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## ESSAYS

### SHOPPING FOR GUCCI ON CANAL STREET: REFLECTIONS ON STATUS CONSUMPTION, INTELLECTUAL PROPERTY, AND THE INCENTIVE THESIS

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#### INTRODUCTION

**A**LONG Manhattan's Canal Street, a large number of vendors operate stalls and more permanent establishments offering consumers a wide range of imitation high-end handbags and other luxury goods, all at drastically reduced prices and almost all of fairly obvious inferiority relative to the original. For the most part, the police do not appear to pay frequent attention to the Canal Street vendors, and cost-conscious consumers regularly arrive in large numbers. Ironically, Canal Street forms the southern border of Manhattan's trendy Soho neighborhood, where many high-end luxury designers maintain stores that purvey the original versions of the items for which the Canal Street shoppers are either unwilling or unable to pay the high price. Casual observation suggests that the Soho designer boutiques enjoy a vigorous level of business and regularly introduce new items. This juxtaposition of original fashion items being sold at full price and unauthorized imitations being sold at substantially reduced prices, with little apparent effect on the flow of new items into the full-price market segment, poses a conundrum for the standard incentive thesis that pervades much academic, judicial, and policy discussion of intellectual property. The incentive thesis holds that without robust enforcement of

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intellectual property rights against unauthorized imitation, producers of intangible goods would have few practical defenses against third-party appropriation of sale proceeds and, as a result, would rationally limit or cease investment in the development and production of new items. Contrary to this thesis, the fashion industry appears to sustain robust levels of investment in new product development even with widespread unauthorized imitation, few effective legal defenses against counterfeiters, and relatively meager state prosecution of counterfeiting operations.

As I have argued elsewhere in the patent context, incentive-based justifications for intellectual property are subject to the factual preconditions that (1) there actually exist few or no effective extralegal means for preventing or delaying imitation, and (2) intellectual property rights are effective at thwarting imitators.<sup>1</sup> In many industries, neither of these preconditions may be met to any significant extent.<sup>2</sup> In this Essay, I will argue that even where these two preconditions are substantially satisfied, the incentive thesis still rests on another vulnerable factual assumption: namely, that third-party imitators necessarily take away sales that would have been captured by the innovator, therefore reducing the innovator's expected return *ex post* and its investment incentives *ex ante*. Specifically, I will identify circumstances where this lost profits assumption may not always be true and sometimes may be *reversed*, such that a legitimate producer will prefer that unauthorized third-party imitators enter the market because counterfeits can reasonably be expected to increase the producer's revenues on sales of the original.<sup>3</sup> This unusual result may arise when three conditions are

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<sup>1</sup> See Jonathan M. Barnett, *Private Protection of Patentable Goods*, 25 *Cardozo L. Rev.* 1251, 1271 (2004). For an interesting critique generally of incentive-based justifications for intellectual property (and in particular, of the claim that intellectual property is required to internalize knowledge spillovers that would otherwise remain unpriced), see Michele Boldrin & David K. Levine, *The Case Against Intellectual Monopoly*, 45 *Int'l Econ. Rev.* 327–50 (2004).

<sup>2</sup> See Barnett, *supra* note 1, at 1272. For further consideration of the limited exclusionary capacities of patent and copyright protections, see Gideon Parchomovsky & R. Polk Wagner, *Patent Portfolios*, 154 *U. Pa. L. Rev.* (forthcoming Nov. 2005). See also Ronald J. Mann, *Do Patents Facilitate Financing in the Software Industry?*, 83 *Tex. L. Rev.* 961 (2005).

<sup>3</sup> A handful of scholars have argued that innovators may prefer a positive level of unauthorized imitation, but on grounds different from those advanced here. These other arguments include: (1) Copying creates network effects that increase demand

met: (1) the relevant market consists of goods that confer significant status benefits, (2) imitators generally produce imitations of the original that are obviously imperfect, and (3) the legitimate producer cannot introduce imperfect grades of the original without significantly depleting its accumulated brand capital.

This result is predicated on consumers' preferences for the enhanced social status conferred by the visible ownership of certain goods. This goods category offers benefits to consumers not only in the form of functional attributes but also in the form of social status. In markets for such status goods, each consumer's preferences are determined in part by the visible purchasing behavior of certain other consumers—what each consumer deems to be fashionable is determined in significant measure by the observed purchasing behavior of certain other consumers. The intellectual property literature has paid little attention to status preferences and the resulting interdependence of consumer behavior. Given that fashions and fads determine to a great extent consumer demand in the varied product markets to which some form of intel-

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for the original in the long term. See Lisa N. Takeyama, *The Welfare Implications of Unauthorized Reproduction of Intellectual Property in the Presence of Demand Network Externalities*, 42 *J. Indus. Econ.* 155, 156 (1994) [hereinafter *Takeyama, Unauthorized Reproduction*]. For a similar argument with respect to software publishers in particular, see Kathleen Reavis Conner & Richard P. Rumelt, *Software Piracy: An Analysis of Protection Strategies*, 37 *Mgmt. Sci.* 125, 126 (1991) and Ariel Katz, *A Network Effects Perspective on Software Piracy*, 55 *U. Toronto L.J.* 155, 156–57 (2005). (2) Copying enables a durable-goods monopolist to commit to a high price to the extent that it can commit to not enforcing its copyright against copies sold to lower-valuation consumers, who will consequently never be part of the consumer pool for the original good and therefore never induce the monopolist to lower prices. See Lisa N. Takeyama, *The Intertemporal Consequences of Unauthorized Reproduction of Intellectual Property*, 40 *J.L. & Econ.* 511, 512–14 (1997). (3) Infringement enables copyright holders to effectively engage in predatory pricing by selectively failing to enforce copyrights in a sub-market where demand is less elastic, thereby reducing rents in that market to near-zero and eliminating an entry opportunity for potential competitors. See Danny Ben-Shahar & Assaf Jacob, *Selective Enforcement of Copyright as an Optimal Monopolistic Behavior*, 3 *Contributions to Econ. Analysis & Pol'y* 1189, 1190 (2004). (4) Unauthorized photocopying may increase a publisher's revenues if the original increases in value to reflect the fact that it can be copied repeatedly and the publisher can price-discriminate between light and heavy copiers. See S. J. Liebowitz, *Copying and Indirect Appropriability: Photocopying of Journals*, 93 *J. Pol. Econ.* 945, 946, 948 (1985). For a review and critique of economic models ascribing gains to copyright holders from unauthorized copying, see Stan J. Liebowitz, *Economists' Topsy-Turvy View of Piracy*, 2 *Rev. Econ. Res. on Copyright Issues* 5–17 (2005).

lectual property protection is generally applicable (for example, music, movies, and clothing), status preferences are certainly not an esoteric case in the intellectual property context. This Essay will look at one such market in particular: the luxury fashion-goods market, which consists of a wide range of items such as women's handbags, luggage, scarves, women's dress shoes, watches, and sunglasses. This market is shadowed by a large counterfeiting industry, which generally produces items of various grades inferior to the original, while legitimate producers have few effective legal remedies against counterfeiters.

The standard incentive argument would anticipate that such widespread counterfeiting, and the relative paucity of effective legal deterrents, should limit legitimate producers' ability to fully appropriate investment proceeds and therefore significantly reduce their incentive to develop new products. As noted at the outset, this argument does not appear to conform to market realities, because even in the face of abundant third-party appropriation, the fashion industry sustains high levels of investment in new product development. This Essay will propose a possible mechanism to account for this otherwise difficult-to-explain result: To the extent that the fundamental conditions set forth above are satisfied, imperfect counterfeiting is likely to increase the revenues of legitimate producers.<sup>4</sup> This counterintuitive proposition rests on two important benefits that legitimate producers can reasonably expect to accrue from the entry of imperfect counterfeiters, each arising as a result of the interdependent demand conditions of fashion-goods markets. First, the introduction of imperfect counterfeits may enable producers to charge an enhanced "snob premium" to "elite" consumers eager to distinguish themselves from the "non-elite" consumers who visibly settle for the fakes.<sup>5</sup> Second, sales by coun-

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<sup>4</sup> For additional observations on the apparently anomalous vigor of the fashion industry and an alternative proposed explanation, see Kal Raustiala, *Fashion Victims*, *The New Republic Online*, at <http://www.tnr.com/doc.mhtml?i=w050314&s=raustiala031505> (Mar. 15, 2005).

<sup>5</sup> As used herein, the terms "elite" and "non-elite" denote classes of consumers occupying different status positions on the social ladder. Note that the elite/non-elite dichotomy corresponds often, but not always, to higher and lower-income brackets. On the possibility of elite consumers being poorer than non-elite consumers, with specific reference to inner-city fashions being imitated by the wealthy, see Gary S. Becker et al., *Social Markets and the Escalation of Quality: The World of Veblen Re-*

terfeiters advertise, and even exaggerate, the popularity of the relevant item, thereby arguably leading some non-elite consumers to adjust upward their estimate of the expected status benefits to be gained by visibly owning the original. Depending on existing wealth constraints, this upward adjustment may translate into a purchase of the original. Each of these effects suggests that legitimate producers may enjoy higher total returns with counterfeiting than without and may therefore rationally limit enforcement of intellectual property rights against counterfeiters even when the costs of doing so are low or nonexistent.

The benefits arguably conferred on legitimate producers by unauthorized imitators would seem to build at least a preliminary case against intellectual property protections in fashion-goods markets. I will argue against drawing this implication. For reasons explained further below, fashion (or more generally, status) goods markets may be prone to collective action inefficiencies resulting in such goods being consumed at socially excessive levels in the absence of any governing mechanism to fix maximum consumption levels. Prosecution of counterfeiting may reduce socially excessive consumption by increasing the cost of acquiring counterfeit fashion goods, thereby having the counterintuitive effect of advancing social welfare generally while (to the extent counterfeiting boosts revenues earned on sales of the original) reducing the welfare of fashion-goods producers in particular. Rather than being its chief beneficiary, the fashion industry potentially would be the inadvertent victim of any strongly enforced regime of intellectual property rights. More broadly, this Essay will suggest that the standard incentive thesis cannot automatically justify introducing or strengthening intellectual property protections in markets to which such protections otherwise would be thought to logically extend. More precisely, in markets where purchasing behavior is strongly driven by status preferences, unauthorized imitation is generally imperfect and, for the reasons advanced in this Essay, counterfeiting may therefore pose little or no threat to (and even increase) the expected revenues of legitimate producers; any significant state investment in the enforcement of intellectual property protections

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visited, *in* Gary S. Becker & Kevin M. Murphy, *Social Economics: Market Behavior in a Social Environment* 84, 90–91 (2000).

must rest, if at all, on a basis other than the preservation of innovation incentives.

This Essay will proceed as follows. In Part I, I will describe fashion-goods markets, the shadow counterfeit market, and the limited set of legal and extra-legal preventive and remedial tools available to fashion-goods producers. In Part II, I will identify the conditions under which fashion-goods producers can expect to benefit from counterfeiting and show that producers probably cannot replicate these benefits without serious risk to accumulated brand capital. In Part III, I will then advance the claim that legitimate producers will tolerate positive levels of counterfeiting even if enforcement costs are low or nonexistent and will preliminarily test the plausibility of this claim against prevailing patterns in the enforcement behavior of fashion-goods producers. Finally, in Part IV, I will consider what implications the foregoing analysis may have for the applicability of the incentive thesis to status-goods markets, and, as a policy matter, for the enactment and enforcement of intellectual property protections in fashion-goods markets specifically.

### I. SNOB, ASPIRATIONAL, AND BANDWAGON EFFECTS

A fashion-goods market is characterized most notably by the fact that demand is determined not only by instrumental factors such as product quality but also by “positional” factors such as social status. Fashion goods are therefore a species of Thorstein Veblen’s more general category of status goods—that is, goods that are valued not only for functional qualities (what Veblen calls their “serviceable” aspect<sup>6</sup>) but also because they confer status on their users within the relevant social community (what Veblen calls their “ceremonial” aspect<sup>7</sup>). To the extent that consumers make purchase decisions based on the status benefits attributed to “being in fashion,” then we should expect that consumer purchasing behavior is highly interdependent—that is, each consumer’s purchase de-

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<sup>6</sup> Thorstein Veblen, *The Theory of the Leisure Class* 94–96 (Transaction Publishers 1992) (1899).

<sup>7</sup> *Id.* at 61, 114–15. The overlap between the categories of status goods and fashion goods is substantial, with the principal defining difference between the two categories probably consisting of the unusual volatility of consumption patterns in fashion-goods markets, a characteristic not true of all status-goods markets (consider the “consumption” of religious practices that remains fixed for generations).

cision rests in part on the observed purchasing behavior of certain other consumers insofar as such behavior indicates the social status accorded to visible ownership of a particular item. Where goods offer potential purchasers benefits solely in terms of functional product attributes (for example, a luxury car's soft and durable leather seats), consumers' purchase decisions are independent—my decision to take the leather seat option on my new car is independent of your decision to take the leather seat option. But where goods also offer potential purchasers benefits in terms of the enhanced social status accorded to “fashionable” consumers (for example, a luxury car's stylish interior design), each consumer's purchase decision is dependent on certain other consumers' purchasing behavior insofar as such behavior defines what is and is not fashionable—now my decision to take the leather seat option on my new car may be dependent at least in part on your decision to take the leather seat option.

Standard models of consumer demand generally adopt the simplifying assumption that consumers independently reach consumption decisions so as to maximize satisfaction based on a fixed set of stand-alone preferences matched against an opportunity set of possible investments (as constrained by budget constraints and net of expected transaction costs).<sup>8</sup> Thus, the conventional economic model begins the analytical work in mid-stream: It assumes that a given consumer has a strong preference for Gucci bags while leaving to non-economists to explain how that otherwise arbitrary preference arose in the first place.<sup>9</sup> Many economists would probably agree, however, that this simplifying assumption as to the ex-

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<sup>8</sup> See Frank Ackerman, *Consumed in Theory: Alternative Perspectives on the Economics of Consumption*, 31 *J. Econ. Issues* 651, 651 (1997) (noting that the neoclassical economic model assumes that consumers come to the market with well-defined desires that “are not affected by social or economic institutions, interactions with others, or observation of the behavior of others”). For an interesting discussion of the historical approaches of neoclassical economists to the problem of status-driven consumption and the resulting interdependence of consumer behavior, see Roger Mason, *Interpersonal Effects on Consumer Demand in Economic Theory and Marketing Thought, 1890–1950*, 29 *J. Econ. Issues* 871 (1995).

<sup>9</sup> See Robin Cowan et al., *A Model Of Demand With Interactions Among Consumers*, 15 *Int'l J. Ind. Org.* 711, 714–15 (1997) (noting that economic analysis of consumption generally treats tastes as exogenous and “hence taste changes are essentially random”).



ogenous status of consumer tastes yields analytical tractability<sup>10</sup> at a significant descriptive cost insofar as it overlooks the well-documented fact that generally consumers *are* highly influenced by the purchasing behavior of other consumers.<sup>11</sup>

In fashion and other status-goods markets, interdependent consumer behavior arises as a result of efforts by certain consumers to acquire status benefits either by imitating, or distinguishing themselves from, the purchasing behavior of certain classes of consumers.<sup>12</sup> Empirical evidence suggests that such status-driven consumption is a thoroughly rational course of action, showing that consumers perceive others' consumption choices as fairly refined signals of social position and prestige, often with a good deal of accuracy.<sup>13</sup> As a result of the status benefits conferred by certain goods, there may be more demand for good *A* relative to good *B* in the case where *A* and *B* are similar or identical in quality, but *A* is visibly used by a certain elite consumer class and consequently confers status benefits on additional users.<sup>14</sup> In a well-known article that elaborates upon Veblen's work, Professor Harvey Leibenstein argued that fashion goods exert two types of status effects: (1) a

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<sup>10</sup> Precisely, this assumption enables the derivation of an aggregate demand curve by simply summing the constituent individual demand curves and therefore without taking into account any interdependence between individual demand curves.

<sup>11</sup> See Rob Alessie & Arie Kapteyn, *Habit Formation, Interdependent Preferences and Demographic Effects in the Almost Ideal Demand System*, 101 *Econ. J.* 404, 404 (1991) (noting that the fact that consumer preferences are influenced by others' behavior is well-documented in the psychological and sociological literature but generally ignored in micro-studies of consumer demand). For an overview of some of the empirical research by economists and marketing scholars concerning interdependent consumer behavior, see William O. Bearden et al., *Measurement of Consumer Susceptibility to Interpersonal Influence*, 15 *J. Consumer Res.* 473, 474 (1989).

<sup>12</sup> One of the earliest writers to make this point was Professor James Duesenberry, who noted that the urge to acquire the prestige benefits earned by imitating the prevailing standard of living drives middle-class consumption behavior, which therefore is based not on the satisfaction of intrinsic wants but on wants generated as a result of observing the purchasing behavior of other consumers. See James S. Duesenberry, *Income, Saving and the Theory of Consumer Behavior* 28–29 (1949) (5th prtg. 1967).

<sup>13</sup> For an overview of some of the evidence, see Juliet B. Schor, *The Overspent American: Upscaling, Downshifting, and the New Consumer* 34–39 (1998).

<sup>14</sup> As Professor Robert Frank points out, there are even circumstances where consumers are willing to pay more for a particular type of luxury car that is considered more “exclusive” than its alternatives even if those alternatives are superior from a functional point of view. Robert H. Frank, *Luxury Fever: Why Money Fails to Satisfy in an Era of Excess* 120 (1999).

“snob effect”—that is, the fashion good confers more status benefits if the number of users is perceived to be limited as a result of high price, constrained output, or other factors, and/or (2) a “bandwagon effect”—that is, the fashion good confers more status benefits if the number of users is perceived to be growing.<sup>15</sup> In the case of the snob effect, status benefits are determined by the extent to which perceived usage is limited to a certain elite consumer class, so that once a certain “adoption threshold” is met,<sup>16</sup> demand falls relative to the perceived number of users (except as countered by the standard relative price effect whereby quantity demanded increases as a function of decreasing price). In the case of the bandwagon effect, status benefits are determined by the extent to which perceived usage extends among the entire population, so demand moves positively relative to the perceived number of users (presumably, until a certain “saturation threshold” is reached<sup>17</sup> and thereafter, except as countered by the standard relative price ef-

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<sup>15</sup> See H. Leibenstein, *Bandwagon, Snob, and Veblen Effects in the Theory of Consumers' Demand*, 64 Q.J. Econ. 183, 189–202 (1950). To be precise, Professor Leibenstein also posits a “Veblen effect,” where consumers’ demand is a positive function of a product’s price due to a desire to demonstrate wealth. This “Veblen” effect arguably reduces to the snob effect insofar as price may be used by potential consumers as an indication that the relevant good is purchased exclusively or primarily by high-status consumers (assuming wealth is generally understood to be correlated with status, a plausible assumption in most market settings). *Id.* at 189, 202–05. For a similar view, see Laurie Simon Bagwell & B. Douglas Bernheim, *Veblen Effects in a Theory of Conspicuous Consumption*, 86 Amer. Econ. Rev. 349, 350 (1996). For earlier contributors who anticipated Professor Leibenstein’s analysis at least in part, see A.C. Pigou, *The Interdependence of Different Sources of Demand and Supply in a Market*, 23 Econ. J. 19, 23 (1913) (observing that interdependent consumer preferences may work in two directions: to be “in the swim” (equivalent to Leibenstein’s bandwagon effect) and to be “out of the swim” (equivalent to Leibenstein’s snob effect)); see also Georg Simmel, *Fashion*, 62 Am. J. Soc. 541, 543 (1957) (arguing that fashion is motivated by two conflicting tendencies: on the one hand, the tendency toward imitation and uniformity, and on the other hand, the tendency toward differentiation and distinction).

<sup>16</sup> Presumably, a minimum number of snob consumers must visibly consume the relevant good before it confers any status utility. This assumption is sometimes made in the fashion economics literature. See, e.g., Giacomo Corneo & Olivier Jeanne, *Snobs, Bandwagons, and the Origin of Social Customs in Consumer Behavior*, 32 J. Econ. Behavior & Org. 333, 337 (1997) [hereinafter Corneo & Jeanne, *Snobs, Bandwagons*].

<sup>17</sup> The bandwagon market may become saturated due to a variety of factors, most notably income constraints. Other possible factors include boredom, limits on the number of eligible consumers, or consumers’ storage costs.

fect). Put differently, in the case of the snob effect, additional perceived users outside the elite consumer class exert a negative consumption externality on existing users; in the case of the bandwagon effect, additional perceived users exert a positive consumption externality on existing users.

More recent contributors have devoted attention to an intermediate consumer category not fully captured by Professor Leibenstein's bipartite model (although fully anticipated by Veblen<sup>18</sup>): the non-elite consumer who purchases a fashionable item in order to imitate the tastes and lifestyle of the elite consumer rather than to conform to the latest styles of a local peer group. This aspirational category seems to have grown in magnitude in recent years and many non-elite consumers of luxury items may now be largely driven by a desire to "get ahead of the Joneses" rather than "to keep up with the Joneses."<sup>19</sup> Aspirational consumers exhibit snob-like behavior, but are generally subject to more severe budget constraints: Demand decreases as a function of increasing perceived usage among consumers generally (since the relevant good is being purchased in order to imitate the exclusive tastes of the elite), but with a later adoption threshold than among snob consumers since aspirational purchases by definition follow snob purchases. Taking aspirational consumer behavior into account, demand patterns in fashion markets may be understood to operate as follows: snob consumers who set or "produce" the trend, aspirational consumers who imitate snob consumers and thereby "distribute" the trend among other non-elite consumers, and bandwagon consumers who imitate the trend in order to be "part of the crowd." As the existing

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<sup>18</sup> See *infra* note 71 and accompanying text.

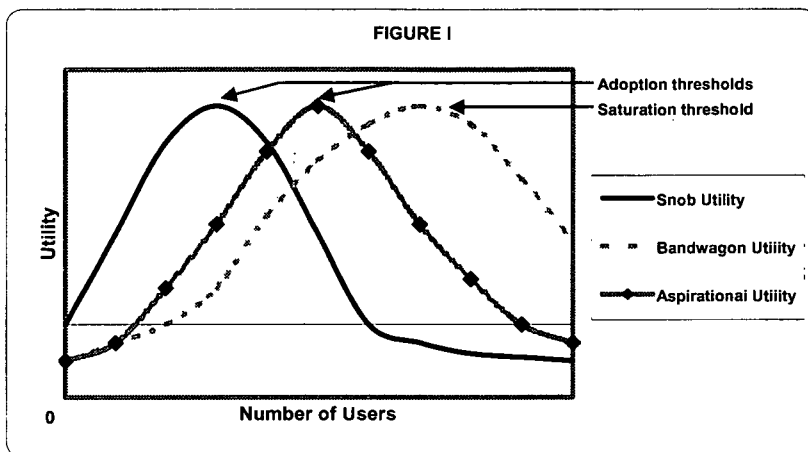
<sup>19</sup> It appears that the distribution of aspirational and bandwagon preferences among non-elite consumers may have shifted over time. Professor Juliet Schor has argued that whereas middle-class consumption practices in the 1950s and 1960s were largely characterized by "keeping up with the Joneses" (that is, bandwagon consumption), middle-class consumption practices in the 1980s and even more so in the 1990s came to be characterized more notably by aspirational preferences to emulate the lifestyle of the most wealthy members of the social scale. See Schor, *supra* note 13, at 7–12. A related thesis is explored extensively in a more recent publication concerning the new "middle market" luxury sector—that is, the significant growth in the "aspirational" consumption of luxury items by middle-class and upper-middle-class consumers for whom luxury goods usually would be thought to be too expensive. See Michael J. Silverstein & Neil Fiske, *Trading Up: Why Consumers Want New Luxury Goods—and How Companies Create Them* 9 (2005).

literature on fashion and luxury markets widely agrees (using varying terminology), these three demand patterns—the snob, aspirational, and bandwagon effects—operate partly in sequence and partly simultaneously. First, a snob effect is produced when a certain elite class visibly employs a particular good. Second, an aspirational effect is created among the most astute non-elite shoppers eager to display the latest trend initiated by the elite. Finally, a bandwagon effect is created among the other non-elite shoppers eager not to be left out of the mainstream, which over time quickly destroys the snob effect, more slowly erodes the aspirational effect, and ultimately undermines the bandwagon effect, leaving elite shoppers to search for the next “in” thing. So the fashion cycle begins anew.<sup>20</sup> This cyclical process is illustrated in Figure 1 below.<sup>21</sup>

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<sup>20</sup> On the Economics of the Fashion Cycle, see Becker et al., *supra* note 5, at 140–43; Giacomo Corneo & Olivier Jeanne, Segmented Communication and Fashionable Behavior, 39 *J. Econ. Behav. & Org.* 371, 380–81 (1999); Paul Frijters, A Model of Fashions and Status, 15 *Econ. Modelling* 501, 502, 504–07 (1998); Wolfgang Pesendorfer, Design Innovation and Fashion Cycles, 85 *Am. Econ. Rev.* 771, 772–73 (1995); George B. Sproles, Analyzing Fashion Life Cycles—Principles and Perspectives, 45 *J. Marketing* 116, 117 (1981). For a model of cyclical consumption using the tripartite model described above, see Cowan et al., *supra* note 9, at 711 (presenting consumption model consisting of: (1) a “peer group” with which the subject individual wishes to share some consumption activities, (2) a “contrast group” with which the subject individual actively seeks to distinguish himself, and (3) an “aspirational” group with which the subject individual actively seeks to identify himself).

<sup>21</sup> Note that Figure 1 contemplates the possibility of negative utilities: in the case of snob consumers, this may arise as bandwagon consumers purchase the relevant good in large numbers and destroy its exclusivity (“I would never be caught dead wearing that anymore”); and to a lesser extent in the case of aspirational and bandwagon consumers, this may arise at the nascent stage of an unproven, new fashion good (“I wouldn’t take a chance wearing that yet”). Figure 1 also assumes that each potential consumer has perfect information as to the number of other users of the relevant fashion good.



## II. THE COUNTERFEITS MARKET

It is commonly observed that luxury producers charge consumers substantial above-cost premia, even when there are numerous alternative goods having objectively similar product characteristics.<sup>22</sup> Prices in excess of marginal cost naturally attract entrants willing to charge a price somewhere above marginal cost but below the existing supra-competitive price. Fashion goods are no exception, and despite entry barriers in the form of exclusive distribution channels and trademarked logos, they are widely counterfeited by imitators who sell the copies at drastically reduced prices, often within days of release of a new item into the market. Many counterfeits are of poor quality, are obviously inferior to the original, and sell at appropriately discounted prices. Although some of the better and more highly priced counterfeits are often similar in ap-

<sup>22</sup> See Bagwell & Bernheim, *supra* note 15, at 349–50; see also D.C. Denison, *Prestige Products Now In Reach of Not-So-Rich*, *Boston Globe*, Nov. 17, 2002, at H2 (citing a report by the Boston Consulting Group and stating that consumers are willing to pay premiums of up to ten times “conventional price levels” for luxury items); *Every Cloud Has a Satin Lining*, *Economist*, Mar. 23, 2002, at 63, 65 (stating that gross margins on Louis Vuitton, Gucci, and Cartier are around seventy percent and operating margins are over twenty percent); *No End of Luxury*, *Economist*, Mar. 6, 2004, at 15, 16 (noting that high-fashion brands enjoy gross margins of fifty to sixty percent on clothes and eighty percent on leather goods); *Upmarket Philosophy*, *Economist*, Dec. 26, 1992, at 95, 96 (noting that analysts believe that Cartier jewelry sells at a market premium of possibly forty percent).

pearance to the original, they are generally known to be less durable, and closer inspection usually reveals poorer workmanship, misprinted or missing official labels and other distinguishing marks, and lower quality materials.<sup>23</sup> Additionally, counterfeits are usually sold in venues, such as New York's Canal Street, that almost certainly are populated by unauthorized dealers (for example, street vendors), even in the eyes of the relatively untrained consumer. Thus, as a New York state court noted in a recent case concerning the sale of counterfeit goods, there does not seem to be any significant problem of purchasers who mistakenly purchase fakes when intending to purchase the original.<sup>24</sup> Since purchasers almost always know they are getting fakes, they demand an appropriately reduced price reflective of the quality differential between the original and the imitation. Some third-party observers of others' purchasing decisions are certainly misled, however, since many of the better-made fakes are not distinguishable except on closer inspection.

Legal means to prevent or deter counterfeiting often are limited or practically ineffective. In the United States, fashion designers generally have only two legal tools at their disposal: trademarks to

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<sup>23</sup> This observation is based on conversations with several experienced shoppers of luxury goods and their counterfeits as well as professionals in the New York fashion industry. The academic literature agrees. See Arghavan Nia & Judith Lynne Zaichkowsky, *Do Counterfeits Devalue the Ownership of Luxury Brands?*, 9 *J. Prod. & Brand Mgmt.* 485, 485–86 (2000) (stating that most shoppers can identify a counterfeit either upon close inspection or by the nature of where it is being sold); see also Peter H. Bloch et al., *Consumer "Accomplices" in Product Counterfeiting*, 10 *J. Consumer Marketing*, 27, 28 (1993) (stating that most consumers buying counterfeit prestige goods are probably aware they are buying a counterfeit, especially given the article's low price and the vendor's location); Gene M. Grossman & Carl Shapiro, *Foreign Counterfeiting of Status Goods*, 103 *Q.J. Econ.* 79, 80–81 (1988) (same; also noting that counterfeits are usually of obviously poorer quality than the original); Luuk van Kempen, *Fooling the Eye of the Beholder: Deceptive Status Signalling Among the Poor in Developing Countries*, 15 *J. Int'l Dev.* 157, 164 (2003) (noting that imitation goods, such as jeans sold in Bolivia, often are identifiable as imitations due to the use of inferior materials, misspelling of labels, and other defects). In addition, the popular press generally agrees with this observation. See, e.g., William Green & Katherine Bruce, *Riskless Crime?*, *Forbes*, Aug. 11, 1997, at 101 (noting that most counterfeit goods look like "cheap knock-offs").

<sup>24</sup> See *People v. Rosenthal*, No. 51738(U), 2003 WL 23962174, at \*2 (N.Y. Crim. Ct. Mar. 4, 2003) (noting that it is probably the exception rather than the rule that a consumer purchases a counterfeit item from a street vendor without the knowledge that the item is fake).

protect name and logo and trade dress protections for garment designs. The latter option is generally thought to be highly ineffective given a difficult set of probative thresholds,<sup>25</sup> with the result that fashion designers have little expectation of any secure property-type rights in their creations.<sup>26</sup> Indicative of this state of affairs, New York state courts have held that it is legal to sell “knock-offs” so long as they do not reproduce the registered trademark of the relevant item.<sup>27</sup> Relying principally on trademark protections, many luxury-goods producers and various trade associations devote relatively significant resources to uncovering counterfeiting operations (often by hiring private security agencies or firms specializing in anti-counterfeiting investigation), and then sue the unauthorized imitators in civil actions.<sup>28</sup> Governmental complements to such pri-

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<sup>25</sup> It is often problematic to bring suit under a trade dress claim in the design context because the claimant must show that the design is purely ornamental (that is, not “functional”), the alleged imitation causes consumer confusion with the original product, and the design is “distinctive” (meaning that it has acquired a secondary meaning such that it indicates to consumers the source of the product). Clothing designs generally are deemed to fail all these tests. See Anne Theodore Briggs, *Hung Out to Dry: Clothing Design Protection Pitfalls in United States Law*, 24 *Hastings Comm. & Ent. L.J.* 169, 196–200 (2002); see also Peter K. Schalestock, *Forms of Redress for Design Piracy: How Victims Can Use Existing Copyright Law*, 21 *Seattle U. L. Rev.* 113, 113 (1998) (“Congress never has provided explicitly for the protection of clothing designs, and courts have been unwilling to use the tools available for even limited protection.”). Note that garment designs generally are not protected by copyright law (largely due to the “useful articles doctrine,” which limits copyright protection for items having a functional as well as artistic purpose) and generally have difficulty qualifying for patent protection (largely due to the difficulty of meeting the non-obviousness standard, a patentability requirement). Even were design patents more easily obtainable, the lengthy process of obtaining patent protection would probably render such protection of little use given the short-lived product cycle in the fashion-goods market. See Briggs, *supra*, at 179–80; Robert P. Merges et al., *Intellectual Property in the New Technological Age* 338 (2d ed. 2000).

<sup>26</sup> For a similar view, see Raustiala, *supra* note 4. The effective absence of any secure intellectual property protections for fashion designs is well-illustrated by the recent widely discussed and unsuccessful suit by the Louis Vuitton fashion house against a rival designer for allegedly copying, with only slight alteration, the design of a popular Louis Vuitton handbag. See *Louis Vuitton Malletier v. Dooney & Bourke Inc.*, 340 F. Supp. 2d 415, 420–21 (S.D.N.Y. 2004).

<sup>27</sup> See *Rosenthal*, 2003 WL 23962174, at \*1 (noting that “while it is perfectly legal to sell merchandise that copies the design and style of a product often referred to as ‘knock-offs’ it is against the law to sell goods that bear a counterfeit trademark”).

<sup>28</sup> See Gene M. Grossman & Carl Shapiro, *Counterfeit-Product Trade*, 78 *Am. Econ. Rev.* 59, 59 (1988); see also Robert Galbraith, *Luxury Groups Battle a Wave of Counterfeit Goods*, *Int’l Herald Trib.*, Sept. 29, 2001, at 12 (stating that most big fash-

vate enforcement actions are relatively meager, as the law enforcement community tends to devote few resources to anti-counterfeiting operations.<sup>29</sup> Although the distribution and sale of counterfeit goods is criminal under federal law and theoretically can trigger lengthy terms of imprisonment and significant monetary penalties,<sup>30</sup> government authorities rarely prosecute sellers, and most convictions result in sentences substantially below the statutory minimum.<sup>31</sup>

On a formal level, European countries generally provide a significantly higher level of legal protection for industrial and applied art designs.<sup>32</sup> Despite this fact, it appears that many private and public efforts to enforce those laws probably fail a cost-benefit

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ion houses now have counterfeiting experts working full-time to trace the source of false products); Margaret Webb Pressler, *Calling a Fake Spade a Spade*, Wash. Post, July 28, 2002, at H-5 (stating that Chanel has put millions of dollars into fighting counterfeiting, including a full-time employee whose sole job is to search the internet for fake Chanel); Tracie Rozhon, *Handbag Maker Takes Aim at Knockoffs*, N.Y. Times, Oct. 29, 2002, at C4 (noting the efforts of Kate Spade, maker of handbags, and Coach, maker of luggage, to combat counterfeiting).

<sup>29</sup> See Green & Bruce, *supra* note 23, at 100 (noting that law enforcement officers tend to leave counterfeiters alone and that, even when arrested, counterfeiters generally are only assessed a fine).

<sup>30</sup> The Lanham Act provides civil remedies for trademark holders against trademark infringement. 15 U.S.C. § 1117 (2000). The Act also allows for the seizure of counterfeit goods. 15 U.S.C. § 1116(d) (2000). The Trademark Counterfeiting Act of 1984 makes counterfeiting (defined as intentional copying of a trademark) a criminal offense with high jail terms for individuals and multi-million dollar fines for businesses. 18 U.S.C. § 2320 (2000). Proposed legislation is currently under discussion in the House of Representatives. If passed, the Stop Counterfeiting in Manufactured Goods Act would provide for the mandatory destruction of equipment used to produce counterfeit articles and certain additional penalties, including criminal sanctions. See Alan Field, *Apparel Anti-Counterfeiting Bill Introduced*, J. Commerce Online 23 (2005).

<sup>31</sup> See Barbara Kolsun & Jonathan Bayer, *Indirect Infringement and Counterfeiting: Remedies Available Against Those Who Knowingly Rent to Counterfeiters*, 16 *Cardozo Arts & Ent. L.J.* 383, 385–86, 418 (1998). The U.S. Customs Service can provide some additional assistance: Under the Lanham Act, a trademark owner may record its registered mark with the U.S. Customs Service, which will then prohibit entry of goods bearing counterfeits of the registered marks into the United States. 15 U.S.C. § 1125(b) (2000). Additionally, the Tariff Act of 1930 gives the Customs Service the power to seize infringing goods. 19 U.S.C. § 1337(i) (2000).

<sup>32</sup> See Briggs, *supra* note 25, at 190; Schalestock, *supra* note 25, at 130. In the United Kingdom, a garment design is protected as long as it can be related back to a copyright-protected drawing. Safia A. Nurbhai, *Style Piracy Revisited*, 10 *J.L. & Pol'y* 489, 514 n.189 (2002). Under French law, garment designs are protected as applied art or non-functional designs and patterns. See *id.*



analysis and therefore are not undertaken.<sup>33</sup> For example, although France offers substantial legal protection against counterfeiting activities, it is a laborious and time-consuming process to obtain relief, and judicial awards generally cover only a portion of claimed damages.<sup>34</sup> Whatever the formal level of legal protection in the relevant jurisdiction, detection and prosecution of counterfeiting operations tend to be highly cost-ineffective due to the small size and “fly-by-night” nature of most counterfeiting operations, in addition to the lack of easily attachable assets.<sup>35</sup> As a result, a party seeking seizure of counterfeit goods must incur costs that can easily exceed the expected monetary recovery.<sup>36</sup> The cost structure facing

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<sup>33</sup> For example, although the United Kingdom has laws expressly providing for formal intellectual property protection for garment designs, it has become a major source of counterfeited clothing, indicating a lack of effective private and public enforcement action. See Briggs, *supra* note 25, at 211; see also Jon Vagg & Justine Harris, *False Profits: Why Product Counterfeiting is Increasing*, 8 *Eur. J. Crim. Pol’y & Res.* 107, 114–15 (2000) (arguing that in the United Kingdom, despite recent legislative change and increased criminal penalties for counterfeiters, enforcement is haphazard, resource problems often dictate that no criminal prosecution is undertaken, and actual penalties remain low).

<sup>34</sup> See Tara Patel, *France’s Law on Fake Goods Has Bark Bigger Than Bite*, 407 *J. Commerce* 5A (1996).

<sup>35</sup> See Kolsun & Bayer, *supra* note 31, at 386–87 (noting that “civil remedies, although obtainable, are often uncollectible since counterfeiters often hide their assets, opening bank accounts in countries with private banking laws, putting their assets in the names of family members, using aliases, and leasing the equipment used to make their illicit goods,”) and concluding that the “significant costs involved in initiating a seizure of counterfeit goods makes the use of that option increasingly rare”); Pressler, *supra* note 28, at H-5 (noting that “going after individual vendors with 500 or even 1,000 pieces of counterfeit goods is almost a waste of time” because shutting down one vendor does not prevent new vendors from opening up); see also Galbraith, *supra* note 28, at 12 (stating that the police in Italy tend to treat selling fake goods as a civil offense and the fines do not ensure that the criminal organizations behind the illegal industry are dismantled); Robert Marquand, *China’s Pirate Industry Thriving*, *Christian Sci. Monitor*, Jan. 9, 2002, at 6 (reporting that the counterfeiting industry in China uses techniques that make detection difficult, such as making counterfeits as part of “off the books” production overruns of authentic products); Org. for Econ. Coop. and Dev., *The Economic Impact of Counterfeiting* 12 (1998) [hereinafter *Economic Impact*] (noting that counterfeiters often evade detection by importing batches of plain clothing and then attaching the labels overnight close to the point of sale, and that some counterfeit production consists of “over-runs” from factories engaged in legitimate production).

<sup>36</sup> See Kolsun & Bayer, *supra* note 31, at 387 n.21 (“The costs involved in taking all of the necessary steps to obtain an *ex parte* seizure, including the costs in conducting a thorough investigation sufficient to meet the high standards of proof required of preparing the necessary pleadings and supporting affidavits can be significant, often ex-

government prosecutors is apparently no different: The legislative history of the Trademark Counterfeiting Act of 1984 expressly contemplates that federal prosecutors would not have the resources to pursue claims under the Act against any but the most egregious offenders.<sup>37</sup> And in certain Asian countries, the counterfeiting industry is so large that strict public enforcement of anti-piracy laws would entail significant economic dislocation and is therefore generally avoided.<sup>38</sup>

While there are few effective legal remedies against counterfeiting, luxury-goods producers still have at their disposal a wide range of extra-legal measures to make life difficult for unwelcome imitators. Although foolproof technological means are generally not available (a handbag's design cannot be encrypted), producers may employ several business strategies to increase counterfeiters' costs and distinguish the original from its inferior imitations. Many producers engage in extensive product differentiation through the use of expensive and distinctive designs, labels, and materials and may frequently change designs or introduce new product lines, which can increase imitation costs. Producers also may use exclusive and highly restricted distribution channels, either by selling only through dedicated retail stores or subjecting retailers to strict contractual obligations regarding product presentation and personnel training,<sup>39</sup> in order to enable consumers to clearly differentiate between vendors selling originals and vendors selling copies. Finally, most luxury-goods producers are also members of national anti-counterfeiting associations that, among other things, undertake

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ceeding the amount of monetary recovery. Such costs include investigative support, storage and transportation costs for the seized goods, and the posting of a bond.") (citation omitted).

<sup>37</sup> See *id.* at 386 n.18.

<sup>38</sup> See Marquand, *supra* note 35, at 6 (noting that the Chinese counterfeiting industry represents a vital "shadow" economy employing millions of people and having a cash inflow of forty to eighty billion dollars). In many developing countries, counterfeiting sometimes is not even considered illegal and there is little or no attention paid to the practice by local law-enforcement authorities. See Bloch et al., *supra* note 23, at 28 (noting that counterfeiting is culturally acceptable in Asia and makes up a significant segment of the local economy); Economic Impact, *supra* note 35, 34-35 (noting that public enforcement is stymied in many countries by the fact that enforcement personnel view counterfeiting as "normal" economic activity).

<sup>39</sup> For further description of such strategies, see *infra* note 66 and accompanying text.

public education and advertising campaigns in order to discourage potential purchasers of counterfeits through the force of moral persuasion.<sup>40</sup>

### III. EXPLOITING STATUS PREFERENCES

There is widespread agreement among social scientists, supported by empirical evidence, that almost all individuals place a high value on social status—that is, having a position in the relevant social community equal or superior to that of others (or, where individuals perceive themselves in terms of a group or class identity, a position equal or superior to that of other social groups or classes).<sup>41</sup> From this well-established proposition, it easily follows, as Veblen argued so forcefully in *The Theory of the Leisure Class*, that many or most consumers purchase certain items to gain status benefits rather than or not only, to enjoy qualities intrinsic to the good.<sup>42</sup> The literature on luxury and other forms of status-based consumption generally defines status benefits in terms of the reference group with which a consumer identifies;<sup>43</sup> thus, status benefits

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<sup>40</sup> See Economic Impact, *supra* note 35, at 12.

<sup>41</sup> See Frank, *supra* note 14, at 115–21 (reviewing behavioral evidence, in real-world and laboratory settings, showing that individuals place great weight on relative income (and more generally, relative position in the social hierarchy) rather than absolute income); see also Robert H. Frank, *The Demand for Unobservable and Other Nonpositional Goods*, 75 *Am. Econ. Rev.* 101, 106 (1985) (citing studies showing that individuals generally care far more about relative standing in the social hierarchy than absolute levels of consumption).

<sup>42</sup> Veblen, *supra* note 6, at 36–40, 64–65. Some empirical evidence has been gathered to support the uncontroversial observation that status-driven purchasing behavior is widespread. For a review, see Schor, *supra* note 13, at 6–19; see also Robert L. Basmann et al., *A Note on Measuring Veblen's Theory of Conspicuous Consumption*, 70 *Rev. Econ. & Stat.* 531, 532, 534 (1988) (providing econometric evidence showing that consumers purchase certain products based on the “secondary utility” attributable to the visible consumption of expensive products rather than to any intrinsic quality characteristics); Angela Chao & Juliet B. Schor, *Empirical Tests of Status Consumption: Evidence from Women's Cosmetics*, 19 *J. Econ. Psychol.* 107, 128 (1998) (using data on female consumers' purchases of more and less socially visible cosmetics products and finding that, as the social visibility of the relevant product increases, consumers' purchasing behavior is best explained by a model in which consumers derive utility principally from the status features, rather than the intrinsic quality features, of the relevant product).

<sup>43</sup> See Ottmar L. Braun & Robert A. Wicklund, *Psychological Antecedents of Conspicuous Consumption*, 10 *J. Econ. Psychol.* 161, 185 (1989) (noting that the symbolic importance or social meaning of certain goods for a particular individual is deter-

are properly understood in generic terms and should not automatically be associated with black-tie dinner events or Porsche convertibles. To take an unexpected example: a status-conscious environmentalist may buy “Hand-Watered Organic Apples” not only because she likes the taste and texture of the product but also because the purchase conveys a certain social message about herself (that is, environmentally and medically conscious and therefore “better” or of a higher status within the relevant social community than others who are less conscious). Similarly, luxury goods may be said to confer status within the relevant social community. Gucci bags may be handmade using fine leather but many if not most or all buyers of Gucci bags probably purchase the bag also or even principally in order to garner the status benefits—either the feeling of exclusivity (a snob effect or aspirational effect) or the feeling of “being in the ‘in’ crowd” (a bandwagon effect) attached to owning the bag. As discussed below, a producer of fashion goods may be able to exploit these status preferences more fully with the presence of counterfeiters in the market than without.

#### *A. How Counterfeits Increase the Snob Premium*

Status is by definition a relative concept (*A* occupies a higher or lower position than *B*). Fashion goods therefore derive their status premium by reference to goods of lower status.<sup>44</sup> Veblen argued that consumption of status goods often is motivated by what he called “invidious comparison”—that is, the desire of “higher-class” persons to distinguish themselves from “lower-class” persons.<sup>45</sup> This concept can be broken down into two sub-concepts. First, and as more commonly emphasized, this is a “self-regarding” concept: An elite consumer wishes to stand out from the crowd and its ge-

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mined within the relevant “identity area” or social subgroup). In a well-known sociological study, Sociologist Pierre Bourdieu extensively explored the correlation of tastes with certain social and economic groupings and collected data as to how class distinctions correlate in a highly predictable manner with certain consumption choices. See generally Pierre Bourdieu, *Distinction: A Social Critique of the Judgment of Taste* (1984).

<sup>44</sup> See Robert H. Frank, *Choosing the Right Pond: Human Behavior and the Quest for Status* 33–34, 135–40 (1985).

<sup>45</sup> Veblen, *supra* note 6, at 10, 29–30, 36, 39–40.

neric lifestyle.<sup>46</sup> We might say that the more a particular good distinguishes its user from non-elite consumers, the greater its “distinctiveness” utility. Second, this is an “other-regarding” concept: An elite consumer wishes to be envied by and attract the notice of non-elite consumers.<sup>47</sup> We might say that the more a particular good is obviously desired but unobtainable by non-elite consumers, the greater its “being envied” utility.<sup>48</sup> The existence of unauthorized and inferior copies of Gucci bags may increase the status premium (both its “distinctiveness” variant and its “being envied” variant) enjoyed by visible buyers of what then becomes the even more highly valued original. In *Louis Vuitton Malletier v. Dooney & Bourke*,<sup>49</sup> a widely followed trademark infringement case, the expert report prepared for Louis Vuitton purporting to show dilution of the Louis Vuitton label actually found that, for at least some consumers, awareness of the alleged copy made the Louis Vuitton bag more desirable.<sup>50</sup> In our hypothetical example, the widespread use of inferior copies is liable to convert the Gucci bag into the “original” and “authentic” (and now more highly-valued) status good<sup>51</sup> while indicating the extent to which non-elite con-

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<sup>46</sup> Social psychologists and marketing scholars have shown that certain individuals have a greater psychological need to distinguish themselves from other individuals and are more likely to adopt new styles and products and invest greater resources in identifying the latest fashions prior to widespread adoption by other consumers. See Jane E. Workman & Laura K. Kidd, Use of the Need for Uniqueness Scale to Characterize Fashion Consumer Groups, 18 Clothing & Textiles Res. J. 227, 233 (2000).

<sup>47</sup> Professor Juliet Schor provides a good historical example of “being envied utility,” noting that Italian nobles during the time of the Renaissance built opulent places and engraved tiles with the words “Pro Invidia” (“To Be Envied”). Schor, *supra* note 13, at 8.

<sup>48</sup> Giorgio Armani has stated that counterfeiting of his products is “flattering.” See *Luxury’s New Empire: Conspicuous Consumption in China*, Economist, June 19, 2004, at 59, 60.

<sup>49</sup> *Louis Vuitton Malletier v. Dooney & Bourke Inc.*, 340 F. Supp. 2d 415 (S.D.N.Y. 2004).

<sup>50</sup> *Id.* at 448.

<sup>51</sup> That the introduction of copies can draw attention to the distinctiveness or authenticity of the original is well illustrated by the famous blunder of “New Coke” followed by the unanticipated success of “Classic Coke.” In the 1980s, the Coca-Cola Company grew increasingly concerned about its steady loss of market share to Pepsi, its chief competitor. Based on several market studies, Coca-Cola replaced its long-standing “Coca-Cola” beverage with “New Coke,” which more closely resembled the taste of Pepsi. The plan famously backfired as consumers widely rejected “New Coke,” often accompanied by highly emotional protests, and sales plunged, further bolstering Pepsi’s market share. In an attempt to alleviate a bad situation made worse,

sumers envy and seek to imitate the fortunate user of the original.<sup>52</sup> Akin to long lines forming for tables at an “in” restaurant, the spectacle of non-elite consumers herding around street vendors to purchase obvious imitations of a difficult-to-obtain original luxury item may provide significantly more concrete evidence of the original’s exclusivity than the limited number of owners of the original.<sup>53</sup> Fashion-goods producers may be appealing to precisely this demand for “distinctiveness” and “being envied” utilities through product differentiation strategies designed to distinguish the original good from its inferior substitutes, such as distributing authenticity certificates to purchasers and inserting authenticity microchips into their products. Note that this line of argument implies that legitimate producers elect to make such differentiation

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Coca-Cola reintroduced the old product but under the new name of “Classic Coke,” denoting values of originality and authenticity. To Coca-Cola’s delight, the introduction of Classic Coke not only corrected the loss in market share attributable to the introduction of New Coke but allowed Coca-Cola to reach its original objective by making inroads into Pepsi’s pre-New Coke market share. See David Greising, *I’d Like To Buy The World A Coke: The Life And Leadership of Roberto Goizueta* 110–38 (1998). The New Coke/Classic Coke story could be viewed as an inadvertent two-stage vertical differentiation strategy in which Coca-Cola first introduced an inferior version of the existing product (the “fake”), which then increased consumers’ valuation of the relabeled “original” product. I am grateful to Gideon Parchomovsky for bringing this example to my attention.

<sup>52</sup> Unfortunately, this hypothesis has not been tested empirically to date. The closest available data is found in a survey study that asked consumers whether they felt that counterfeits lower the value and status of luxury goods or devalue their “brand equity.” Among the respondents, sixty-nine percent strongly disagreed or disagreed that counterfeits decreased the status of the original. *Nia & Zaichkowsky*, *supra* note 23, at 492.

<sup>53</sup> Professor Gary Becker has argued that interdependent preferences best explain why popular restaurants with long lines of customers waiting for tables do not increase prices to the profit-maximizing level and thereby “clear” the market. Because consumers’ demand for a particular restaurant is in part a positive function of other consumers’ visible demand for the same restaurant, restaurant owners maximize profits over the long term by not raising prices and thereby preserving long lines for tables, a visible sign of high demand. See Gary S. Becker, *A Note on Restaurant Pricing and Other Examples of Social Influences on Price*, 99 *J. Pol. Econ.* 1109, 1114–15 (1991); see also Becker et al., *supra* note 5, at 139–40 (noting that visible efforts to buy a difficult-to-obtain luxury good can be “excellent and profitable advertising”). For a similar argument attributing price and wage rigidities to the fact that the value of certain products is in part a positive function of aggregate excess demand (because either consumers seek exclusivity or consumers use excess demand as a signal for product quality), see Kaushik Basu, *Monopoly, Quality Uncertainty and ‘Status’ Goods*, 5 *Int’l J. Indus. Org.* 435, 436 (1987).

investments not to prevent unauthorized imitation of their products as would be intuitively assumed, but rather to maximize the premium that producers can demand from elite consumers in a market that is expected to include imperfect counterfeits.

To the extent that counterfeits increase the status benefits conferred by visibly using the original version of the relevant luxury good, the introduction of counterfeits should increase the profit-maximizing price that producers of the original can demand from snob consumers. This result can be illustrated in simple formal terms as follows. Let  $Q^*$  equal the number of originals of good  $A$  purchased in the absence of copying, and  $P^*$  equal the price at which good  $A$  is sold. Let  $Q^{**}$  equal the number of originals of good  $A$  purchased after copying, and  $P^{**}$  equal the price at which such goods are sold. Where it appears that a large percentage of snob consumers believe that the status benefits conferred by owning the original version of good  $A$  have increased as a result of the widespread sale of inferior copies and consequently are willing to pay a higher price for the original, then the producer may expect to maximize profits by setting  $P^{**}$  such that  $P^{**} > P^*$ .<sup>54</sup> Assuming that the resulting percentage increase in the purchase price exceeds the resulting percentage decrease in total sales (which is likely to be the case given the large percentage of higher-valuation snob con-

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<sup>54</sup> It may be argued that the legitimate producer cannot demand an increased premium from snob consumers who make purchases immediately following the initial release of the relevant item since no copies would have yet entered the market. As a practical matter, however, to the extent that copies are often made within a short time following release of a new item into the market leading to a substantial overlap in time between the snob and aspirational stages of the fashion cycle, the bulk of the snob consumer population likely makes its initial purchase following dissemination of unauthorized copies. See *supra* note 23 and accompanying text. Moreover, it can reasonably be argued that the legitimate producer can demand an increased premium on purchases made by *all* snob consumers given that at least in the case of established designers, even initial snob consumers rationally anticipate the subsequent dissemination of unauthorized copies with the result that the market “prices in” the enhanced premium from the start. Interestingly, under either of the foregoing alternatives, counterfeiters effectively lengthen the product cycle by artificially deferring the inevitable erosion in the prestige value of the relevant item consequent to wide distribution among non-elite consumers. For an alternative view, see Raustiala, *supra* note 4 (arguing that counterfeiters effectively truncate the product cycle by disseminating copies among less “fashionable” consumers, thereby eroding the prestige value of the relevant item, which benefits legitimate producers by accelerating demand for new items among more fashionable consumers).

sumers assumed immediately above), then  $(Q^{**})(P^{**}) > (Q^*)(P^*)$ . Given that the increased status premium (equal to  $P^{**}-P^*$ ) would not exist but for the introduction of counterfeits into the market, the legitimate producer prefers some counterfeiting rather than none at all. Note that this result will hold even if we make the extreme assumption that enforcement costs are zero—that is, even if the original producer could deter all counterfeiting at no cost, it would rationally decline to do so.

### *B. Vertical Differentiation*

It may be fairly objected that the above argument does not explain why a fashion-goods producer will prefer copying. Rather, it only supports the more modest claim that a fashion-goods producer prefers that inferior versions of its product exist. If this is the case, then it is unclear why the fashion-goods producer would not elect to maximize profits by a vertical product differentiation strategy. That is, the producer may introduce at a significantly lower price product lines that are obviously inferior in quality to the original product.<sup>55</sup> Two or more product lines would exist, with the higher-quality product line targeted at elite consumers willing to pay a snob premium and the lower-quality product line (or lines) targeted at non-elite consumers not willing to pay a snob premium. Interestingly, the logic of the above argument suggests that the fashion-goods producer should be willing to even give away these inferior versions or pay non-elite consumers to use them, provided the cost of doing so is less than the expected increase in profits following the introduction of degraded product lines.

The best answer to this objection is that historical example teaches that it has a high probability of being untrue, in which case fashion-goods producers may be unwise to place much stock in it. More specifically, this objection overlooks the fact that fashion-goods producers often cannot introduce degraded product lines

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<sup>55</sup> Professor Takeyama advances precisely this argument, claiming that a durable-goods monopolist may maximize profits by selling downgraded versions of its products to “low-demand” consumers in order to commit credibly to high prices to “high-demand” consumers. See Takeyama, *Unauthorized Reproduction*, supra note 3, at 514. For the reasons set forth immediately hereafter in the text above, I think this argument is vulnerable in markets where purchases are driven in part by status considerations.



without incurring—or without taking the considerable chance of incurring—an intolerable reputational cost in the long term. Whereas the introduction of imperfect copies by unauthorized third parties may enhance the original's status premium, the introduction of imperfect copies by the producer reduces, or threatens to reduce, that premium since it violates the producer's commitment to the brand's exclusivity. This problem may be explained by analogy to the intertemporal pricing dilemma originally identified by Ronald Coase: Insofar as higher-valuation consumers anticipate that the monopolist will have an interest in progressively reducing prices to marginal cost in the future in order to make sales to lower-valuation consumers, even a monopolist facing few or no entry threats cannot demand supra-competitive prices from higher-valuation consumers in the present.<sup>56</sup> This problem can be solved theoretically by having the monopolist credibly promise to "burn the factory" (that is, commit to no future supply) after all sales are made to higher-valuation consumers. But the fashion-goods producer has a more gentle method at its disposal. At the time of sale, an elite producer commits to its consumers that it will take certain actions, or refrain from taking certain actions in the future, so as to safeguard the exclusivity of—that is, the future expected stream of status benefits conferred by—the good that is being purchased and purchasers agree to the firms' high price in reliance on this commitment.<sup>57</sup> Luxury-goods producers maintain this commitment by

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<sup>56</sup> See R. H. Coase, *Durability and Monopoly*, 15 *J.L. & Econ.* 143, 145 (1972). A fuller explanation of this well-known argument is as follows. A durable-goods monopolist will rationally sell to lower-valuation consumers at lower prices either (a) after having exhausted demand among the higher-valuation consumer pool or (b) when faced with competition in later periods by second-hand sellers of its goods. Anticipating either of these outcomes, far-sighted higher-valuation consumers will not agree to pay full monopoly prices because they know that the monopolist will later lower prices to capture lower-valuation consumers or compete with the secondary market. Consequently, the monopolist cannot earn full monopoly profits even with a secure dominant market share.

<sup>57</sup> See Paul Frijters, *A Model of Fashions and Status*, 15 *Econ. Modelling* 501, 502 (1998) (arguing that luxury fashion-goods products do not lower prices as demand lags (as a model grows older and becomes less fashionable) because luxury-goods producers commit to maintaining their products' exclusivity by effectively committing not to bring prices within the range of lower-status consumers, and thereby preserve their ability to sell new models in the future to higher-status consumers). For a similar argument, see Becker et al., *supra* note 5, at 98. This argument is a special application of the more general thesis that a durable-goods monopolist can demand supra-

restricting diffusion of their products, through high prices, limited production runs,<sup>58</sup> or limited production capacity (for example, only handmade production methods are employed). An elite firm that offers a secondary line of lower-quality and lower-priced products may succeed in capturing non-elite consumers and enjoy increased short-term sales as a result. But because it has violated its earlier exclusivity commitment (that is, it has *not* “burned the factory” as promised), it will ultimately lose subsequent sales from elite consumers who discount heavily the future stream of status benefits to be generated by ownership of the original and therefore move on to other more exclusive competitors (“if everyone now owns or will soon own a BMW, I will have to buy a Ferrari, or at least the highest-series Mercedes”). In short, the producer will have fallen prey to Coase’s intertemporal pricing dilemma: Since any new customers will assume that it will introduce dilutive lower-quality product lines at a later stage, the producer loses its ability to make any credible statements with respect to maintaining the exclusivity of its products.<sup>59</sup>

This claim has strong empirical support. Much of the marketing literature (both its academic and trade variants) argues that many luxury-goods brands that sought to capture the middle- or lower-end market later become diluted middle-market brands with little

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competitive prices (in spite of Coase’s objection) by credibly pre-committing to a “price path” at the time of the initial period of sales. See Nancy L. Stokey, *Intertemporal Price Discrimination*, 93 Q.J. Econ. 355, 362–63 (1979).

<sup>58</sup> In a more extreme form of limiting product capacity, a fashion line recently opened a chain of stores, all of which commit to close within one year. See Amanda Fortini, *The Anti-Concept Concept Store*, N.Y. Times Magazine, Dec. 12, 2004, at 54.

<sup>59</sup> Note that this claim is a mirror version of arguments that have been advanced to explain why producers of sports and entertainment events do not increase prices to “market clearing” levels in order to satisfy demand among higher-valuation consumers and thereby eliminate the entry opportunity for ticket scalpers. While I argue that luxury-goods producers do not introduce lower-tier product levels in order to satisfy demand among *lower*-valuation consumers because doing so may injure brand capital and therefore limit future profits, it has been argued previously that producers of sports and entertainment events do not introduce higher prices in order to satisfy demand among *higher*-valuation consumers because doing so may injure goodwill among repeat customers with resulting damage to long-term profits. See James L. Swofford, *Arbitrage, Speculation and Public Policy Toward Ticket Scalping*, 27 Pub. Fin. Rev. 531, 536 (1999).

appeal for elite consumers.<sup>60</sup> Specifically, several leading fashion houses are believed to have undermined the reputational equity associated with a well-established brand by introducing an excessive number of brand extensions and sub-product lines having lower quality than the original brand,<sup>61</sup> by licensing logos and trademarks too widely,<sup>62</sup> by failing to closely regulate retailers' product displays and other sales practices, or simply by overproducing,<sup>63</sup> so that the firm's brand image became tarnished and sales ultimately fell as a result.<sup>64</sup> Even luxury-goods firms that have taken great care in undertaking vertical differentiation strategies are not always successful in separating middle-market and upper-market lines, with the

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<sup>60</sup> See *Upmarket Philosophy*, supra note 22, at 98; see also Becker et al., supra note 5, at 98 (noting that lower-grade brand extension by luxury-goods producers is "delicate, and it is easy to go too far and lose the commitment to exclusivity").

<sup>61</sup> See Eric T. Anderson & Duncan I. Simester, *Research Note: Price Discrimination as an Adverse Signal: Why an Offer to Spread Payments May Hurt Demand*, 20 *Marketing Sci.* 315, 315, 327 (2001) (arguing that in premium quality markets, a seller that tailors pricing to different income segments suggests that the product is suitable for price-sensitive customers, thereby undermining perceptions of the product's quality); Deborah Roedder John et al., *The Negative Impact of Extensions: Can Flagship Products Be Diluted?*, 62 *J. Marketing* 19, 29 (1998) (providing evidence that lead brands can be diluted by extensions that are inconsistent with the brand's image or fail to meet consumer expectations in some other respect); Barbara Loken & Deborah Roedder John, *Diluting Brand Beliefs: When Do Brand Extensions Have a Negative Impact?*, 57 *J. Marketing* 71, 79–80 (1993) (finding that dilution effects are most salient when a firm introduces a product extension that is in some respects typical of the family brand but in other respects displays attributes inconsistent with the family brand).

<sup>62</sup> See *Business Sense: It Takes a Lot More Than Individual Flair to Stay at the Top*, *Economist*, Mar. 6, 2004, at 6, 8 (noting that Pierre Cardin proliferated its licensing operations extensively to a broad variety of products, including toilet seat covers, which ultimately led to its products becoming "too common for many high-fashion customers").

<sup>63</sup> See Silverstein & Fiske, supra note 19, at 55 (noting that Abercrombie & Fitch "lost much of its cachet" through excessive volume, which destroyed the exclusive image of the brand).

<sup>64</sup> See *Brand Extension, With Jacuzzi*, *Economist*, Feb. 28, 2004, at 61, 61–62 (citing Pierre Cardin, Yves St. Laurent, Christian Dior and Calvin Klein as examples of brand over-extension); *Every Cloud Has a Satin Lining*, supra note 22, at 64 (citing Pierre Cardin and Ralph Lauren as examples of brand over-extension); *Upmarket Philosophy*, supra note 22, at 98 (arguing that by allowing their trademark and logo to be placed on shoddy products, Yves St. Laurent and Christian Dior tarnished their exclusive image to a significant extent, and that Gucci and Tiffany similarly deteriorated their exclusive image by widely selling products in the middle-market price range).

result that the former ultimately sullies the image (and consequently, injures sales) of the latter.<sup>65</sup>

The business press reports that, in recent years, several elite luxury-goods producers have sought to rectify the brand dilution caused in the past by establishing their own retail stores and buying back or revoking previously distributed licenses to exert greater control over brand presentation and retail pricing.<sup>66</sup> Some luxury-goods producers have even taken legal action against retailers for selling their goods too cheaply, on the ground that discounted pricing may increase sales in the short term but will injure the brand's exclusive image (and therefore reduce total sales revenue) over the long term.<sup>67</sup> While some commentators have observed that certain luxury-goods producers have recently adopted "middle-market" differentiation strategies that bring the range of available models within the purchasing power of some middle-class consumers,<sup>68</sup> the

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<sup>65</sup> See Suzy Menkes, *Is Luxury's Triangle Eternal? Democratization is Chipping Away at the Elitist Peak of High Fashion's Pyramid*, *Int'l Herald Trib.*, Dec. 5, 2002, at 18 (noting that some industry observers criticize LVMH, Louis Vuitton and especially Dior for an "expansion strategy of 'entry-price' products," because this could "cheapen the brand"); *Upmarket Philosophy*, *supra* note 22, at 98 (noting that Giorgio Armani introduced a middle-market line and, despite substantial efforts to keep the two lines distinct in public perception, is believed to have tarnished the brand's exclusive image).

<sup>66</sup> See *Business Sense*, *supra* note 62, at 8–9.

<sup>67</sup> See *id.* at 8 (noting that Calvin Klein sued its licensee for breach of contract for selling its jeans on sale in "cut-price" outlets); Wilfred Amaldoss & Sanjay Jain, *An Analysis of the Impact of Social Factors on Purchase Behavior*, 2 *Rev. Marketing Sci. Working Papers* 1, 1 (2002) (noting that "Christian Dior sued supermarkets for carrying its products"); Becker et al., *supra* note 5, at 95 (noting that Givenchy brought suit when discount stores began to sell its high-prestige perfume, *Amarige*). A standard defense raised in the antitrust context by companies accused of employing "retail price maintenance" policies (that is, prohibiting retailers from selling below a certain minimum price level) to sustain above-cost pricing is that, irrespective of any anti-competitive effect in the market composed solely of the company's goods, such policies have a pro-competitive effect insofar as they preserve the prestige of the company's brand in the broader market composed of its goods and those of its competitors.

<sup>68</sup> A recent Boston Consulting Group publication advances the claim that the "middle-market" luxury sector (that is, luxury producers that cater to the middle class and upper-middle class) has developed substantially in recent years, giving rise to what the authors label a "New Luxury" market lying midway between discount retail items and the high-end luxury goods. This market sector relies on a vertical product differentiation strategy where producers ration "super premium" product lines to higher-valuation consumers while making available plentiful amounts of mid-range product lines, thereby garnering sales in the "middle-market" sector normally avoided by lux-

most elite luxury producers tend to avoid or expressly reject such strategies, taking the position that introducing lower-quality product lines (or allowing licensees to display their goods along with lower-quality products) either has diluted, or could dilute, the exclusive image of their top-end brands.<sup>69</sup>

#### IV. NURTURING STATUS PREFERENCES

As discussed above, Veblen argued that the consumption of status goods among “higher-class” persons was driven by “invidious comparison”: a desire to distinguish themselves from “lower-class” persons.<sup>70</sup> But Veblen also argued that the consumption of status goods among lower-class persons was driven by a desire to be thought of as a member of a higher social class (what he calls “pecuniary emulation”<sup>71</sup>). This mechanism applies naturally to the fashion industry: Through various advertising campaigns, producers address non-elite consumers’ desire for pecuniary emulation by emphasizing the status benefits conferred by owning the luxury goods consumed by the wealthy, the famous, and the otherwise distinctive. In more formal terms, luxury-goods producers seek to increase the expected status benefits attributed to visible ownership of the relevant good by consumers occupying the less elastic portions of the market demand curve.<sup>72</sup> As part of this effort, producers must persuade these potential aspirational consumers that the relevant luxury good is already or will soon be used widely by an elite consumer class of which they would be wise to join. Hence the widespread use of sports and entertainment celebrities to endorse

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ury-goods manufacturers. See Silverstein & Fiske, *supra* note 19, at 1–4, 10–12. While there may be some divergence of opinion among market participants as to the likely risks of adding lower grades to a firm’s product scale, it is unlikely that even middle-market luxury producers would cater to the lowest end of the pricing scale (as counterfeiters do) and probably would not contemplate doing so precisely due to the brand integrity concerns identified in the text above.

<sup>69</sup> See Jose Luis Nueno & John A. Quelch, *The Mass Marketing of Luxury*, *Bus. Horizons*, Nov.-Dec. 1998, at 65 (noting that Hermès and Tiffany’s have elected to sell to a broader public by offering many accessories, available at a lower price, and stating that many luxury brand owners believe that this strategy can injure profits in the long term by endangering the brand’s exclusivity).

<sup>70</sup> Veblen, *supra* note 6, at 29–30, 36, 39–40; see also *supra* Part III.A.

<sup>71</sup> Veblen, *supra* note 6, at 39–40.

<sup>72</sup> On producers’ attempts to cultivate “consumption norms,” see Corneo & Jeanne, *Snobs, Bandwagons*, *supra* note 16, at 345.

products or the large sums companies pay to place their products in mass-market Hollywood movies. Where this sort of marketing strategy is successful, producers may lead certain non-elite consumers to value more highly the relevant good (or more precisely, estimate more highly the expected stream of status benefits to be gained by acquiring the relevant good) given a perceived increase in the frequency of usage among elite consumers.

Unauthorized copiers may inadvertently advance this effort to appeal to the aspirational preferences of certain non-elite consumers. Assume, as argued above, that a producer believes that it cannot introduce degraded versions of its product line without risking significant injury to its exclusivity commitment, diluting its brand image, and thereby ultimately reducing long-term profits. Even employing the marketing strategies described above, firms may have difficulty credibly representing to aspirational consumers that their product is a necessary entry card into the elite class. But counterfeiters can assist them a great deal. The visible sale of numerous copies of a luxury fashion good to certain aspirational consumers may indicate to other non-elite consumers that the elite circles have propagated a new trend, which is now being imitated by the most highly informed non-elite consumers, and thus signal that another fashion cycle has begun.<sup>73</sup> In other words, visible sales of counterfeits act as an advertising mechanism that coordinates non-elite consumers' expectations as to the purchasing behavior of elite and certain other non-elite consumers.<sup>74</sup> Experimental research in the software context supports the general proposition that dissemi-

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<sup>73</sup> This mechanism is not unlike that of certain economic models of "rational herding" where the actions of a few visible individuals to whom special information or expertise is attributed can dictate the actions of most other members of the relevant population, who have "weak" private information and rationally elect to imitate the "leaders'" consumption behavior. See Sushil Bikhchandani et al., *Learning from the Behavior of Others: Conformity, Fads, and Informational Cascades*, 12 *J. Econ. Perspectives* 151, 160 (1998). For a review and synthesis of the herding literature, see Christophe P. Chamley, *Rational Herds: Economic Models of Social Learning* (2004).

<sup>74</sup> For a theoretical model of the manner in which advertising can coordinate consumers' expectations as to other consumers' purchasing behavior, which can translate into increased sales in markets with positive consumption externalities (that is, markets where the value attributed to a product is in part a positive function of its popularity, either due to social influences or network effects), see Ivan Pastine & Tuvana Pastine, *Consumption Externalities, Coordination, and Advertising*, 43 *Int'l Econ. Rev.* 919, 919–21 (2002).

nating information about the extent of usage of a particular product by other consumers can significantly increase purchases of that product, all else being equal.<sup>75</sup> Without counterfeiters, none or far fewer of these demonstrative sales would be made, fewer non-elite consumers would be apprised of the latest movement in the fashion cycle, and the resulting aspirational effect would be weaker. Unlike the case with respect to the snob effect, producers may prefer that some third-party observers mistakenly believe that some fakes are the original since any aspirational effect should be heightened by visible purchases of the original (logically assuming that a purchase of the original indicates a higher valuation than a purchase of the fake). Put differently, from the perspective of the legitimate producer, counterfeiters and their customers generate a positive externality by advertising (and, to the extent some fakes are mistaken for originals, even exaggerating) the popularity of the relevant good, thereby bolstering aspirational consumers' valuation of the status benefits to be derived from visible ownership of the relevant good.

But does this necessarily translate into increased demand for the original? The obvious objection is that even if counterfeiters create an aspirational effect, they simply generate increased demand for copies that mimic the original rather than for the original itself. Given the likely budget constraints of many aspirational consumers, this is certainly true to some extent but not completely. Consider that fashion goods also may be categorized as experience goods—that is, goods whose characteristics consumers cannot fully assess and verify until after extended use.<sup>76</sup> A non-elite consumer who first purchases the copy of a luxury good in order “to try it out” may adjust upward her estimation of the status benefits of owning the original. Use of the inferior copy may increase the non-elite consumer's valuation of the status benefits conferred upon

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<sup>75</sup> See, e.g., Ward A. Hanson & Daniel S. Putler, Hits and Misses: Herd Behavior and Online Product Popularity, 7 *Marketing Letters* 297, 298–302 (1996). The authors' experiment involved “treating” particular downloadable software games by repeatedly downloading the game and increasing the recorded number of downloads, which translated into huge actual downloads of the relevant game relative to “control” software games that had similar characteristics (and popularity as of a particular date) but were not so treated.

<sup>76</sup> On the distinction between experience goods and search goods, see Phillip Nelson, Information and Consumer Behavior, 78 *J. Pol. Econ.* 311, 312–13 (1970).

owners of the original, which, depending on budget constraints, may translate into a purchase of the original or other items then or subsequently offered by the same designer.<sup>77</sup> Thus, if the copy gives the consumer the aspirational utility derived from imitating the lifestyle of the rich and famous, the consumer who uses the copy and then revises upward her valuation of the status benefits conferred by the luxury good may become willing to contemplate purchasing the “real thing” in order to gain the snob utility derived by setting herself apart from the masses who only buy fakes.<sup>78</sup> In other words, the purchase of counterfeit luxury items may lead the aspirational consumer to “walk up” the demand curve and move to a higher valuation position with respect to the utility to be obtained by acquiring the original. If this is the case, then counterfeiters inadvertently would increase both the multiplier and the multiplier-cand—that is, they would enable legitimate producers to assess a higher-status premium on sales of the original (by enhancing the snob effect) while increasing the total number of sales of the original (by enhancing the aspirational effect).<sup>79</sup> Where either or both of these effects are substantial, the legitimate producer likely would have grounds to prefer a market with counterfeiting over a market without.

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<sup>77</sup> It is likely that the extent to which counterfeiters generate aspirational purchases of the original version of any particular fashion item correlates positively with the length of the relevant fashion cycle. Where the fashion cycle is short (i.e., a “fad” handbag), aspirational purchases of the original would tend to be limited to purchases of other items then or subsequently offered by the relevant designer. Where the fashion cycle is long (i.e., a “classic” handbag), aspirational purchases of the original are more likely to include purchases of both the original of the relevant item in addition to purchases of other items then or subsequently offered by the same designer.

<sup>78</sup> A limited survey study has found that purchasers of counterfeit fashion goods report a greater willingness subsequently to purchase the original rather than the counterfeit. See Seung-Hee Lee et al., *Do Fashion Counterfeits Function as a Promotion for Genuine Products?*, *Int’l Textile & Apparel Assoc. Proc.* 60 (2003), available at <http://www.itaaonline.org>. This very phenomenon appears to be taking place in China with respect to luxury watches. In China, where the sale of counterfeit luxury watches is widespread, sales of genuine luxury watches have been climbing in recent years as newly wealthy consumers appear intent on distinguishing themselves from (and being envied by) the masses who must settle for imitations. See Psst. *Wanna Real Rolex?*, *Economist*, Jan. 24, 2004, at 55, 55–56.

<sup>79</sup> These two effects may cancel each other out to a certain extent insofar as consumption by aspirational consumers of the original item may limit the price that snob consumers are willing to pay for the original item.



## V. SELECTIVE ENFORCEMENT AS A PROFIT-MAXIMIZING STRATEGY

As described above, under existing law in a wide variety of jurisdictions, legal protection for fashion goods often is limited in scope and, where available, is usually costly and laborious to enforce. The standard incentive thesis in the intellectual property literature would anticipate as a consequence low production incentives and correspondingly low investment rates in the fashion industry, or, at the least, a positive correlation between investment rates and the level of legal protection in various jurisdictions. But no such evidence exists. To the contrary, the production of new fashion items appears to operate at vigorous levels despite the absence of any meaningful form of intellectual property protection for fashion designs and the relatively low costs at which such designs can at least be imperfectly imitated. This result is all the more perplexing if one takes into account the fact that fashion designers lack effective legal protection not only against counterfeiting operations but also against other competing designers,<sup>80</sup> who can probably incorporate significant elements from existing designs with relatively little fear of liability for misappropriation or similar claims.<sup>81</sup> The thesis advanced in this Essay provides a strong explanation for this otherwise anomalous phenomenon: Specifically, the peculiar demand conditions of fashion-goods markets give rise to the possibility that high levels of unauthorized imitation (provided such imitation is generally of a visibly imperfect nature) are an entirely sustainable environment for legitimate producers. Moreover, this line of argument suggests that this status quo may be the best of all possible worlds for the legitimate producer. That is, even if the cost of enforcement were zero, and assuming that counterfeiters produce imperfect imitations,<sup>82</sup> fashion-goods producers would not increase

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<sup>80</sup> See, e.g., *Louis Vuitton Malletier v. Dooney & Bourke, Inc.*, 340 F. Supp. 2d 415, 452–53.

<sup>81</sup> See Raustiala, *supra* note 4 (noting the common practice among fashion designers of copying portions of competitors' designs, known in the industry as "referencing").

<sup>82</sup> As the proviso indicates, this argument does not impugn the notion that perfect copying can harm innovation incentives, and therefore perfect copying operations should be vigorously prosecuted, subject to the standard cost-benefit criterion barring enforcement expenditures in excess of anticipated social benefits. Perfect copying would not enable consumers to distinguish between the original and the counterfeit and, to the extent copiers have lower production costs since they did not incur the ini-

their enforcement expenditures beyond current levels. They also would not wish governmental authorities to do so except to the extent that they replaced producers' current enforcement expenditures. If imperfect counterfeits increase total expected revenues on sales of the original, then, from the perspective of the legitimate producer, the desired level of unauthorized imitation is likely to be greater than zero, irrespective of enforcement costs.

Given the foregoing, we should expect that legitimate producers would selectively enforce their legal rights against imperfect counterfeiters in order to preserve a positive but not excessive level of unauthorized imitation in the market. While precise data on fashion houses' expenditures on trademark enforcement and similar actions is difficult to obtain, this thesis is not irreconcilable with available information. It is true, as described above, that fashion-goods producers expend significant amounts in detecting and taking legal action against counterfeiters, and initiating public education campaigns against the evils of counterfeiting.<sup>83</sup> However, any observation as to the apparent vigor with which some producers target counterfeits is made in absolute terms and, without a base reference point, provides little insight as to whether counterfeiters could feasibly devote additional resources to enforcement activities. Moreover, there are indications that the fashion industry often takes a restrained posture towards unauthorized imitation, illustrated notably by the sometimes nonchalant attitude of certain fashion houses toward unauthorized imitation and the failure of the fashion industry to lobby Congress for secure intellectual property protections.<sup>84</sup> Additionally, vigorous legal action by fashion houses against counterfeiting

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tial design and marketing costs, producers of the original would not be able to compete on price and, anticipating all of the above, would drastically reduce or even cease investment.

<sup>83</sup> See *supra* note 40 and accompanying text.

<sup>84</sup> See Raustiala, *supra* note 4. Outside the fashion context, it has been observed that software producers often decline to take enforcement actions against counterfeiters and sometimes evidence ambivalent attitudes toward the existence of unauthorized copies. See Conner & Rumelt, *supra* note 3, at 125 (arguing that, in some circumstances, software firms can maximize profits by tolerating piracy, principally because piracy has a network effect that increases the total number of program users); Katz, *supra* note 3, at 18–20 (arguing that the fact that many software publishers do not employ any technological measures to protect against piracy can be explained by publishers' rational incentives to allow discreetly infringement in order to build up an in-

houses against counterfeiting operations on a periodic basis may be entirely consistent with a policy of selective targeting of perfect or near-perfect imitations (which cannot have a positive expected effect on producer revenues).<sup>85</sup> Alternatively, luxury-goods producers may bring suit against counterfeiters in order to procure a cash settlement and thereby effectively recapture a portion of the revenues on unauthorized imitations of their products.<sup>86</sup> This strategy would enable a legitimate producer to realize a portion of the revenues earned from non-elite consumers without incurring the long-term reputational penalty that would be triggered if the legitimate producer were to pursue non-elite consumers by reducing prices or releasing degraded product lines. Finally, luxury-goods producers may invest resources in public education and lobbying campaigns against counterfeiting because they appreciate the commercial necessity of taking public stands against counterfeiting in order to preserve the exclusivity of their brand.<sup>87</sup> This represents a rational strategy to the extent that a luxury-goods producer may have trouble preserving its exclusivity commitment if it displayed an obvious indifference to the distribution of unauthorized copies of its products.

## VI. THE AMBIGUOUS SOCIAL-WELFARE BENEFITS OF ANTI-COUNTERFEITING LAWS

The peculiar conditions characterizing consumer demand in fashion and other status-goods markets appear to give rise to an exception to the intuitive assumption that innovators rationally should prefer a zero level of unauthorized imitation, setting aside enforcement costs. As argued above, this exception arises as a result of the possibility that copies may increase both the snob value that elite consumers, and the aspirational value that certain non-

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stalled customer base, thereby creating network effects that contribute to future sales).

<sup>85</sup> See Becker et al., *supra* note 5, at 98 (arguing that efforts to prevent diffusion of “look-alike” copies explain lawsuits and other efforts by owners of trademarked goods to close down counterfeiters).

<sup>86</sup> I am grateful to Peter Siegelman for bringing this possibility to my attention.

<sup>87</sup> For a similar argument in the software context, see Katz, *supra* note 3, at 22–23 (arguing that software publishers take stands against piracy even though piracy may increase sales (through network effects) because failing to do so would restrict publishers’ ability to demand high prices on legitimate software).

elite consumers, attribute to visible consumption of the original item. But any argument that targets this positive proposition also suggests a weakness in its normative corollary: namely, that net social welfare is always enhanced by the introduction of property rights covering intangible goods and the regular enforcement of those rights against unauthorized users. This normative proposition requires as a necessary, but not sufficient, condition that the standard incentive thesis hold true to a significant degree. That is: it requires assuming that protecting innovators against unauthorized imitation solves a market failure (specifically, the limited appropriability of the proceeds of intellectual production) that would otherwise depress innovation incentives. This Essay's analysis casts doubt on the extent to which this normative proposition is valid in markets where demand is driven to a large extent by status preferences and consequently (provided certain other fundamental conditions are satisfied), innovation incentives may persist at robust levels even in the face of widespread unauthorized imitation.

To be sure, it should be uncontroversial to state that eliminating all counterfeiting, even assuming zero enforcement costs, is not an undiluted social benefit.<sup>88</sup> Assuming that consumers have substantially complete information as to product quality (an assumption that appears to be generally well-founded in the fashion-goods industry), counterfeiting improves *static* market efficiency by satisfying the preferences of lower-valuation consumers willing to pay a price equal to at least the marginal cost of the relevant item.<sup>89</sup> Notwithstanding this social benefit, it is equally uncontroversial to state that unauthorized imitation may still constitute a *dynamic* efficiency loss insofar as allowing counterfeiters to satisfy the preferences of lower-valuation consumers in the short term results in legitimate producers' innovation incentives being reduced in the long term. This Essay's positive analysis augments these basic normative observations by suggesting that counterfeiting may generate an ef-

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<sup>88</sup> This statement only should be controversial among those who subscribe to moral or other deontological arguments (most notably Lockean arguments based on notions of desert) that do not attribute any social value to the utility derived by purchasers of counterfeits. I do not address these arguments as they lie outside the scope of this Essay's efficiency-based analysis.

<sup>89</sup> See generally William R. Johnson, *The Economics of Copying*, 93 *J. Pol. Econ.* 158 (1985).

efficiency benefit even on a net basis in the long term. If counterfeiters increase innovators' expected revenues on sales of the original, then the counterfeiting risk should enhance rather than diminish (or at the very least have little or no effect on) legitimate producers' innovation incentives. This possibility would significantly reduce any reasonable estimate of the long-term efficiency costs that would normally be deducted from the short-term efficiency benefits of counterfeiting.

Given the foregoing, it would appear that anti-counterfeiting laws are at best unnecessary in the fashion-goods industry with respect to imperfect counterfeiting since, as argued in Part V, legitimate producers are expected to forego vigorous enforcement of their rights under these laws.<sup>90</sup> But that conclusion may be premature. Practically speaking, it would be difficult to formulate and implement a statute that proscribed only perfect counterfeiting. More fundamentally, a peculiarity of fashion-goods markets suggests that the foregoing efficiency analysis may be incomplete. Even taking into account the efficiency benefits arguably generated by sales of counterfeits, there still may be net efficiency benefits to be gained by introducing, preserving, and at least moderately enforcing anti-counterfeiting laws.

As Professor Robert Frank has argued extensively, the acquisition of status benefits is a socially wasteful exercise to the extent it constitutes a zero-sum game in which each player's movement up the social ladder pushes another player down the ladder, who in turn must expend resources to retain the earlier position.<sup>91</sup> Assum-

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<sup>90</sup> Though it is possible that well-meaning or conviction-hungry prosecutors may attempt to enforce these laws against producers' wishes, that does not seem to occur.

<sup>91</sup> See, e.g., Frank, *supra* note 44, at 88–89; Frank, *supra* note 14, at 104. For other contributors expressing similar views, see Schor, *supra* note 13, at 107–109; Philip R. P. Coelho & James E. McClure, *Toward an Economic Theory of Fashion*, 31 *Econ. Inquiry* 595, 600–601 (1993). Gary Becker, Kevin Murphy and Edward Glaeser have offered a related argument, showing that “leader” consumers will purchase at quality levels far higher than what would otherwise be their utility-maximizing quality level in order to distinguish themselves from “follower” consumers, even if the leaders only have a slightly stronger preference for social prestige than the followers. Both leaders and followers would be in the same status position and a superior economic position if followers never sought to imitate leaders. See Becker et al., *supra* note 5, at 88–89. It is worth noting that Veblen anticipated the possible inefficiencies of status-driven consumption, albeit in less formal terms. See Veblen, *supra* note 6, at 88 (“[A] code of

ing that provisionally demoted players have the resources to reclaim their original position and do not drop out of the race, the original relative positions on the social ladder are maintained at the end of each round of the status game, but all participants are poorer as a result of status-game expenditures. On a net basis, a social loss has been incurred and all players would have been better off if the game had never been initiated. Some commentators have argued that the social losses from positionally driven consumer behavior can be substantial, leading to a deterioration in the quality of life despite an absolute increase in the quantity and/or quality of products consumed.<sup>92</sup>

To be sure, this efficiency-based criticism—as distinguished from distributive or ideologically grounded criticisms—of status-based consumption is qualified significantly, but not neutralized, by several important factors: (1) Individuals usually also acquire utility from status goods other than in the form of status benefits (for example, high-product quality), (2) the pursuit of status may drive individuals to engage in many activities that generate other redeeming social benefits (for example, competitions to acquire social status through charitable donations, or honest behavior by public servants in order to acquire status in the political talent pool, or, more generally, the pursuit of profit and other risk-taking entrepreneurial behavior that indirectly contribute to total community wealth<sup>93</sup>), and (3) status goods can sometimes provide a signaling solution in markets that suffer from imperfect information due to an inability to credibly indicate asset quality (for example, university diplomas from prestigious institutions).<sup>94</sup>

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accredited canons of consumption, the effect of which is to hold the consumer up to a standard of expensiveness and wastefulness in his consumption of goods . . .”).

<sup>92</sup> Professor Juliet Schor provides some quantitative support to the social losses caused by aspirationally driven consumer behavior, noting that a survey of American households found that the level of income individuals believed necessary “to fulfill all their dreams” doubled between 1986 and 1994, thereby indicating a growing aspirational gap caused by increasing pressure to emulate the lifestyles of the most wealthy members of the social scale. See Schor, *supra* note 13, at 14–15.

<sup>93</sup> On the incentives to engage in risk-taking behavior supplied by competition for status, see Gary S. Becker et al., *Status and Inequality*, in *Social Economics: Market Behavior in a Social Environment*, *supra* note 5, 105, 122–23.

<sup>94</sup> On the ability signaling qualities of private investments in the pursuit of social status, see Frank, *supra* note 14, at 139–140; see also Becker et al., *supra* note 93, at 123 (noting that status expenditures may be efficient where the individuals making

Notwithstanding such significant side benefits of status-based consumption, it still may be the case that counterfeiters, by satisfying the preferences of lower-valuation consumers who always would go home unsatisfied in a world with perfectly enforced anti-counterfeiting laws, may generate a net social loss to the extent that they facilitate socially excessive expenditures on fashion goods. If this is true, then moderate enforcement of anti-counterfeiting laws may play a socially beneficial function by raising the overhead of counterfeiters and thereby increasing the price at which counterfeit items are sold, consequently decreasing demand. Akin to past sumptuary restrictions on consumption of certain luxury items, state investment in the enforcement of anti-counterfeiting laws may be deemed as effectively levying a tax on copies of luxury items that may be consumed excessively from a social point of view.<sup>95</sup> If this were the case, then anti-counterfeiting laws would be socially beneficial but not for the reason commonly assumed—that is, not by *increasing* private investment in intellectual production, but by *limiting* status-driven expenditures by lower-valuation consumers. If legitimate producers indirectly benefit from lower-valuation consumers' purchases of counterfeit goods, then anti-counterfeiting laws actually may reduce the revenues earned by such producers on sales of the original. This raises the interesting possibility that anti-counterfeiting laws may operate as a form of paternalistic legislation that advances the welfare of the public generally (in particular, its poorer members) while reducing the welfare of fashion designers, their most obviously intended beneficiaries.

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such expenditures are fully compensated by the utility gains enjoyed as a result of being matched with a satisfactory partner as a consequence of such status expenditures).

<sup>95</sup> Becker, Murphy, and Glaeser advance a related claim, arguing that trademarking and promotional activities that attract elite consumers willing to pay a premium for prestige goods that are only marginally superior in quality to cheaper alternatives may be socially beneficial insofar as elite (or leader) consumers would otherwise excessively consume high-quality merchandise in excessive quantities in order to distinguish themselves from "follower" consumers. See Becker et al., *supra* note 5, at 96–97.

## VII. IMPLICATIONS: VIABILITY OF THE INCENTIVE THESIS

This Essay's analysis identifies arguable limits to the standard positive claim that counterfeiting always diminishes legitimate producers' innovation incentives and the resulting policy position that, subject only to the cost-benefit test, the state always should seek to preserve innovation incentives by investing additional amounts in deterring unauthorized imitation. This unusual result is likely to arise in status goods markets where counterfeits are obviously inferior, consumer demand is highly interdependent, and producers cannot introduce inferior product lines without courting serious injury to accumulated brand capital. To be clear, the incentive rationale for intellectual property rights always is limited to the extent that such rights constrain the ability of subsequent innovators to develop derivative applications. For example, a blanket enforcement of copyright protections without the "fair use" exception for certain derivative applications would almost certainly result in a net efficiency loss as a result of "creativity bottlenecks" leading to reduced aggregate output, either as a quantitative or qualitative matter, over the long term.<sup>96</sup> Given these dynamic inefficiencies in the form of reduced third-party improvement incentives together with the static inefficiencies in the form of supra-competitive pricing on products protected by secure intellectual property entitlements, it generally is agreed that properly sized and timed entitlements should provide initial innovators with no more protection than is required to cover innovation costs plus a reasonable rate of return. The arguments presented in this Essay concerning the limited applicability of the incentive thesis in fashion-goods markets do not address these important counterweights that any proponent of vigorously enforcing intellectual property rights always must overcome. In other words, this Essay casts doubt upon strongly enforced intellectual property protections in fashion-goods markets without even considering the countervailing efficiency losses that *already* militate against such protections.

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<sup>96</sup> For discussions of the tradeoff between enhanced productivity and diminished accessibility in the intellectual property context, see Robert P. Merges & Richard R. Nelson, On the Complex Economics of Patent Scope, 90 Colum. L. Rev. 839 (1990); Janusz A. Ordover, A Patent System for Both Diffusion and Exclusion, 5 J. Econ. Perspectives 43 (1991).



As a matter of intellectual genealogy, the incentive thesis would appear to be a logical extension of the standard economic principle according to which well-enforced property rights are required in order to preserve incentives for the cultivation of land and other tangible assets.<sup>97</sup> Contrary to desert-based and other deontological rationales for property entitlements, this is a contingent rationale that stands and falls depending on confirmation of a particular social fact: that the market fails to provide sufficient incentives for the recovery of development costs plus a reasonable rate of return. This fact is generally assumed to characterize most intangible goods markets,<sup>98</sup> and the luxury-goods market normally would be presumed to be a case where the incentive rationale would provide an especially strong justification for intellectual property protections given the large discrepancy between the high fixed costs incurred to establish a prestigious brand and the low imitation costs incurred by third parties (therefore implying that competitive conditions would drive prices rapidly toward marginal cost and prevent recoupment of brand development costs). Notwithstanding this fact, the claims set forth in this Essay suggest that the incentive rationale provides little justification for significant state enforcement of intellectual property protections in fashion-goods markets given that unauthorized imitation may not reduce (and may even increase) the revenues earned by legitimate producers. This proposition in turn accounts for the otherwise puzzling fact that private investment in fashion-goods production proceeds vigorously even with few effective legal or technological protections against counterfeiters.

While further empirical confirmation certainly would be merited, this Essay's claim concerning the limited applicability of the incentive rationale in fashion and other status-goods markets holds up well even assuming less than complete certainty concerning the

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<sup>97</sup> The classic statement of this principle is found in Harold Demsetz, *Toward a Theory of Property Rights*, 57 *Am. Econ. Rev.* 347, 359 (1967). For alternative views on the relationship between property theory and intellectual property theory, see Mark A. Lemley, *Property, Intellectual Property, and Free Riding*, 83 *Tex. L. Rev.* 1031 (2005).

<sup>98</sup> As a recent commentator has noted, while this fact is frequently assumed to characterize intangible goods markets, that assumption often rests on little empirical scrutiny and often is shown to have little real-world support once confirmation is actually sought. See Boldrin & Levine, *supra* note 1, at 1–3.

possible benefits conferred by counterfeiters on legitimate producers. First, assuming that status-goods markets are subject to the likely possibility that counterfeiters may increase the expected revenues of legitimate producers, thereby doing no harm to (and even enhancing) innovation incentives, the incentive thesis obviously has limited applicability to such markets. Second, to the extent that the arguments set forth in this Essay at least raise significant uncertainty concerning the applicability of the incentive thesis to status-good markets, the most prudent policy choice may be approximated by the current status quo, in which private plaintiffs largely handle and finance enforcement, thereby allowing legitimate producers to “purchase” the desired level of intellectual property protection.<sup>99</sup> Third, the incentive thesis may offer limited normative guidance in markets where consumer demand is driven in part by positional concerns, with the resulting possibility of socially excessive consumption of the relevant status good. In these markets, the preferred strength of intellectual property protections may be dictated not so much (if at all) by the objective of inducing vigorous innovation on the part of producers but by the objective of limiting overly vigorous consumption on the part of certain consumers. Depending on the relevant facts of a particular market, these “sumptuary” concerns may still recommend introducing and/or maintaining a nontrivial to substantial level of intellectual property protection, but are likely to reach a far less determinate policy result that would be the case in a straightforward application of the incentive thesis. As these implications suggest, the incentive thesis does not always survive wholly intact—or at least, does not do so with the certainty that would justify its often reflexive invocation in policy discussions and judicial rhetoric in the intellectual

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<sup>99</sup> Of course, this option is not as uncomplicated as it sounds since it requires analyzing possible modifications to the set of remedies available for “purchase” by legitimate producers. These include changes to the penalties that can be sought by plaintiffs or the causes of action that plaintiffs may bring against counterfeiters. Consideration of such matters, which would require an analysis of the extent to which intellectual property holders may engage in excessive enforcement from a social point of view, lies beyond the scope of this Essay. For an analysis showing that trademark holders are likely to engage in socially excessive levels of enforcement, see Richard S. Higgins & Paul H. Rubin, *Counterfeit Goods*, 29 *J.L. & Econ.* 211, 223 (1986).

property context<sup>100</sup>—in markets where consumer demand is driven at least in part by the pursuit of social status.

### CONCLUSION

This Essay contests the general assumption in the intellectual property literature and related judicial and public policy discussions that unauthorized copying always harms innovation incentives. Specifically, it calls into question the assumption that counterfeiting unambiguously harms incentives to invest in the fashion-goods industry by depriving producers of a portion of their investment proceeds. To construct this argument, I examined status preferences that sometimes play an important role in determining consumer demand for intangible goods generally eligible for some form of intellectual property protection. Consumers' preferences for the status benefits conferred by fashion goods, and the resulting interdependence of consumer purchasing behavior, give rise to the possibility that fashion-goods producers may prefer some counterfeiting to no counterfeiting at all, irrespective of enforcement costs. This unusual outcome may arise for two reasons. First, the introduction of copies, provided they are visibly imperfect, may increase the snob premium that elite consumers are willing to pay for a fashion good. Second, the introduction of copies may lead non-elite consumers to adjust sufficiently upward their estimate of the status benefits to be gained by acquiring the relevant good, thereby translating into purchases of the original. Both effects would increase the producer's revenues on sales of the original: the first by increasing price per unit, the second by increasing total units sold. Assuming the foregoing, a legitimate producer's long-term profit-maximizing strategy may sometimes consist of selectively enforcing its legal rights against counterfeiters, thereby preserving a positive level of "unauthorized" imperfect imitation. As a normative matter, this analysis endorses (with respect to imperfect counterfeiting) what appears to be currently low-to-moderate levels of state investment in enforcing anti-counterfeiting laws while raising the counterintuitive suggestion that enforcement of such laws may enhance social welfare not by promoting the interests of legitimate producers (who may actually be injured to some extent by such

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<sup>100</sup> For discussion of this phenomenon, see Lemley, *supra* note 97, at 13–17.

laws), but by limiting consumers' partially wasteful acquisition of counterfeit fashion goods. Finally, at the most general level, this Essay suggests that the incentive rationale most commonly invoked to justify the enactment and enforcement of intellectual property protections may have limited applicability in status-goods markets, where such protections must rest, if at all, on efficiency rationales other than preserving innovation incentives.

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