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Trademark infringement and optimal monitoring policy

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ABSTRACT

The paper addresses a trademark infringer who seeks to capitalize on the reputation of a trademark owner, sells an identical product under a trademark which is confusingly similar to that of the owner, charges the same price and competes with him in the same market. We show that the welfare-maximizing monitoring intensity is zero, hence the government is not likely to engage in monitoring infringement. Recognizing this, the trademark owner may consider monitoring the market himself, discovering, however, that this is worth his while only if the penalty for infringement, which he fully collects, is sufficiently high. Given the entry condition, an increase in the penalty may either raise or lower the optimal monitoring intensity. In the former case it will counter-intuitively increase the infringer's expected profit, apparently because a higher penalty will also lead to a raise in price. While monitoring enables the trademark owner to maintain a positive profit level, it reduces social welfare. The government may intervene to eliminate the private incentive for monitoring through taxing the collected penalty.

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1. Introduction

A trademark is a word, symbol or phrase, used by a seller to identify his products and distinguish them from those sold by another (Radack, 1996). By being the first to use the trademark in commerce or by being the first to register the trademark with an official agency, one acquires rights as a trademark owner. Trademark infringement occurs when another party uses a confusingly similar trademark in relation to products which are identical or similar to those sold by the trademark owner. It is prohib-

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ited by unfair competition laws because it confuses consumers as to the origin of the product and it unfairly curtails the trademark owner's profits. Nevertheless, trademark infringement is a widespread phenomenon throughout the world.¹

While trademark infringement is an illegal act in its own right, it is also an essential feature of counterfeiting and piracy, which have been extensively modeled in the theoretical literature (e.g., Higgins & Rubin, 1986; Grossman & Shapiro, 1988; Bae & Choi, 2006; Belleflamme & Picard, 2007). Piracy refers to the unauthorized copying of goods (e.g., software, music disks, DVD movies, books) which is usually distinguishable from the original, known to be of lower quality and therefore sells for a lower price in a separate market. Counterfeiting involves an imitation that, at the time of purchase, is indistinguishable from the authentic product. It may be of the same quality as the original so that consumers never notice the difference, but it is often of lower quality which is likely to be revealed after using the product. It is not necessarily aimed at deceiving consumers if selling at a lower price in a separate market (e.g., fake Gucci handbags). Consumers may still be willing to buy a counterfeit because they value the prestige associated with the brand-name product. In contrast, trademark infringement which is not connected to counterfeiting and piracy aims at confusing consumers to believe that they are buying the original product. Unlike counterfeiting and piracy, it need not involve the unauthorized utilization of a patented invention or the reproduction of copyrighted material, nor is it necessarily associated with lower quality (it may even be of a higher quality). Its sole purpose is to capitalize on the trademark owner's success in building reputation for the trademark.²

The present paper addresses an infringer who attempts to confuse consumers that she is the trademark owner, therefore charging the same price as the latter and competes with him in the same market. The infringer's product is assumed to be a perfect substitute to the imitated product, hence consumers, while confusing between the two, are not harmed in any way by the infringement. While focusing on pure trademark infringement, the model developed in the paper is also applicable to the case of *perfect* counterfeiting or piracy, which is indistinguishable from the original, has the same quality and sells at the same price.³ This constitutes a major departure from the existing literature which assumes that

¹ Clicking in Google "trademark infringement" + "lawsuit" yielded 807,000 results. As early as 1920, the Coca-Cola company brought suit against the Koke Company of America for using a variant on the name *Coke* to sell a similar soda. The supreme court ruled that the name *Coke* was the property of Coca-Cola and that the competitor was guilty of trademark infringement, choosing the name *Koke* for the purpose of reaping the benefit of the product's goodwill (<http://supreme.vlex.com/vid/coca-cola-v-koke-america-20019618>). On November 2008, Carol's Daughter, a popular personal care line, commenced legal proceedings against Carol's Express, distributed at CVS stores, claiming that Carol's Express was trying to capitalize on the name, trademark and brand of Carol's Daughter, consequently causing consumers to be confused or mistaken into wrongly believing that the products found in CVS were associated with Carol's Daughter. The Manhattan Federal Court issued an order requiring Carol's express and CVS to stop selling (<http://www.reuters.com/article/pressRelease/idUS181104+07-Nov-2008+PRN20081107>). On December 2008, Apple Inc. won a trademark infringement lawsuit against New Apple Concept Digital Technology Co. Ltd, a Chinese electronic company which put the pattern of an apple with two wings on its products, wrappings and website. The court ordered the infringer to pay Apple Inc., which entered the Chinese market in 1993 and has exclusive trademark rights till 2013, 400,000 yuan (58,000 USD) as infringement damages (<http://idannyb.wordpress.com/2008/12/02/apple-wins-trade-infringement-lawsuit-in-china/>). On May 2009, Levi Strauss & Co. filed a civil lawsuit against the sportswear company Polo Ralph Lauren Corp., claiming that it manufactures and sells jeans having pocket stitching designs that are confusingly similar to Levi's trademark. Levi is seeking unspecified damages as well as a court injunction to stop Ralph Lauren from producing the infringing jeans (<http://blog.patents-tms.com/?p=89>).

² There is also a legal difference between counterfeiting and trademark infringement. All counterfeit trademarks are also infringing trademarks, but it is easier to prove that a trademark is "confusingly similar", thus demonstrating infringement, than it is to prove that a trademark is "substantially indistinguishable," or counterfeit. In the former case, the trademark owner can request an injunction against the infringer as well as damages and attorney fees. In the latter case, the trademark owner is also entitled to recover the counterfeiter's profit.

³ A vivid example to this case (suggested by a referee) is book piracy in Turkey, as described in a report published by the Turkish Copyright Holders Association of Literary and Scientific Works (EDISAM, 2005): "The lax controls in the banderole system, the fact that pirates can get hold of banderoles without any difficulty, and the availability of stolen banderoles, resulted in pirated copies having banderoles as well. Furthermore, it has become almost impossible to distinguish between original and pirated copies. Hence, the banderole application has become un-functional. Pirates, who were denied the chance to sell their pirated copies on the pavements and streets, managed to sell through booksellers benefiting from banderoled pirated copies. The end result was pirated copies and originals being sold side-by-side at the bookshops." (p. 1). The report notes that in 2004 book pirates were absorbing 40% of the publishing sector's turnover, estimating that 200 trillion TL (150 million USD) had been stolen from publishers.

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