfeit is an original, the more sales are likely to be diverted, harming the original. (Though logically, were this true, we would expect more often than we do to see counterfeit prices that are not tiny fractions of the real price but instead much closer to the real price—since consumers in this scenario, by definition, think they are buying the real thing, knockoff sellers can charge prices closer to the market price in originals.)

How likely is it that a Louis Vuitton counterfeit confuses a consumer into thinking she is about to purchase a real Louis Vuitton item? Whether we're talking about American or Chinese consumers, it is conceivable that some of them – probably a very small number – purchase counterfeit luxury goods thinking they are buying the original. This might happen where the counterfeit is an unusually good copy of the original.⁵¹ But for luxury goods, many of which are made with expensive materials and workmanship and are therefore difficult to copy both cheaply and with precision, high-end knockoffs of the type that are likely to fool most consumers are very rare. Those that do exist are priced fairly high as a result.⁵² Much more common are knockoffs that any reasonable buyer would know right away are fake—obviously inferior copies with cheaper materials, shoddy workmanship, and sometimes completely different designs. For some luxury products that cannot be evaluated pre-purchase—such as rare Bordeaux wines, unusual Scotch, or

⁵⁰ We note that Chinese trademark law defines “infringement” quite broadly, subjecting counterfeiting and even the unauthorized use of similar marks to what looks, at least on the face of the Chinese trademark statute, like per se liability. See Trademark Law of the People's Republic of China (as amended up to Decision of October 27, 2001, of the Standing Comm. Nat'l People's Cong., Revising the Trademark Law of the People's Republic of China), available at http://www.wipo.int/wipolex/en/text.jsp?file_id=131395. That said, Chinese courts interpreting the 2001 Chinese trademark law have implemented a consumer confusion test for trademark infringement. See Luckie Hong, *China's Dilution of the Dilution Doctrine*, WORLD TRADEMARK REV., Apr./May 2009, at 24.

Trademark law also often prohibits uses that may *dilute* the selling power of famous marks. We'll talk about this interesting and complex issue separately below. It is unclear whether Chinese law recognizes a separate cause of action for trademark dilution. See *id.*

⁵¹ Elizabeth Holmes, *The Finer Art of Faking It*, WALL STREET JOURNAL (June 30, 2011), <http://online.wsj.com/news/articles/SB10001424052702304791204576401534146929212>

⁵² *Id.*

very old Maotai—it is far easier to imagine consumer confusion, and so the case for government regulation is stronger. But for most luxury fashion and accessories, the products can be touched and tried on and their quality easily discerned before purchase.

Moreover, inferences about counterfeits are not based simply on the product, but also on the seller. Whether high or low quality, counterfeits are very rarely if ever sold in a brand's own boutique; nor are they likely to be sold in any high-end retailer. Hence the context of the purchase will almost always give away the provenance of the good. In short, although the story may be different with fake pharmaceuticals or auto parts, for luxury goods the incidence of consumer confusion at the point of sale is likely to be quite low overall. If counterfeit luxury goods do not often confuse consumers, they are unlikely to interfere very much with the ability of trademarks to designate source. As a consequence, strict enforcement of anti-counterfeiting laws, at least in the area of luxury goods, does not line up very well with the primary underlying justification for trademark law.

If there is very little likelihood of consumer confusion at the point of sale, perhaps there may be what is sometimes called “post-sale” confusion. Accepted in some jurisdictions and not others,⁵³ the concept of post-sale confusion is controversial among trademark experts. It posits that brand owners can be harmed if consumers see a counterfeit good being worn or carried or used *after the sale*. The theory is that these observers will mistake it for the branded original and then draw a negative inference about it. That is simple enough to state, yet the precise mechanism of harm, and the circumstances that can lead to harm, are far from clear.

⁵³ The relevant Chinese statute does not discuss post-sale confusion. However, Beebe, *infra* note 56, at 851, suggests that Chinese courts may be using a version of it:

To take an example from recent Chinese case law, the buyer of knockoff Gucci shoes at the Shanghai No. 1 Yaohan Department Store is certainly not confused as to their true source, particularly since the shoes prominently bear the trademark “Senda” (a well-known Chinese shoe manufacturer) on the insole and are sold at a relatively moderate price from the “Senda” counter in the department store. Nevertheless, as the Chinese court explained:

[W]hile the consumers are actually wearing the shoes, by-standers are unable to see the ‘Senda-woman’ label covered by the feet; but [Gucci’s] double-G interlock pattern on the upper cloth can be recognized clearly, which would lead to the mistaken belief by third parties of the actual brand of the products bought by purchasers. This situation would undoubtedly reduce the value of the double-G interlock pattern trademark and affect its commending function.

Barton Beebe, *Intellectual Property Law and the Sumptuary Code*, 123 Harv. L. Rev. 809, 851 (quoting *Guccio Gucci S.P.A. v. Jiangsu Senda Group Co.*, (2007) Case 78 of Pu Min San (Zhi) Chu Zi, at *6 (People’s Ct. of Shanghai Pudong New Dist., Apr. 7, 2008)). We thank Haochen Sun for pointing out this example.

Suppose a consumer sees a stranger wearing a fake pair of Lanvin sneakers and believes that they are the genuine item. How is the brand owner harmed? It might be that the fake Lanvin sneakers are shoddily made⁵⁴, and that the consumer perceives that and has a lower opinion of the brand owner's product thereafter. But for that to be true, there are some specific conditions that must be met. First, the observer must see the shoes well enough to perceive them as Lanvin. And he must see them well enough to perceive that they are low quality. But he must also *not* perceive them well enough to understand that the low-quality sneakers are in fact fakes. In other words, there must be just enough perception that the observer draws a negative inference about a specific brand, but not enough that they recognize the item is in fact a counterfeit.

There is little empirical study of these mechanisms. And given that post-sale confusion requires a Goldilocks-like level of perception by others, there is little reason to believe that post-sale confusion is a major problem for luxury goods firms. Moreover, there are other consequences of post-sale confusion – and indeed, of any post-sale exposure to luxury goods counterfeits, whether the observer is confused or not – that are potentially *beneficial* to brand owners. We'll describe these later; for now it will suffice to say that from a policy perspective any positive effects flowing from consumers' post-sale experience with counterfeits must be balanced against the (probably quite slight) harm from post-sale confusion.

While the magnitude of post-sale confusion is questionable, consider another possible form of harm to the original brand that is sometimes suggested: that counterfeits degrade the brand by diffusing the brand or logo into the larger community, robbing it of its exclusivity. To understand this, imagine that some set of observers see the fake Lanvin sneakers worn on another person, know they are fake, and infer that Lanvin, as a brand, is now being adopted by lower class consumers. The very existence of (hypothetically) cheap counterfeit Lanvin sneakers shows that the Lanvin brand is not only coveted by the high end and fashion-conscious, but by a larger and more ordinary swath of society—large enough to create a market in fakes.

None of this speaks to *confusion* about the brand, however. Indeed, this line of reasoning requires a fairly detailed knowledge of the brand and its place in the fashion/status firmament. But to take this form of “harm” seriously introduces a larger issue we discuss further below: how

⁵⁴ Of course some luxury goods are shoddily made, especially in high end fashion, or even designed to look shoddily made, but we'll assume, as is often the case, that luxury goods are actually well-made.

trademark protection often has as its undeclared mission not the protection of consumers, which has almost nothing to do with this scenario, but instead the protection of producer interests and the bolstering of class distinction.⁵⁵

Do Counterfeits Dilute the Value of Brands?

Thus far we have argued that, at least in the context of luxury goods, counterfeits are unlikely to cause much direct harm via consumer confusion and displacement of sales—whether at the point of sale, which is the point that really matters, or even in the (far more disputed) post-sale context. But that does not exhaust the inquiry. We must also ask whether counterfeits have an *indirect* effect on branded goods. The conventional answer is yes, and we agree with it. However, there is not just one indirect effect; there are several. And on balance, there is good reason to think the overall indirect effect is likely to be very small or even, in some cases, *positive*.

Although trademark law is primarily concerned with consumer confusion, trademark rules also address what is known in American law as dilution of a trademark's distinctiveness via either "blurring" or "tarnishment." A trademark is said to suffer dilution by blurring when an unauthorized use of a mark harms consumers' ability to associate that mark with a particular product or service. This can occur, for example, when a famous mark is used on a product different from its ordinary usage. So, for example, dilution by blurring may occur if Cadillac, a famous mark for automobiles, were applied to watches. Consumers encountering the Cadillac watch may, the argument goes, now find it more difficult to make the association between Cadillac and automobiles. But very little of the luxury goods counterfeit trade in China raises the possibility of dilution by blurring. For the most part, Chinese luxury goods counterfeits are recognizable (albeit imperfect) imitations of a legitimate branded good: rather than a Tom Ford toaster, fake Tom Ford sunglasses. Counterfeits like these are very unlikely to "blur" the association of the luxury goods mark and the

⁵⁵ On this larger point see Beebe, *supra* note 54, at page number needed. The one way such a rule could be seen as consumer protective is as protecting consumer investment in exclusivity; i.e. consumers pay a premium for Lanvin sneakers (a casual suede pair, available on the website Mr. Porter, lists for \$575) not because they are fantastic athletic wear but because of the status that accrues to the Lanvin wearer. Degrading that status through knockoffs will in turn cause the value of the consumer's investment in the status-conferring item to drop. Perhaps that is a reason to police post-sale confusion, but it is not been one widely articulated, or defended, to date. Perhaps because the analysis cannot be restricted to the possible reduction of wealthy consumers' investment. To be a true social welfare analysis, and not simply a measure of the preferences of rich people, it must also consider the welfare gains of less affluent consumers who are priced into some simulacrum of status consumption by the presence of fakes. The balance between status losses at the top and status gains for everyone else is not susceptible to theoretical analysis – it must be measured empirically.

products to which they are applied. The entire purpose of a counterfeit luxury good is *to call precisely that association to mind*.

Counterfeiting of luxury goods, whether in China or elsewhere, is also unlikely to lead to what trademark law recognizes as dilution by “tarnishment”. A brand is said to be tarnished if it is weakened by unflattering associations. Tarnishment can stem from unauthorized use of the mark on other products, or, much more controversially, perhaps by adoption by certain consumers—as in our Lanvin sneaker example above. Tarnishment of this kind is rarely discussed because it is awkward to state. But when the managing director of Roederer Cristal champagne was asked by *The Economist* magazine whether the well-known association between the brand and hip hop could hurt the brand, he replied “that’s a good question, but what can we do?”⁵⁶ More typically, claims of tarnishment come from use, even parodic use, by another firm with another product.⁵⁷ An American case involving the globally well-known Victoria’s Secret brand illustrates this mechanism.⁵⁸ In that case, lingerie giant Victoria’s Secret claimed, successfully, that a small and local lingerie and sex toys shop named “Victor’s Little Secret” tarnished the Victoria’s Secret brand – apparently by associating the brand owner’s comparatively tame lingerie with a more frankly sexual aesthetic.

For the most part, however, unsavory association is not the sort of harm that luxury brands face from counterfeits. The real concern for luxury brands, rather, is that the presence of counterfeits will weaken the brand by diminishing the degree to which consumers perceive it as *exclusive or rare*. By this reasoning, Patek Philippe watches are more valuable if only obviously wealthy or well-connected people carry them. If ordinary consumers can have passable fake Patek Philippe watches, and will be publically seen wearing them, then the real thing will no longer enjoy the exclusivity premium it once did.⁵⁹ Again, there is no confusion at sale or post sale; the concern, rather, is the perception that, due to counterfeits, a brand is embraced by downmarket consumers and more widely available than either the producer or the consumers of the original prefer.

⁵⁶ *Bubbles and Bling*, THE ECONOMIST, May 8, 2006, available at <http://www.economist.com/node/6905921>. In a sense, as we discuss above, our hypothetical example of fake Lanvin sneakers noted (negatively) by a fashion-conscious observer is a species of tarnishment, though not one endorsed by any court we are aware of. It is probably a bridge too far for a court to acknowledge that a brand such as Cristal could be tarnished by having even original purchased and publicly displayed or consumed by putatively undesirable groups.

⁵⁷ See *Louis Vuitton Malletier S.A., v. Haute Diggity Dog*, 507 F.3d 252 (4th Cir. 2007).

⁵⁸ *Victor’s Little Secret Catalogue, Inc. v. Moseley*, 558 F. Supp. 2d 734 (W.D. Ky. 2008).

⁵⁹ Beebe, *supra* note 54, at page number needed.

Brand owners' desire to maintain product exclusivity is not irrational. Exclusivity is the major source of value in most, if not all, luxury goods brands. Luxury products from well-known brands confer status on their owners because they are expensive and (sometimes *or*) rare. To be sure, that status may be very contextual: for some audiences in some places a given brand may confer no status, or low status, whereas for others, it confers significant status. Status signals depend on a larger set of social and cultural norms, as well as a baseline context of market depth (how great a variety of products competing for status?) and density (how visible is status consumption to others?) and connection to the larger world (how powerfully are status signals reinforced from the outside?).

Still, does all this mean the presence of counterfeits inevitably *diminishes* exclusivity? As we have shown, there is substantial reason for doubt. The harm to exclusivity from counterfeits is not as straightforward, nor as obvious, as the conventional wisdom suggests. And as we describe in the next section, there is even evidence suggesting that under some conditions counterfeits can *bolster* consumers' perception of a brand's desirability. Similarly, while tarnishment and blurring may be reasonable targets of trademark law, when tarnishment is caused by the poor wearing brands associated with the rich, it is a much harder case to justify the intervention of the legal system. All these factors help explain why China has not traditionally viewed counterfeits as a major problem to be solved--and why that stance is rational in a nation riven by inequality and fearful of social unrest.

The Advertising Effect and the Gateway Effect

Thus far we have discussed why counterfeits may not harm originals very much. The notion that counterfeits may actually *help* originals comes in at least two forms: that counterfeits can serve as effective advertisements for originals, and that counterfeits can serve as gateways to originals, providing a trial run for those who are unsure if they want to splurge on the real thing.

A 2011 study by economist Yi Qian, for example, looked at data from 31 branded shoe companies, as well as a number of counterfeiters, operating in China in 1993–2004.⁶⁰ Qian took advantage of a natural experiment that allowed her to test how counterfeits and their originals fared

⁶⁰ Yi Qian, *Counterfeiters: Foes or Friends? How Do Counterfeits Affect Different Product Quality Tiers*, (Nat'l Bureau of Econ. Research, Working Paper No. w16785), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1759857##

under different systems of IP enforcement. The study found that for low-end items, counterfeits did cause some harm; the substitution effect was present. Yet counterfeiting had a surprisingly *positive* effect on the sales of high-end items in China. For these products, the tendency of counterfeits to advertise the desirability of the branded product—what we call the “advertising effect”—outweighed any substitution effect. Thanks to the advertising effect, counterfeits served to strengthen high-end brands and their sales numbers, not weaken them. In Qian’s study, only for low-end branded products did the substitution effect outweigh the advertising effect.

A study by Bonghee Yoo and Seung-Hee Lee of 324 female college students in South Korea likewise found interesting interactions between counterfeit luxury products and originals. Rather than decrease the likelihood of purchasing originals, Yoo and Lee’s research indicated that counterfeit purchases seem to fuel it. In their words, luxury goods firms

should investigate the possibility that they might benefit from counterfeits. Purchase intention of luxury fashion counterfeits positively affects purchase intention of originals...*This finding clearly implies that counterfeit consumers are very likely to become ultimate consumers for originals and do not return to counterfeits*, a likelihood that is consistently found in pirated software or illegal music file download research, where counterfeits aid a full and fast market penetration of the originals...Likewise, fashion counterfeits might function as a risk free trial version, generate interest among consumers, and make them spread positive word of mouth to other consumers.⁶¹

We see similar evidence that sales of counterfeits can bolster sales of originals in studies in the U.S. Research by Renee Gosline looked at people who knowingly purchase counterfeit luxury items, like handbags and sunglasses, at so-called “purse parties.” These consumers were under no illusion that their purchases were originals; the parties and their hosts were open about the provenance of the goods. Yet this did not clearly lead to reduced sales over time. Indeed, Gosline found that counterfeits do not hurt the sales of luxury brands so long as consumers can reliably distinguish between them. On the contrary, and consistent with Yoo and Lee’s findings, counterfeits in the study often used as “trial versions” of the high-end genuine branded item. After trying the counterfeit version, over 40% of counterfeit handbag consumers ultimately purchased the real brand. Rather than substituting for the original, counterfeits seemed to serve as a gateway to the original.

⁶¹ Bonghee Yoo & Seung-Hee Lee, *Buy Genuine Luxury Goods Products or Counterfeits?*, 36 ADVANCES CONSUMER RES. 280, 285 (2009) (emphasis added).

The Qian, Yoo and Lee, and Gosline studies all suggest that in both the U.S. and in Asia fake luxury goods can serve as an effective form of advertising that actually spurs, rather than squelches, the market for originals. People who buy them and live with fakes have a significant probability of being converted to the brand and buying the real thing once they can afford to do so. Copies, in short, can act as a kind of “gateway drug” that leads to consumption of the harder (or at least, more expensive) stuff. What’s more, every time consumers go out with their fake item, they’re publicly displaying the desirability of the brand.⁶² In short, these studies suggest that China may be living through a time where a boom in counterfeits is a sign of a coming boom in branded luxury goods.⁶³

While highly suggestive and intriguing, these studies are of course not definitive; much more research is needed. The important point is that the overall effect of counterfeits in China for luxury brands is unclear, and that there is at least some compelling evidence suggesting that the overall effect could be muted or even positive. And that raises significant public policy issues, both for the West and for China. Should the Chinese government devote substantial resources to a problem of such uncertain dimensions? Should the United States expend substantial political capital on efforts to induce the Chinese government to focus more aggressively on anti-counterfeiting enforcement with regard to consumer products like mobile phones and luxury items like handbags and footwear?⁶⁴

The Chinese leadership, like any government, faces conflicting political pressures with regard to enforcement. On the one hand, Beijing may want to blunt the effects of high or rising economic inequality and, as a result, may tolerate a relatively high level of counterfeiting as a way to allow the lower and middle class citizens access to coveted goods – or at least simulacra of those goods – they could otherwise not afford. As Barton Beebe has argued, IP law often functions as a new sort of

⁶² Whether visible copies signal desirability and help raise demand or, rather, (or perhaps in addition) shift demand from wealthier consumers to poorer ones is an empirical question. Both arguments appear plausible, and indeed both may be true with the key issue being the brand’s willingness to expand downmarket in pursuit of greater numbers of customers at the risk of losing overall brand appeal in the longer run. The classic example of the risks of this trajectory is Halston in the 1970s, who in a move widely seen in the fashion industry as disastrous “cashed in on his famous name, cutting a deal with J. C. Penney in 1983 to sell cut-rate clothes.” But, the story goes, “the association cost him dearly: Bergdorf dropped him, and the average Jane didn’t seem too enthused, either.” Halson’s brand never recovered. Laura M. Holson, *The Men (and Women) Who Would Be Halston*, N.Y. TIMES, Sept 2, 2011, at ST1, available at http://www.nytimes.com/2011/09/04/fashion/the-men-and-women-who-would-be-halston.html?pagewanted=all&_r=0.

⁶³ See Haochen Sun, *Can Louis Vuitton Dance with Hipbone? Rethinking the Idea of Social Justice in Intellectual Property Law*, 15 U. Pa. J. L. & Soc. Change 387, 426 (2012) (“Even though many *shanzhai* companies copy products made by luxury brands, they actually have little impact on the market share of luxury companies. Rather, the luxury market . . . achieved an unprecedented rapid growth in China at the same time that the *shanzhai* phenomenon grew from its infancy to nation-wide popularity.”)

⁶⁴ See Raustiala & Sprigman, *supra* note 6.

sumptuary code, reinforcing class distinctions via legal means.⁶⁵ Protecting the interests (or distinctiveness) of elites, as sumptuary codes do, can be unpopular, especially in extremely unequal and rapidly-changing societies like China. On the other hand, governments also face political pressures—sometimes quite intense—to protect IP rights. Rights-holders are often powerful actors with access and resources to bring to bear to vindicate their preferred policies. Of course, when the IP rights holders are almost uniformly foreigners, as is true for luxury products in China, those pressures are far less strong. The balance struck is likely to be more protective of consumers' interest in access to goods than of producers' interest in protecting market share. And this is indeed what we see in today's China.

Class distinctions and economic inequality, in short, are inevitably at the heart of trademark protection in the luxury context. These factors are especially complex in China. Indeed, the tremendous inequality between China's major cities and its vast hinterland has created marked disparities in the luxury market. A recent news report, for example, suggests that China's crackdown on corruption among government officials has diminished interest in some of the most readily identified luxury brands. "Prada is among a few premium brands reporting solid growth in the world's second largest luxury market even as a government campaign against conspicuous spending and gift-giving hurts firms with instantly recognizable brands like LVMH, Compagnie Financiere Richemont and Kering SA. The logos on Prada's deluxe leather handbags, wallets and shoes are, by and large, low-key and these days, discretion is a wise strategy in China."⁶⁶ The story suggests further that "The shift away from in-your-face luxury brands is most prominent in big cities such as Shanghai and Beijing, where many companies have their biggest stores and where customer tastes are rapidly evolving. Logos, however, are still very popular in China's vast interior, where luxury labels are still a novelty, analysts say."

Marketing analysts have called this strategy "abranding." As one study puts it, abranding, which was common among the most affluent subjects in their study, has as its goal

to conceal consumption habits from the lay gaze of distant others. Underlying this behavior was a rampant desire to perpetuate social distance by restricting the knowledge others had about these consumers (Simmel 1950). Consumers in this group did not recognize a

⁶⁵ See Beebe, *supra* note 54, at pg. number needed.

⁶⁶ *In China, the Devil Doesn't Wear Prada*, LIVE MINT & WALL ST. J. (Sep. 17, 2013, 8:39 AM), <http://www.livemint.com/Consumer/9P3VsUHCdyexHEauBD0e7I/In-China-the-Devil-doesnt-wear-Prada.html>

distinction between those buying counterfeits and any other consumer who wants to emulate the rich. Affluent consumers—uneasy with the idea that previously disenfranchised consumers wanted to emulate them—appeared to gravitate preemptively toward brands that lower-income consumers find difficult to detect.⁶⁷

As this suggests, and any trip to a major Chinese city will confirm, what Veblen originally perceived as the driver of conspicuous consumption—status competition—is clearly alive and well in China. But whether the presence of counterfeit luxury goods has the straightforwardly harmful effect on original brands that the conventional view of trademark supposes is not so clear. The key to market success of a luxury good is the brand's ability to credibly signal wealth, taste, and style to others. Counterfeit goods trade on that signal, but whether in the process they also *impair or diminish* is a question that has yet to be satisfactorily answered.

Conclusion

China is by some measures the largest market in the world for luxury goods, and luxury goods constitute a category famously dependent on intellectual property for its value. China is also the undisputed world champion of counterfeiting. How these two facts coexist—and why—has been our focus in this chapter.

Because so little empirical work on the relationship between IP and copying has been done in China, our arguments are necessarily preliminary. But they draw on a more fundamental and well-grounded claim, which is that counterfeits and copies are not nearly as harmful as the conventional wisdom suggests.⁶⁸

There is no compelling reason to reject this logic for China. But there are some additional factors or twists that we believe make the Chinese case distinctive. One is that unprecedented economic growth over the last three decades has produced, even in a supposedly-Communist society, enormous income differences. This creates both great pressure for the newly-wealthy to engage in Veblenesque conspicuous consumption, but also a vast market of poor and middle class

⁶⁷ Suraj Commuri, *The Impact of Counterfeiting on Genuine-Item Consumers' Brand Relationships*, 73 J. MARKETING 86, 86 (2009).

⁶⁸ We have developed this argument at length elsewhere. See RAUSTIALA & SPRIGMAN, *supra* note 42.

Chinese who can only aspire to afford counterfeited facsimiles of the fancy goods they desire. China's rapid urbanization adds to this by providing dense spaces for status competition to unfold. At the same, many have argued that China has a literary and artistic tradition that is quite forgiving and even positive about copying, and a vibrant contemporary *shanzhai* culture that celebrates the clever copy as a triumph of ingenuity and creativity.

Adding to this is a set of dynamics that are not unique to China, but that serve to underscore the ways in which counterfeits can help as well as harm luxury brands. As research in the US, China, and South Korea have shown, counterfeits can serve as advertisements, highlighting the desirability and trendiness of particular brands and associated styles. Counterfeits can also serve as gateways, allowing customers with the means to purchase the original luxury item a low-cost way to "try on" a purchase and essentially sample the marketplace. These studies turn the conventional wisdom on its head, and highlight the complex relationship between original and knockoff.

Together, these considerations make the Chinese tolerance of knockoffs easier to understand, and provide a rational basis for China's continuing resistance to the pressure from the West for more aggressive policing of counterfeits. There is little reason to believe that China's luxury goods market, or its counterfeit market, will change anytime soon; China remains a largely poor country despite its astounding growth rate and notwithstanding its large number of newly minted millionaires. These considerations also suggest – although they do not yet prove -- that counterfeit and original can coexist more readily than conventional wisdom allows. In other words, one compelling explanation for the simultaneous and astonishing success of both legitimate luxury goods and counterfeits in China is that there is nothing surprising at all. Counterfeits do not injure the branded goods they imitate – at least not substantially – and it is in the interest of the Chinese government to permit both the luxury boom and the associated boom in luxury fakes to continue.