

Case #5b. Alibaba Deals with “Brushing”* and Counterfeit Goods on Its Web sites

***Merchants using fake orders and shell storefronts to gain prominence in Alibaba’s on-line marketplaces**

Synopsis: Case #5a looks at the property rights and social contract issues raised for Alibaba by (a) “brushing” and (b) counterfeit products offer for sale on its website.

Alibaba Group Holding Limited is a Chinese e-commerce company that provides consumer-to-consumer, business-to- on consumer and business-to-business sales services via its various web portals. It also provides electronic payment services, a shopping search engine and data-centric cloud computing services.

Alibaba is the brainchild of Jack Ma, whose reputation in China is akin to a Steve Jobs (Apple), or Jeff Bezos (Amazon) in the U.S. In 1995, Ma created China Pages, a directory and portal that was one of the earliest websites in China, but it was ahead of its time and achieved limited success. Four years later he had left China Pages to start the website Alibaba.com, a business-to-business portal to connect Chinese manufacturers with overseas buyers out of his apartment.

In 2014, two of Alibaba’s various portals handled 1.5 trillion yuan (\$240 billion,) in sales. (1 yuan – 0.147 euros) On the date of its initial public offering (IPO) on 19 September 2014, Alibaba's market value was measured as US\$231 billion and raised US\$25 billion, making it the largest IPO in history. Because China forbids foreign ownership buyers weren't purchasing actual shares in the group, but rather just shares in a Cayman Islands shell corporation.

Alibaba's consumer-to-consumer portal Taobao, similar to eBay.com, features nearly a billion products and is one of the 20 most-visited websites globally. The Group's websites accounted for over 60% of the parcels delivered in China and 80% of the nation's online sales. Alipay, an online payment escrow service, accounts for 50% of all online payment transactions within China.

Alibaba and “Brushing”

Alibaba has a complex formula that determines where a listing appears when shoppers search for items. So when a new firm wants to draw more attention to a new product offering, it often relies on fake orders. Faking orders, or “brushing,” as it is called in China, involves paying people to pretend to be customers. By padding their sales figures companies raise their standing on online marketplaces like Alibaba, which often give more prominence to high-volume sellers with good track records.

Typically, vendors pay brushers the cost of the products they are ordering, plus a fee. The brushers place the orders and make payments using that money. The vendors then ship boxes that are empty or full of worthless trinkets, and the brushers write positive reviews.

The practice is considered a form of false advertising, which is prohibited by the **Federal Trade Commission (FTC)** in the U.S. and by law in China, where Chinese sellers found doing so face fines and restrictions on their business. In a report earlier this year, Chinese regulator **State Administration for Industry and Commerce (SAIC)** accused Alibaba of allowing bribery, fraud and illegal behavior as well as counterfeit goods to proliferate on its sites. Alibaba called the report biased, and it was later removed from the agency's website.

But the **SAIC's** criticism led to investor lawsuits and prompted the **U.S. Securities and Exchange Commission** to request more information about Alibaba's talks with the **SAIC** ahead of its September 2014 IPO.

Brushing puts Alibaba at risk of regulatory scrutiny by the FTC in the US. Alibaba says it doesn't condone fake transactions and that it removes them from reporting on merchandise volume for its two main shopping platforms, Taobao and Tmall.

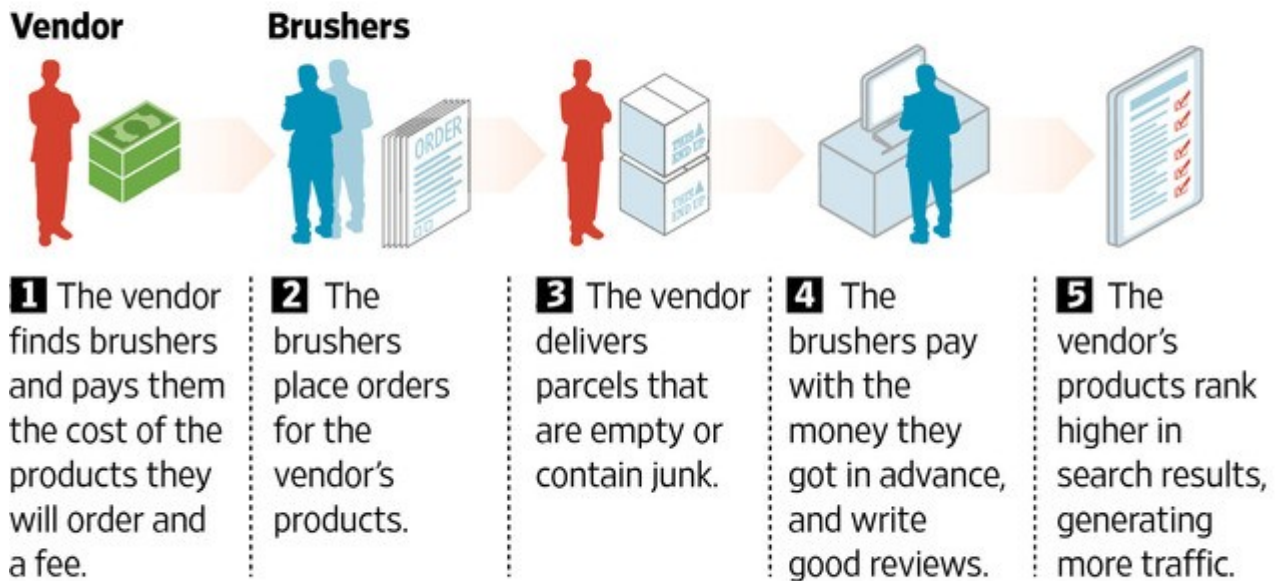
Recently, interviews by **The Wall Street Journal** of more than two dozen vendors, brushers and e-commerce consultants say brushing is still common among sellers trying to gain prominence on Alibaba and China's other highly competitive shopping sites.

Daniel Zhang, Alibaba's chief operating officer, said the e-commerce giant uses sophisticated tools to identify and exclude fake transactions from its financials. But in a November 2014 article from China's state-run Xinhua News Agency, Alibaba Vice President Yu Weimin reported that the company had found that 1.2 million sellers on its main Taobao shopping site—or roughly 17% of all merchants—had faked 500 million transactions worth 10 billion yuan in 2013. Mr. Yu said those transactions were “only the tip of the iceberg” and his “conservative estimate” was that tens of thousands of people in China were helping online sellers fake transactions, according to the article.

Some brushers even list their services on Alibaba's sites, while others offer classes on mimicking real shoppers and eluding auditors.

How Fake Orders Work

High sales volume and good reviews help vendors move up in search results and attract shoppers. Some vendors turn to 'brushers' who place fake orders for products. Here's how it works:



Source: staff reports

THE WALL STREET JOURNAL.

Legal experts say that under Chinese law, Alibaba and the brushing sellers could be held liable if transactions are being faked on Alibaba platforms, but Chinese regulators do not actively enforce the law.

Acting on its own, Alibaba says that sellers found faking transactions face penalties ranging from having positive reviews deleted and losing the right to appear in search results, to fines of as much as 150,000 yuan and closure of their online stores. Extreme cases are turned over to the police, the company said.

Alibaba also analyzes transaction patterns to identify anomalies—like a large number of orders coming from the same IP address or going to the same mailing address—and maintains a list of sellers and buyers who have engaged in fake transactions so it can more easily monitor them.

Fake transactions are much less common on U.S. e-commerce platforms such as Amazon.com Inc., which mainly buys goods from suppliers and sells them to customers,

and eBay Inc., which charges sellers a percentage of each sale. Alibaba's Taobao site, by contrast, connects buyers and sellers and doesn't charge a commission.

One way to get products in front of customers' eyes is to buy advertising, but ad prices in competitive product categories have risen 10% to 20% a year recently, making them unaffordable for small merchants. Alibaba auctions off banner ads and search keywords.

Web Presence in China, a Beijing digital-marketing firm, estimates sales volume accounts for 25% of where a listing appears in the search results, while relevance counts for 10% and product review, shipping and customer-service ratings each account for a fifth, and price about 5%.

Alibaba says the algorithm takes into account hundreds of factors, including product relevance as well as product and seller quality, and directs extra traffic to new sellers. While Alibaba doesn't disclose the weight it assigns each factor, sales volume doesn't outweigh everything else, said an Alibaba spokeswoman.

Alibaba' Problem with Counterfeit Luxury Goods

In November 2014, a group of luxury goods makers sued Alibaba, claiming it had knowingly tolerated counterfeiters selling their products.

The lawsuit was filed in Manhattan federal court by Gucci, Yves Saint Laurent and other brands owned by Paris-based Kering SA seeking damages and an injunction for alleged violations of trademark and racketeering laws. The lawsuit alleged that Alibaba had conspired to manufacture, offer for sale and traffic in counterfeit products bearing their trademarks without the company's permission.

A spokesman for Alibaba, Bob Christie, said in a statement:

"We continue to work in partnership with numerous brands to help them protect their intellectual property, and we have a strong track record of doing so. Unfortunately, Kering Group has chosen the path of wasteful litigation instead of the path of constructive cooperation. We believe this complaint has no basis and we will fight it vigorously."

Concerns over fake products on Alibaba's platforms have existed for years, although **the U.S. Trade Representative** removed Alibaba's Taobao web portal from its list of "notorious markets" in 2012 in light of progress Alibaba made.

The lawsuit alleges that Alibaba and its related entities "provide the marketplace advertising and other essential services necessary for counterfeiters to sell their counterfeit products to customers in the United States."

The lawsuit cited as an example an alleged fake Gucci bag offered on Taobao for \$2 to \$5 each by a Chinese merchant to buyers seeking at least 2,000 units. The authentic Gucci bag retails for \$795, the complaint said.

The case is Gucci America Inc v. Alibaba Group Holding Ltd, U.S. District Court, Southern District of New York, No. 15-03784.

Alibaba's Efforts Prior to Its IPO

Alibaba worked hard to rid its virtual shopping sites of counterfeit goods prior to its initial public offering. But industry experts and companies say that fakes still persist on Alibaba's popular web platforms -- Taobao, Tmall, AliExpress, Alibaba.com.

"Even though we've seen advances in the last couple of years ... there is certainly a lot of counterfeit activity on those sites," said Haydn Simpson of NetNames, a firm that tracks fakes on the Internet. "Some of [our clients] would estimate up to 80% of [their] goods found on Taobao ... are counterfeit."

Columbia Sportswear, with 100,000 Columbia products that claim to be authentic on Taobao, gets Alibaba to take down as many as 3,000 fake listings each month.

Unlike Amazon, Alibaba doesn't own any of the merchandise sold on its platforms, which gives it little control over what vendors offer for sale. Because Alibaba makes its money on the number of merchants and sales commissions, reducing volume means lost revenue, so it hasn't always been a priority for Alibaba.

Efforts to fight what co-founder Jack Ma has described as a "cancer" intensified ahead of its November 2014 IPO. Alibaba signed anti-piracy agreements with luxury brands and industry groups and launched a policy for some of its platforms that bans sellers after "three strikes." In the first 10 months of 2013, it removed 114 million product listings from Taobao alone.

While Alibaba developed a procedure for firms to report suspected fake listings a few years ago, critics said the process was much too "cumbersome," and more difficult than systems used by eBay and Amazon. Critics also noted the extensive documentation Alibaba requires brands to produce before shutting down unauthorized sellers. Alibaba sometimes even requires a court ruling before taking action against a violator.

China's State Administration for Industry and Commerce (SAIC) and Alibaba Counterfeiting

In January 2015, **China's State Administration for Industry and Commerce (SAIC)** accused Alibaba of failing to crack down on the sale of fake goods, bribery and other illegal activity on its sites, a rare public dispute between the Chinese government and one of the China's most prominent companies.

In response, Alibaba accused a senior official at a government agency of misconduct and threaten to file a formal complaint. “We believe director Liu Hongliang’s procedural misconduct during the supervision process, irrational enforcement of the law and obtaining a biased conclusion using the wrong methodology has inflicted irreparable and serious damage to Taobao and Chinese online businesses,” Taobao said in a statement.

The SAIC said it held off on disclosing details of the talks with Alibaba which were held in July 2014 so as not to affect the company’s November 2015 IPO.

The SAIC “white paper” paper alleged that Alibaba turned a blind eye to the sale of fake cigarettes, alcohol and branded handbags by vendors on its marketplace sites, as well as the sale of restricted weapons and other forbidden items. It also alleged that Alibaba staffers took bribes from merchants and others seeking help to boost their search rankings and to get advertising space. It also alleged that Alibaba ignored the practice by some vendors of faking transactions to make their sales volumes appear higher.

The paper also said company officials did nothing to stop merchants from using tactics such as false and misleading advertising. It accused Alibaba of alleged anticompetitive behavior such as forbidding merchants to participate in rival sites’ promotions.

The criticism comes as China has put increasing emphasis on intellectual-property protection as it tries to foster innovation and move away from an economy dependent on cheap manufacturing and big government spending.

Last year the Chinese government announced a campaign to address online infringement and counterfeiting that includes a significant focus on e-commerce.

“There’s no question that [the government has] concluded Alibaba isn’t doing enough,” said Joe Simone, a Hong Kong-based anticounterfeiting lawyer specializing in China, who called the government’s open criticism “sort of unprecedented.”

Alibaba is widely considered to enjoy a healthy relationship with the government, despite initiatives like online payments that have challenged the traditional supremacy of China’s stodgy state-owned banks. Speaking at the WSJD Live Conference in October, Alibaba founder and Executive Chairman Jack Ma said, “we create 14 million jobs for China. We are making all the banks change. So the government finally realized that we’re helping them.”

It wasn’t clear whether the SAIC’s accusations would result in further action. In the white paper, it said the July meeting “basically achieved the anticipated outcome.” It said SAIC officials would beef up their monitoring of Alibaba’s practices and build a system to better supervise online transactions.

Questions:

1. (1.5) What property rights conflicts are raised in the brushing issue in this case:

Show conflicts in this form:

_____ right to _____ [state very specific to the case] _____

versus

_____ right to _____ [state very specific to the case] _____

[NOTE: in this and future cases, there may be more than one actor asserting its rights on either side of the rights conflict]

NOTE: The rights of government agencies and NGOs are not at issue in the cases in this course and should not be included in any analysis of rights conflicts! However, as actors, Government agencies and NGOs do advocate on behalf of the rights of others who for a variety of reasons cannot act for themselves in many cases.

2. (1.5) Referring where appropriate to the rights issues, what is Alibaba's social contract (responsibility) when it comes to minimizing "brushing" on its websites?

- 3.(1.5) What property rights conflicts are raised in the counterfeiting issue in this case:

Show conflicts in this form:

_____ right to _____ [state very specific to the case] _____

versus

_____ right to _____ [state very specific to the case] _____

[NOTE: in this and future cases, there may be more than one actor asserting its rights on either side of the rights conflict]

4. (2.0) Again referring where appropriate to the rights issues, how would you contrast Alibaba's social contract (responsibility) for eliminating counterfeiting with its responsibility for combating brushing? **Make clear which should have higher priority.**

5. (1.5) If you were to view this case as an ethics case, how would you respond to a question from you boss, Jack Ma, founder and CEO of Alibaba, "Am I being highly unethical because I know we have lots of brushers and sellers of counterfeit goods on our website?"

Maximum length: 400 words