Fake product, real exposure: The growing threat of counterfeiting

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The counterfeiting of products, particularly those with well-known trade names, is a growing problem for companies and consumers alike. It is not just the street corner sales of “knock-off” watches and other luxury goods that is of concern these days. With the Internet and other secondary markets for products, the opportunities for counterfeit goods to be introduced into the chain of distribution have grown exponentially. Counterfeiting products is a crime involving the theft of intellectual property rights, and Congress has passed measures over the past two decades to deter such activity. Even so, brand owners and all companies in the marketplace should be prepared to consider litigation as a tool to protect their interests.

The value of intellectual property for many years went underestimated. Today, companies recognize that one of the most significant parts of their value arises from the intellectual property ("IP") they own: the brand names and logos affiliated with the goods they produce and sell; the copyrights they hold in recordings; and the trade secrets used to protect secret formulas. These rights have become increasingly important when evaluating the true value of many companies. It has therefore become critical for corporations to protect their IP and to aggressively pursue infringers. Even with increased pursuit of counterfeiters, counterfeit products present real exposure to consumers and to companies in the chain of distribution.

The allure of profits that can be gained from trading upon the intellectual property of others has compromised the public marketplace for consumer goods. While the government has done quite a bit to step up enforcement and penalties, many manufacturers have found that they need to take steps themselves by employing investigators and aggressively pursuing counterfeiters to protect these important assets.

Without the Nike “swoosh” affixed to a pair of sneakers, would a pair of leather running shoes sell for more than $100? Without the can of soda having a label announcing it to be Coke, would the soda sell for $1 or more in a soda machine? Would a consumer pay more than $3 for a bottle of cleaning fluid without the “Fantastik” label if other similar cleaning solutions cost $1? Without prominent marks including brand names, logos and distinctive packaging, many consumer goods would be relegated to earning the returns often seen in connection with generic or staple goods (e.g., milk, fruit, eggs, beef, vegetables, and no-name products).

The cost differential between brand name products and generics is astonishing. It is this differential that counterfeiters rely upon when seeking to exploit the public. While comparing the quality of two generic goods would give the consumer a basis upon which to compare two products, the counterfeiter utilizes the trademark of another to convince the public that its product is better than the other generic good because the authentic name brand product has been shown to be somewhat more desirable. Thus, by packaging a product under a famous brand name, a counterfeiter typically bypasses the scrutiny that a consumer may give to a product he or she is buying.

The marketplace, however, is not solely to blame for the emergence of counterfeiters. If the manufacturers strictly controlled the products they sold, counterfeiting might be more difficult. Today, many manufacturers sell large quantities at low-end prices in order to capitalize on large volume purchasers. However, large volume purchasers often acquire more than they need, and they then turn around and sell the excess at prices below those charged regularly by the manufacturer. This then creates a secondary market that competes with the primary market.

With the creation of a secondary market, the level of control that manufacturers have over the pricing of their products is lost. Thus, a cottage industry of parallel lines importers and excess wholesalers has entered the fray, selling goods through valid chains of distribution. These can involve distributors who sell goods that have only traveled domestically, as well as goods that have been traded internationally. With these uncontrolled and unregulated markets comes the risk that counterfeit product can infiltrate the authentic product supply. Apart from exposing the market to potentially harmful products
(counterfeit products may not be tested for safety at the same level as legitimate products or even tested at all), this infiltration impacts the economics of the industry. If the international product supply suddenly doubles in size, and significant quantities are flowing back into the United States, the supply in the United States (encompassing authentic and fake product) will increase and weaken the price that can be charged.

It should be noted that the manufacturing and sale of counterfeit products is considered a crime involving the theft of intellectual property rights, including patents, trademarks and copyrights. In the past, the counterfeiting industry was primarily involved in the sale of fake luxury goods, such as Rolex watches and designer handbags, as well as DVDs and other novelty items. These “knock-offs” were mostly found on street corners and were readily distinguishable from their genuine counterparts. It is usually obvious to a consumer when purchasing a designer item on the street for below-market value that he or she is in fact purchasing a “knock-off.”

Despite potential criminal exposure, the marketplace for counterfeit goods has expanded exponentially. As a result, counterfeit-related seizures by the U.S. Customs Service rose 125 percent during the past five years. This necessary response can be seen in the types of products being counterfeited. For example, there has been a growth in the counterfeiting of everyday consumer products, such as shampoo, batteries, auto parts and razors.

The need for monitoring and counter-intelligence has become even greater since the channels and markets through which the counterfeit goods are sold have expanded. Traditionally, flea markets and street vendors had been the primary outlets for counterfeit goods. However, counterfeit goods are becoming increasingly available for sale on the Internet and at popular retail stores. These sales are most alarming since retailers are often not aware that these goods are counterfeits, and online purchasers may not realize that they are being sold “knock-offs.” The consumers who purchase at traditional retail outlets must now be concerned that the products they are purchasing may not be authentic.

Legislation in response to counterfeiting activities

In an effort to secure the product supply, Congress has passed legislation over the past 20 years to respond to the increased presence of counterfeiting activities. In 1984, Congress passed the Federal Counterfeiting Act of 1984 (or 18 U.S.C. 2320). This was the first time trademark counterfeiting became a federal crime. Individuals could face criminal penalties, which included a fine of not more than $2 million, imprisonment for up to 10 years, or both. Entities could face criminal penalties for up to, but not more than, $5 million. The Act also allowed for law enforcement officers to seize and destroy counterfeit goods.

The 1984 Act, however, did not do enough to stop counterfeiting. Thus Congress passed the Anti-Counterfeiting Consumer Protection Act of 1996. This Act increased criminal liability exposure for counterfeiters by making counterfeiting a predicate act of the Racketeer Influenced and Corrupt Organizations Act (“RICO”) and its harsher penalties. This 1996 Act also enabled law enforcement officers to seize related assets that were used as part of counterfeiting, such as property, equipment, and storage facilities. The Lanham Act was also amended to allow for civil statutory damages of $500 to $100,000 per counterfeit mark for goods or services. Courts could award up to $1 million per infringing mark if willful counterfeiting were found.

Recently, Congress expanded its authority under 18 U.S.C 2320 to provide for greater penalties for trafficking in counterfeit marks. Congress made several findings that were a basis to amend Title 18. For example, the Bureau of Customs and Border Protection estimated that counterfeiting costs the United States approximately $200 billion annually. Congress also found that counterfeiting products had spread into numerous industries that included toys, electrical appliances, medicines, tools, office equipment, clothing and others.

The 2006 revision to the Act is called the “Stop Counterfeiting in Manufacturing Goods Act.” This revision expands the definition of “counterfeit mark” to include falsified marks on labels attached to goods. Criminal penalties have also been expanded, and courts are required to order the destruction of all counterfeit products seized as part of a criminal investigation. Counterfeiters are required to turn over their profits and any equipment used. These provisions were added to assist law
enforcement officials in shutting down illegal operations. It remains to be seen how effective these provisions are, but it is clear that manufacturers are not content to allow the government to pursue this alone. Enforcement divisions of major companies continue to grow in an effort to protect IP assets.

**Civil litigation and potential liability to innocent infringers**

Civil penalties have also been fortified to assist in combating infringement. Unfortunately for some innocent infringers (i.e., those who unwittingly have sold counterfeit product they believed to be authentic), this has resulted in potential exposures with stiff remedies. While at first blush it may seem unfair to assess strict liability to innocent infringers, and subject them to the harsh remedies, the public policy argument favors the mark owner. The mark owner is not only trying to protect its commercial advantage, but in doing so is trying to protect the public and give it confidence that it can consistently rely upon products sold with said mark.

Under the Trademark Law, any individual or company that sells counterfeit goods is subject to a strict liability standard. This means that any seller will be held liable for selling counterfeit goods, even if the seller did not know the goods were counterfeit, nor intended to engage in such activity. This standard for liability can potentially pose a significant risk to companies that cannot trace their purchases of products directly to the manufacturer. In many instances, counterfeit products will end up on retailers’ shelves without them even realizing it.

The increase in product diversion in the marketplace has allowed greater infiltration of counterfeit products into the stream of commerce. Products do not always follow a direct line of commerce from the manufacturer to a retail store. As mentioned above, the frequency with which products are resold in the marketplace allows for the introduction of fake products into the supply chain.

For example, the health and beauty aids market offers numerous opportunities to infiltrate the supply chain. Often, health and beauty aids will be sold to stores that will keep the products on the shelves for a limited time before returning them to the chain of commerce by selling short-dated products to discount wholesalers. When merchandise changes hands so often, it provides opportunities for counterfeiters to introduce extra product into the chain of distribution without much suspicion. This happens in the apparel industry, consumer goods, and even in the pharmaceutical industry.

In the pharmaceutical industry, there is an increasing number of counterfeit drugs being sold. Some drugs change hands five or six times between the manufacturer and the pharmacy shelf. A portion of the prescription drug market goes from the manufacturers to smaller wholesalers, which then sell to pharmacies, clinics and doctors. The secondary market that is created thereafter is typically where most of the problems occur. Chinese manufacturing plants have reverse-engineered many medications and flooded the secondary market. This not only harms the margins for the original manufacturer, but it also harms the legitimate secondary market suppliers who now must confront cheaper prices and an overabundance of supply due to the fake products. Moreover, the consumers who take these medications may not be getting the medication they need.

In an effort to ensure that counterfeiting is discouraged, the Trademark Law has placed burdens on those who are in the best position to avoid dealing in counterfeit product. There is one way to ensure that a product is authentic: purchase it from the manufacturer. If a wholesaler, or reseller, is going to engage in commerce, selling product that comes from anyone other than the original manufacturer, they assume the risk of dealing in counterfeit product. As such, sellers bear strict liability for violations of the Trademark Act, and a defendant will not be excused from liability due to his or her ignorance.

The U.S. Court of Appeals for the Sixth Circuit recently reinforced this theory when confronting a situation where a retailer of cigarettes was concerned with the terms of a proposed injunction. In *Lorillard Tobacco Co. v. Amouris’s Grand Foods, Inc.* 453 F.3d 777, 383 (6th Cir. 2006), the court interpreted the Trademark Law as providing protection for the mark holder to ensure that the public is protected from false labeling. The court noted that “in allocation-of-risk terms, the law favors the innocent producer of legitimate goods over a party that may be an innocent marketer of counterfeit goods.” A preliminary injunction was issued against the seller of counterfeit cigarettes that carried the “Newport” trademark. The defendant requested that it be enjoined only from “knowingly” selling counterfeit cigarettes. This proposal was rejected.
The court noted that counterfeit items create confusion for consumers, and that if “potential purchasers are confused, no amount of good faith can make them less so.” The court continued, “Whether or not the defendant has authored the counterfeit is irrelevant to the question of customer confusion.” Thus, it became clear that while it may seem unfair to penalize an innocent infringer, such standards are necessary to discourage the trade in counterfeit products and to protect consumers from false labeling.

The potential exposure to an innocent infringer
Once it is determined that a product is counterfeit, exposure will attach to the seller of the product. Each and every seller in the chain will be subject to a claim. An innocent infringer will be held liable to the mark holder for actual damages and for a disgorgement of profits. An innocent infringer can also find itself subject to an indemnification claim from a downstream seller. For example, a wholesaler, who sells to a smaller distributor, who sells to a retailer, who sells to a consumer, can find itself subject to claims of indemnification from the retailer and distributor. That wholesaler will then need to look to the seller that sold it the counterfeit product for indemnification. Somewhere in the chain it is likely that a seller will be without assets to indemnify the sellers below, or may be beyond the jurisdiction of the court. In such a case, a real innocent infringer will have nowhere to look and will be left exposed for the claim and any other damages that may result from its sale to customers below.

Conclusion
The increased channels of distribution, as well as the greater number of products being counterfeited, present a threat to everyone, including brand owners, the consuming public, and companies that sell the goods. The distribution of counterfeit goods is a growing problem that Congress and the courts have recognized and continue to battle. To the extent that there is a significant amount of economic damage and harm to reputation involved, brand owners as well as all companies in the marketplace should be aware of counterfeiting activity and be prepared to consider litigation as a tool to protect their interests.

Moreover, in light of the potential exposure from innocent infringements, it is necessary for anyone in the supply chain, be they wholesalers, distributors or retailers, to ensure that the products they sell come from reputable entities and that the supplier has either sufficient assets or other protection to ensure that any claim brought will be indemnified.

Wilson Elser’s Intellectual Property Practice Team is available to discuss this and other issues related to copyrights, trademarks, trade dress, trade secrets, patents and unfair competition. For further information regarding Wilson Elser’s Intellectual Property capabilities, please contact Thomas A. Leghorn at thomas.leghorn@wilsonelser.com or Adam R. Bialek at adam.bialek@wilsonelser.com.

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