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A CONTRACTUAL APPROACH TO THE GRAY MARKET

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Abstract

Parallel imports are genuine products imported without the authorization of the trademark or copyright owner in a country. Authorized dealers have employed trademark and copyright law to exclude parallel imports using claims of infringement. Our assertion is that trademark and copyright laws are inappropriate for enforcing restrictions against parallel imports for two reasons. First, trademark exclusion of parallel imports indiscriminately eliminates intrabrand competition and should be scrutinized from an antitrust perspective. Second, trademark laws inefficiently constrain the feasible set of distribution systems. We propose a policy combining contract, tort, and antitrust law to regulate parallel imports.

I. Introduction[1]

Parallel imports, also known as gray goods, are genuine products imported without the authorization of the trademark or copyright owner in a country. Owners of intellectual property such as trademarks and copyrights complain that these sales infringe upon their exclusive rights, while gray marketers counter that the goods being sold are genuine, and observe that consumers benefit from the lower prices they offer. These opposing points of view have been debated in U.S. courts for over 100 years.[2] We revisit the debate in this paper, using a contractual approach from modern economic theory. Our claim in this paper is that trademark and copyright laws are not the appropriate instruments for enforcing restrictions against gray goods for two reasons. First, these laws fail to discriminate between efficient restrictions on gray goods and those that are anticompetitive. Since the effect of exclusion of gray goods is to eliminate intrabrand competition, it should be scrutinized from an antitrust perspective.[3] Second, trademark enforcement against gray goods constrains the feasible set of arrangements for organizing an efficient distribution system. We propose that a policy which combines contract, tort and antitrust law is superior to trademark laws in both of these dimensions.

We adopt a framework that resembles a typical gray market situation: a manufacturer supplies a product to an authorized distributor in each of several countries.[4] In most countries including the U.S., the trademark (TM) owner has the exclusive right to use (or to delegate the use of) a particular symbol or attribute which is attached to a good. (For example, a product obtains special protection from its TM or from the copyrighted design of its box.) This property right may be undermined by gray markets, which arise

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[2] For a thorough historical review and analysis of the current confused state of the law relating to gray market goods, see SETH LIPNER, THE LEGAL AND ECONOMIC ASPECTS OF GRAY MARKET GOODS (1990).

[3] It was Kenneth Dam, *Trademarks, Price Discrimination and the Bureau of Customs*, 7 JOURNAL OF LAW AND ECONOMICS, (1966), 45-60 who first noted the connection between TM and antitrust law, observing that any attempt by a TM owner to prevent gray goods through exclusive territory contracts reduces intrabrand competition and raises antitrust concerns.

[4] Usually, there is a single authorized firm in each country, responsible for distribution of the product in its country. Developing an organization where the responsibility of these tasks is left largely with a single independent distributor or subsidiary within each country can be efficient in the presence of large set-up costs, economies of scale in distribution and in collecting information on local tastes. For example, many multi-national corporations are organized around subsidiaries or head-offices in each country that have substantial decision-making power for the local market; this is the efficient means of organization.

when the retail price in a country is higher than the wholesale price in a second country plus shipping costs.[5] The gray good is typically sold in direct competition with the authorized distributor through a discount store without warranties or other services. Authorized distributors worldwide have sought to use various mechanisms for restricting parallel imports, including most commonly claims of TM infringement. This is not a trivial issue, since gray markets are sizable, especially in countries with appreciating currencies. For example, a 1988 estimate of the size of the gray market in the U.S. was $7 - 10 billion per year.[6] Some 60,000 gray market cars were imported from Europe in 1985.[7] Gray market car sales in Germany in 1996 are estimated at over 300,000, implying a minimum of $6 billion in sales.[8]

A manufacturer's private incentives to prevent gray goods are equivalent to those for establishing exclusive territories (ET), a common market restriction that constrains distributors from selling directly or indirectly (through third parties) into each others' territories. This observation is important since the economics of territorial restrictions is well understood and can be directly applied to the analysis of restrictions on gray goods. The main focus of our paper is then: when ET (or equivalently, gray good exclusion) is socially efficient, what is the appropriate legal mechanism for enforcing this restriction? In many countries including the U.S., a TM owner can prevent competition from gray goods by invoking its rights under TM laws. Opponents of such a policy argue that it grants powers to TM owners that extend well beyond protection from counterfeits and unauthorized copies to exclude even genuine products. Proponents of such protection, on the other hand, warn that gray goods may create consumer confusion and harm the

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[5] The incentive to engage in the gray market is more pronounced when exchange rates change rapidly but nominal prices in different markets are not sufficiently responsive. Prices may not respond to exchange rate fluctuations because of informational problems or adjustment costs. For example, two camera companies reported to Customs that they preferred to fix their prices for a reasonable period of time to avoid "yo-yoing" their distribution network. Cited in D.Tarr, *An Economic Analysis of Gray Market Imports*, FEDERAL TRADE COMMISSION, (unpublished manuscript, 1985) at 23. This aspect appears to be empirically important: gray markets seem to flourish at times of currency appreciation. For example, the U.S. gray market in luxury automobiles grew 2000% between 1981 and 1986 on the tail of considerable dollar appreciation. L.S. Lowe and K.F. McCrohan, *Minimize the impact of the gray market*, 10 JOURNAL OF BUSINESS STRATEGY (Nov.-Dec. 1989): 47-50. And as the Japanese yen appreciated at the end of the 1980s, gray imports achieved greater penetration in Japan. Armstrong L., W. Holstein, and A. Cuneo, Now, *Japan is feeling the heat from the gray market*, BUSINESS WEEK (March 14, 1988), pp. 50-51.

[6] F. Cespedes., E.R. Corey, and V.K. Rangan, *Gray markets: causes and cures*, HARVARD BUSINESS REVIEW, July-August 1988, p. 75. Other countries also face large gray markets: see, for example, Robert Weigand, *The gray market comes to Japan*, 24 COLUMBIA JOURNAL OF WORLD BUSINESS, (Fall 1989), pp. 18-24.

[7] J. Holusha, *Unauthorized Sales Up for Cars from Europe*, NEW YORK TIMES, 4 March 1985, p. 1.

[8] *Automakers See Red over the Gray Market*, BUSINESS WEEK, 20 November 1995, pp. 20 - 21.

goodwill of the TM owner, resulting in a reduction in product quality, special services, information and product availability.

This issue is representative of the interface between intellectual property and antitrust policy. In general, trademark rights are "exhausted" after the first sale of a product, in the sense that the purchaser of a trademarked product may do with it as he wishes, including reselling it. Thus gray marketers claim that the manufacturer or authorized distributor in the U.S. has no right to prevent them from reselling their goods here. However, when the TM is "territorial" (rather than universal), TM law sometimes suspends this notion of exhaustion for the special case of cross-border sales and the gray marketer is prevented from resale of the product here, on the basis that the TM in one country is different from the same TM in another country. The effect of this policy is to enforce a vertical restraint, typically the domain of antitrust law. To the extent that this vertical restraint would not be supported in an antitrust court, the two sets of laws are in conflict. We argue that they should actually be complementary in coordinating the policy toward gray goods so that the optimal policy allows for both ET and exhaustion.

The paper is organized as follows. In Section II, we analyze the private incentives for designing a distribution system around ET (or gray good exclusion), as identified in the economic literature, and the social implications of such a design. After establishing that gray good restrictions may be socially efficient in some cases, we address the issue of how these territorial restrictions might be best enforced. In Section III we review the use of TM laws to exclude gray goods and show that enforcement based on it will be inefficient. A policy toward gray market imports is recommended in Section IV which relies on the laws which are used to regulate other types of territorial distribution systems. Section V concludes the paper.

II. Restricting Intrabrand Competition: the ET Decision

As noted in the Introduction, a manufacturer's incentives to restrict intrabrand competition (competition between distributors of the same product) through the assignment of separate territories are identical to its incentives to prevent parallel imports. The vast economic literature on vertical restraints in general, and on ET in particular thus provides insights for the analysis of the gray market problem. We first review the private incentives for establishing ET as identified in this literature, and then the social implications of that practice. This analysis implies a first step toward a policy on gray market imports, which is outlined in C below.

A. The Private Incentives for ET

The economic literature on the theory of the firm identifies a fundamental conflict that prevails in most organizations: the collective interest of an organization may diverge

from the individual interests of its parts.[9] This conflict is exacerbated in international distribution networks, where the manufacturer attempts to maximize profits of the entire organization but each distributor cares only about the profits that it generates within its own market. Vertical controls may be necessary in order to attain local behavior which is aligned with the interests of the organization.

In this section, we identify four predominant motivations for establishing ET. In all cases, the profits of the organization are maximized when distributors operate in separate markets, but may be undermined by the distributors' individual incentives to compete with each other. The conditions that make ET *collectively* rational are, in fact, also the ones that make the emergence of gray markets *individually* rational: ET only has value if a differential exists between the price that a gray marketer pays for the product plus transportation costs and the retail price in another country.

(i) Price Discrimination

Manufacturers may use ET (or attempt to exclude gray goods) in order to facilitate price discrimination: if the price elasticities of demand for a product vary across countries, then a manufacturer may attempt to exploit those elasticity differences to increase its profits by charging different prices in different countries. Conditions that must exist in order for firms to practice successful price discrimination are well known.[10] First, the firm must have some market power. Second, customers must be sorted according to different demand elasticities. Third, resale of authorized goods (gray goods) from one country to another must be prevented. The first and second conditions are often satisfied in markets for goods protected by TM rights since product differentiation, typical of such goods, grants some market power to the TM owner, and since the price elasticity of demand generally varies across countries in relation to income per capita. The third condition is simply that gray market goods be excluded from high price countries.

(ii) Facilitating Collusion

Rey and Stiglitz show that territorial restrictions may be used to dampen competition between manufacturers of differentiated products.[11] Through ET, retailers enjoy market power which results in mark-ups over the wholesale price. In contrast to the situation with competitive distributors in which an increase in the wholesale price is passed on entirely in the form of higher retail prices, an increase in the wholesale price to

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[9] See, for example, O. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985), O. Hart, *The market mechanism as an incentive scheme,* 74 BELL JOURNAL OF ECONOMICS 366 (1983).

[10] See Varian, H., *Price Discrimination,* cap. 10 in R. SCHMALENSEE AND R.D.WILLIG, THE HANDBOOK OF INDUSTRIAL ORGANIZATION, VOL. I, (1989) for a comprehensive review of price discrimination.

[11] P. Rey and J. Stiglitz, *The Role of Exclusive Territories in Producers' Competition*, RAND JOURNAL OF ECONOMICS, forthcoming Autumn, 1995.

exclusive retailers will be only partially passed on since imperfectly competitive retailers will maximize profits by absorbing part of the price increase. This makes the demand facing the manufacturers less elastic than for competitive retailers, hence softening competition between the manufacturers. Unless prevented from selling outside of their designated territories, distributors who compete with gray goods will squeeze margins and thus attenuate such collusion.

(iii) Preventing free-riding

Manufacturers often impose territorial restrictions to encourage the exclusive distributor to make specific investments in goodwill or intangible assets. This goodwill includes a reputation for delivering a certain quality of product and service, brand awareness, pre-sale information and post-sale services (such as warranties), and is created by investment into marketing, customer service, quality control and protection from counterfeits. TM owners may invest in product control in ways that cannot be verified when the product is purchased.[12] These investments may represent a substantial fixed cost for the authorized distributor. Rival distributors, or gray marketers, may not need to incur the expense of these investments and so can price above marginal cost but below the price set by the authorized distributor.

An extreme example of this is the fragrance industry, which has been the constant target of gray marketers. The cost of marketing perfumes is frequently over 30% of the selling price, while transportation costs are very small, certainly less than 10%. Thus gray marketers, who spend very little on marketing, will typically be able to undercut the authorized distributors.[13] Unless authorized distributors are restricted from selling (directly or indirectly) in another distributor's country, each may have the incentive to divert some of its production to a firm (gray importer) outside of the distribution system.[14] Even with identical retail prices, gray goods may flow as long as there is a difference between the wholesale price in one country and the retail price in another. A price-marginal cost wedge for a good may give an authorized distributor the incentive to extract another distributor's quasi-rents by diverting some products to a gray marketer in the latter's country.

(iv) Preventing consumer confusion

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[12] For example, the life of batteries may be shortened if the temperature is not properly controlled when the goods are being shipped.

[13] U.S. Customs Service, Department of the Treasury, *Comments of the Coalition to Preserve the Integrity of American Trademarks*, Oct. 20, 1986, p. 37.

[14] This free-riding explanation for establishing ET was first recognized by L. Telser *Why should manufacturers want fair trade?* 3 J. LAW AND ECON.(1960). See also F.Mathewson and R. Winter, *An Economic Theory of Vertical Restraints* 15 RAND JOURNAL OF ECONOMICS (1984), and J. TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION (1988) and the references therein for further discussions of vertical restraints.

ET may be used to prevent consumer confusion when the product differs between countries. Many goods with identical TMs are produced in different locations under different specifications, vary according to local tastes, have different packaging and instructions, and comply with different safety standards. A common TM may be used because of economies of scale in brand development, or because information flows easily between countries through newspapers, television, and travel.

However, if a common TM is used and prices differ between countries, then gray markets may emerge as unauthorized importers try to pass off one product for another.[15] This undoubtedly will cause confusion. In response to the "passing-off" problem, distributors may reduce their investment to alter the product to local tastes. Hence, some guarantee of an exclusive territory is needed to ensure that their efforts will not be undermined by gray marketers (or other authorized distributors).

B. The Social Efficiency of ET

The four private motivations for restricting competition between distributors are, as shown in the previous section, to

i. price discriminate,
ii. facilitate collusion,
iii. prevent free-riding, and
iv. prevent consumer confusion.

Opponents of gray good restrictions argue that exclusive territories are most often established for the first two reasons, price discrimination and collusion, so that gray goods increase consumer welfare. Those who favor gray good exclusion tend to rely on the third and fourth arguments: free-riding and product differences. If the former motivations for ET are relevant, then private efficiency of such a market arrangement may not coincide with social efficiency. The clearest case of this is ET established for collusive purposes; the efficiency implications of price discrimination are less transparent. The welfare of the country accepting gray goods is unambiguously harmed by enforcing ET if the exclusive territories are supporting a scheme of international price discrimination, since allowing gray goods would not eliminate the availability of the good in the country but would reduce the price. However, such a policy may jeopardize the availability of the product in markets with high price elasticity. Since the requirement of a uniform world price might

[15] Differences in prices may be attributed to different costs of production incurred by local distributors rather than demand-driven, as in the case of price-discrimination.

make it uneconomic to supply many low-demand countries, price discrimination may be *globally* welfare-enhancing.[16]

Motivations (*iii*) and (*iv*) often involve situations in which private efficiency coincides with social efficiency. If gray markets arise for these reasons, authorized distributors will be forced to cut back on their investment in goodwill or in product development at a loss to consumers' welfare (assuming that the investments into goodwill had some real value to consumers.) Often, the authorized distributor's margin will be "justified" by the provision of advertising or point-of-sale services, such as product explanations or demonstrations. Moreover, quality differences of gray goods may be so significant that the gray good might be better described as a counterfeit than as a genuine good. In such a case, a TM owner's investment may require some protection (especially if appropriate labeling to distinguish different products with a common TM is not possible).

C. Toward a Policy on Gray Goods

We have examined the private and social incentives for eliminating intrabrand competition between distributors (and gray marketers). Attempts to identify empirically which motivations are most pervasive for excluding gray goods reveal that all motivations are important and suggest that more than one explanation may apply in many cases. Malueg and Schwartz find that both price discrimination and free-riding seem to be responsible for gray market imports, but observe that an important additional factor in stimulating the gray market are sudden changes in exchange rates.[17] Currency revaluations are particularly important since setting up a network to arbitrage price differences across countries usually takes some time and expense, allowing a firm to price discriminate opportunistically until gray marketers organize. It seems unlikely that the increases in gray market activity observed in countries whose currencies are being revalued upward indicates a sudden increase in free-riding. Hilke finds that a combination of factors may have stimulated the growth in gray market imports in the U.S. in the early 1980's, but argues that price discrimination was most powerful.[18] Tarr concludes that free-riding was an important factor in some industries, such as fragrances, but that price discrimination was the key factor in other industries, such as automobiles, Japanese cameras, ski

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[16] D. Malueg and M. Schwartz, *Parallel Imports, demand dispersion, and international price discrimination,* 37 JOURNAL OF INTERNATIONAL ECONOMICS 167 (1994) note that since production of TM goods usually takes place in high-demand countries, international price discrimination may not reduce welfare in those countries since profits to the TM owners will be higher under price discrimination.

[17] idem.

[18] Hilke, J.C., *Free-trading or free-riding: An examination of the theories and available empirical evidence on gray market inports,* 32 WORLD COMPETITION (1988), 75-91.

equipment, outboard motors, and champagne.[19] For example, in *Osawa v. B&H Photo*, the defendants (gray marketers) argued that Osawa-Japan was price discriminating to such an extent that the gray market retail price was lower than the official U.S. wholesale price.[20]

Quality differences are often alleged to be the motivating factor for eliminating gray goods; however, courts in the U.S. have been reluctant to protect distributors against gray goods on the basis of product differences.[21] In several cases in which the warranty was the primary difference, the court recommended a resolution by centralizing warranties through the manufacturer rather than by gray market restrictions.[22]

The paucity of cases brought under the allegation of collusion suggests that it may not be common, perhaps since it requires a restrictive set of conditions: rival firms must have market power and they must coordinate exclusive territories across countries. Alternatively, coordination may be common but difficult to identify, since firms are unlikely to publicize it. Although issues of antitrust have been raised in gray market cases,[23] a violation against the Sherman Act was found in only one U.S. case, *Guerlain*, by

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[19] Tarr, *supra* note 4, pp. 40-48.

[20] 589 F. Supp. 1163 (S.D.N.Y. 1984)

[21] In *Weil Ceramics and Glass, Inc. v. Dash* (11 USPQ 2d 1001 at 1022 (3rd Cir. 1989)), the judge commented on the different qualities of the LLADRO figurines: "Lladro had full power to use different TMs for different levels of quality and thereby prevent harm to Weill's reputation." Any confusion was attributed to the plaintiff's decision not to differentiate its product with different TMs. In *Russia Cement Co. v. Frauenhar* (133 Fed. 518 at 520 (2nd Cir. 1904)), the product sold in the US was superior to the one sold in Europe; however the court was not impressed. They noted:

> If the public gets an inferior quality of glue when it purchases that [of] defendants, it is because the [plaintiff] has seen fit to sell such glue under the same tradename as it has applied to the superior article, and has chosen to reap the profit from the sale of two qualities of grades of the same article under the same tradename.

[22] In *Weil Ceramics v. Dash*, *supra* note 16, defective goods were returned to the original retailer, who then shipped defective pieces to Weil, who credited the retailer's account. Since all goods sold through authorized distributors had a legitimate warranty, there was no harm to a distributor's goodwill or cost to a distributor from honoring a warranty on units sold by a gray marketer. However, if costs of shipping are high, or delays are great, decentralization may be more attractive. Moreover, principal-agent problems of asymmetric information and moral hazard may make centralization of the post-sales service inefficient.

[23] Gray marketers have not been very successful in countervailing TM owners with claims of anticompetitive behavior. In *Model Rectifier Corp. v. Takachiho International Inc.* (221USPQ 502 (9th Cir. 1983)), the court stated "One who opposes the enforcement of a TM on the ground that its use violates antitrust laws has a heavy burden. The natural monopoly that a TM owner has over its product does not violate antitrust law unless it is used to gain control of the relevant market." This view is consistent with current jurisprudence on competition policy towards vertical restraints, under which exclusive territories are subject to rule of reason. In *Disenos v. Work*, 676 F.Supp. 13844 (SDNY 1984), Judge Glasser found that the allegation leveled against the distributor of misusing the trademark for the sole purpose of stifling competition was a triable issue, but required that the gray marketer show that the product had sufficient market share to constitute a threat to competition. Gray marketers received a more hostile reception in *Original Appalachian Artworks v. Granada Electronics* (816 F.2d 68 at 74 (2d Cir. 1987)), in which their argument that the "wide disparity in price" between domestic and foreign Cabbage

a lower court .[24] However, the judge's reasoning behind his conclusion that a number of perfume companies were engaged in collusion was considered erroneous, eventually leading to a dismissal of the case.[25]

The empirical evidence indicates that all the four motivations for restricting competition between distributors may be important. Keeping in mind that disentangling the motivations may not always be straightforward, as a first step toward a policy on gray goods, we make the following recommendation:

> *Recommendation 1: The exclusion of gray goods should be allowed, except when it is used to facilitate collusion or to impose price discrimination that has anti-competitive consequences.*

Recommendation 1 establishes that since the exclusion of gray goods may be socially efficient, an optimal policy should allow the exclusion of gray goods in some cases, essentially setting up the same standard as that laid down by the Supreme Court's 1977 decision on *Continental T.V. v. GTE Sylvania*. Note, however, that this recommendation is only a preliminary step toward a policy on gray goods. It simply states what to do if policy makers are omniscient of the motivation behind attempts to exclude gray goods. It begs two important questions: first, which laws should be used to enforce or prevent the exclusion of gray goods? And, second, how might policy makers identify which motivation is relevant in a particular case? Both of these issues are addressed in Section IV where a complete policy toward gray goods is developed. Before developing the policy, we examine in Section III the legal mechanisms that are actually invoked in U.S gray market cases, and identify the inefficiencies of those policies.

III. Trademark and Copyright Law as an Instrument for Preventing Gray Imports

The previous review of the incentives for excluding gray goods summarizes the accepted message from the vertical restraints literature: restrictions on intrabrand competition may be efficient both from private and social points of view. In this section,

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Patch dolls reflected a violation of antitrust laws was dismissed on the grounds that the gray marketers had suffered no "antitrust injury that would give [them] standing to challenge" the pricing.

[24] In this case, three US exclusive distributors of high-priced perfumes and colognes, together with foreign manufacturers of the product, were named as parties to a collusive agreement that "monopolized the trade in these products by attempting to exclude gray market imports." (See Lipner *supra* note 1, p. 21.)

[25] *US v. Guerlain Inc.* 155 F Supp. 77 (SDNY 1957) vacated and remanded 357 US 924 (1958) dismissed 172 F. Supp. 107 (SDNY 1959). The judge was criticized for his misdefinition of the market. The judge noted that since the trademark was "the most important element in the appeal of perfume", an unknown brand could not compete effectively with the known brands. Equating an inelastic demand of a TM product with monopolization, he concluded that "the lack of objectivity in consumer demand impairs the basis of interchangeability and negates a finding of cross-elasticity."

we examine the current approach for enforcing such restrictions. Section A reviews the U.S. law governing gray goods. In B we show that these laws may inefficiently distort manufacturer distribution systems.

A. Gray Market Policy in the U.S.

Three key trademark statutes affect the importation of gray goods in the U.S.[26]: (i) § 42 of the Lanham Act, which prohibits the import of an article "which shall copy or simulate" the name of any manufacturer or trader registered in the U.S. or abroad; (ii) the Tariff Act (19 U.S.C. § 526) which prohibits the importation of "any merchandise of foreign manufacture if such merchandise ... bears a trademark owned by a citizen of, or by a corporation or association created or organized within, the United States" without consent; and (iii) Customs Regulation 19 C.F.R. 133.21 which forbids the importation of "foreign-made articles bearing a trademark identical to one owned and recorded" by a U.S. citizen or corporation. The latter regulation also contains the "common control exception", which exempts imports of goods where the foreign and U.S. TM owners are "parent and subsidiary companies or are otherwise subject to common ownership or control". The validity of the common control exception has been widely discussed in the U.S. courts, culminating in a 1988 Supreme Court ruling supporting the exception.[27]

The conclusions reached by the Supreme Court can be summarized in the following rules:

Rule 1. If the authorized and gray goods differ materially, the goods may be excluded under § 526.

Rule 2. Regardless of product similarity, if the U.S. mark holder is independent of the foreign manufacturer, or if it authorizes production of the TM goods by an independent firm abroad, then the gray goods may be excluded under § 526; otherwise, Customs may choose not to exclude the gray goods.

The first rule is intended to prevent consumer confusion. The rationale for the second rule is to protect the American TM owner's goodwill, but only applies when the U.S. distributor is not under common control with the manufacturer. This is based on the assumption that an integrated firm can use "self-help" methods to prevent gray goods by ensuring that its distributors minimize sales to gray marketers.

Additionally, the Copyright Act (17 U.S.C.A. §§ 101-914) protects copyright owners against both unauthorized importation and subsequent unauthorized distribution of

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[26] Other relevant statutes are § 337 of the Tariff Act (1930); and various state laws, including legislation requiring vendors of gray market goods to give conspicuous notice to the consumer of differences in their product from the product sold through authorized distributors.

[27] *K-Mart v. Cartier Inc.*, 108 S. Ct. 1811 (1988)

copies of copyrighted materials. This statute has been used in two recent cases to exclude gray market importers, in one case, to prevent imports of copyrighted music, and in the second case, to prevent imports of a perfume, based on the copyrighted box design, which had been sold to the authorized U.S. distributor, Parfums Givenchy.[28] The perfume case was of particular interest because the authorized distributor was the wholly-owned subsidiary of the manufacturer, so that the appeal to the Copyright Act has somewhat eviscerated the common control exception of TM law. It remains to be seen whether other authorized distributors will successfully use the Copyright Act to minimize the gray market. To the extent that copyright is used in the same way as TMs to exclude gray goods, then the discussion in this paper also applies to it.

B. Distortions Created by TM Enforcement in Gray Good Cases

The previous section reveals that TM owners have considerable scope to prevent gray good imports, and therefore to support a system of international exclusive territories. Two features stand out: (1) distributors can successfully protect exclusive territories if they appeal to TM law; and (2) more protection is given to distributors which are not affiliated with the original mark owner (manufacturer).

We argue that these two features of current policy toward gray markets may lead to distortions in the distribution of the product. To see this, we define the "first-best" *privately* optimal organization of distribution as the organization that maximizes profits when the manufacturer is unconstrained to contract as it wishes with its distributors. We show that current policies constrain the manufacturer from reaching this optimal organization.

Distortion #1: A Bias Against Competition

Assume for the moment that the manufacturer chooses to distribute its product through an independent firm, rather than to integrate into distribution. Four organizational structures for distributing a product are possible:

1. Assign only national TM rights to each national distributor.
2. Assign only exclusive territories to each national distributor; under this restriction, distributors are constrained from selling, either directly or indirectly through third-parties, in another distributor's territory.
3. Assign both TM and ET rights.
4. Assign neither TM nor ET rights.

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[28] *BMG Music v. Perez*, 952 F.2d 318 (1991), cert. denied 112 S.Ct. 2997 (1992) and *Parfums Givenchy, Inc. v. Drug Emporium, Inc.,* 38 F.3d 477 (1994) cert. denied 115 S.Ct.xxx (1995).

When TM owners are automatically protected from gray goods by TM laws, the first arrangement will not be feasible. If TM rights are extended to include the right to exclude gray goods, then assignment of those rights to the distributor effectively eliminates any possibility of competition from other distributors or gray marketers. That is, if the manufacturer chooses to assign the TM, the distributor is thus incidentally given an ET, and might seek to prevent intrabrand competition in situations where complete market segmentation is neither privately (from the organization's point of view) nor socially efficient. Hence, a bias in organizational design may be created if the manufacturer wants to transfer the TM rights to the distributor.

There is only a bias if ET and assignment of TM rights are distinct; that is, if arrangement (1) is a separate choice from (3). We show below that this may be the case and that it may be privately efficient to maintain competition among distributors, while assigning TM rights to some (or all) distributors.

(i) Encouraging competition among distributors

As shown in Section II, several incentives exist for eliminating competition between distributors; however, this may not always be best from the organization's point of view. Several motivations for encouraging competition (and therefore gray goods) have been given in the literature: (1) to reduce the externality when neither the manufacturer nor the exclusive distributor takes into account the profits of the other in making its pricing (wholesale or retail) decision (the double mark-up problem); and (2) to provide insurance to risk-averse distributors.

The double mark-up problem reduces the first-best monopoly profits that could be achieved by a vertically integrated firm (and incidentally harms consumers).[29] Competition among distributors (either directly or through gray marketers) can eliminate or at least reduce this problem, so that retail prices approach those that would be set by a vertically integrated firm. Consequently, competition between distributors (either direct or through gray goods) may be desirable from the manufacturer's point of view.

Competition also has the advantage of providing good insurance for distributors, as shown by Rey and Tirole.[30] Competing retailers are fully insured in the sense that their

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[29] If the foreign TM owner is constrained to charge a per unit wholesale price for the goods transferred to the distributors, and firms are allocated ET, there will be a double mark-up; that is, both the foreign TM owner and the distributor will set the wholesale and retail prices, respectively, above their marginal costs. Fixed fees may be imperfect instruments for extracting rents either because of unknown demand (the manufacturer cannot estimate the correct fee to charge), or possibly because of risk aversion on the part of the distributor. Alternatively, incentives for the manufacturer to advertise or upgrade the product's quality may require that the manufacturer retain a claim on the profits earned, so that it will have the incentive to improve the product.) See TIROLE *supra* note 12 for a more detailed explanation of the double mark-up.

[30] Rey, P. AND J. Tirole, *The logic of vertical restraints*, 76 AMERICAN ECONOMIC REVIEW (1986) 921-939.

profit margin is equal to zero for any realization of the cost uncertainty. When a distributor's cost increases, so does its competitors', so that the competitive price fully reflects the cost uncertainty. In contrast, distributors' profits under ET fluctuate; so the manufacturer is forced to raise the wholesale price above its marginal cost, introducing double marginalization. Since ET has poor insurance properties, the manufacturer may want to allow for competition between its distributors when they are risk-averse.

If competition between distributors is desirable for any of these reasons, one might ask why the TM owner does not simply license a second distributor in a particular country if it wants to discipline the exclusive distributor. One possible answer is that competition from a foreign distributor may be more efficient since it has already incurred the fixed distribution/production costs in order to serve another market. Alternatively, the TM owner may want to limit the competition (so as to maintain incentives for providing services); transportation costs provide a natural constraint.

(ii) The Decision to Sell or Assign a TM

At its most basic level, a TM distinguishes one brand from another, thus achieving two goals simultaneously: it prevents consumer confusion and protects the firm's goodwill. (A copyright may be used in the same way when the product includes some distinct copyrighted characteristic, as in *Parfums Givenchy*.) In practice, investment in developing a TM may involve monitoring for counterfeiters who attempt to pass off their product as the genuine one; controlling product quality to ensure consistency in product characteristics; and developing the consumers' image of the brand through, for example, advertising and product promotions. These are ways in which goodwill is fostered in a brand. These reasons for selling or assigning a TM, however, are similar to those for granting ET. That is to say, giving a firm exclusive rights to distribute a product in a country provides similar incentives to develop the TM so as to generate maximum profits.

Some incentives for assigning a TM, however, may be distinct from those for reducing competition between distributors. For example, sale or assignment of a TM may reduce the possibility of manufacturer opportunism.[31] For example, if the manufacturer retains TM ownership, it may have an incentive to introduce substitute products under the same brand name through a different distributorship after the first distributor has made specific investments in developing it.[32] Recognizing the potential for opportunism, the

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[31]For example, in *DEP Corporation v. Interstate Cigar Company,* (622 F.2d 621 (1980)), DEP the contractually "exclusive" distributor was unable to prevent the manufacturer from selling to U.S. gray marketers since it had not been assigned the TM.

[32] Economides, N., *The Economics of Trademarks*, 78 TRADEMARK REPORTER (1989) notes that "tradenames may indirectly signal a quality standard extending to multiple products within a category...Firms may use tradenames to help the consumer identify the quality level of

distributor will either reduce its payment to the manufacturer or invest less in marketing the product. By assigning the TM, the manufacturer commits itself not to behave opportunistically in this respect for the period of the assignment. To the extent that contracts are incomplete, especially regarding future products, the transfer of the TM may be efficient. As noted by Grossman and Hart, ownership of a TM differs from contractual rights to an exclusive territory by the "residual rights of control": the rights to determine how that asset will be used under contingencies not specified in the contract.[33] They show that these residual rights should be given to the party whose investment in the value of the asset (brand name capital) is more important; that party may very well be the distributor. For example, a TM may be assigned when the distributor has a better knowledge of the local market that cannot be easily conveyed to the foreign manufacturer and thus has a competitive advantage in developing the TM.

To summarize, a manufacturer may want to sell or assign its TM while simultaneously promoting international competition between distributors. If TM rights automatically provide for territorial protection by law, then the distribution of products will be (privately) inefficient. Is this bias serious in the sense that manufacturers really do wish to assign a TM but not give ET? We think so, and adduce as evidence the frequency with which distributors complain that the manufacturer seems to be doing little to prevent gray goods. The obvious implication is that many manufacturers are content with some degree of intrabrand competition.

Distortion #2: A Bias towards TM Assignment

When the manufacturer wishes to set up a system of exclusive territories, but does not wish to assign the TM, because, for example, it has some advantage in TM development, it may nevertheless choose to assign the TM because of the stronger protection obtained against intrabrand competition. At least two cases have come before the courts in which a would-be gray marketer has claimed that a TM assignment to an independent distributor was an assignment in gross (that is to say, invalid) since the principal purpose of the assignment was to ensure the exclusion of gray goods.[34] Although these cases were unsuccessful, in one of them the trial judge agreed that the assignment might have been motivated by the ability to qualify for customs exclusion, which in itself was not a triable issue. Normally, a TM would be assigned because the distributor has

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products...Choosing a high quality standard in the category of electronic products, a manufacturer can use his tradename to transmit information on quality through the direct previous experience of consumers."

[33] S Grossman and O. Hart, *The costs and benefits of ownership: a theory of lateral and vertical integration,* 94 JOURNAL OF POLITICAL ECONOMY (Aug. 1986) 691-719.

[34] *Premier Dental Products Co. v. Darby Dental Supply Inc.*, No. 85-1468, slip opinion (E.D.PA. 1986); and *J. Atkins Holdings Ltd. v. English Discounts Inc*. 14 USPQ2d 1301.

greater efficiency or lower cost in promoting and developing the TM. However, these cases suggest that given the many private advantages from gray good exclusion, international manufacturers may choose to assign the TM to the U.S. distributor not because of efficiency or cost considerations but in spite of them.[35]

Distortion #3: A Bias in Corporate Structure

A third inefficiency caused by the laws relating to gray goods is that they may give an incentive to the manufacturer to distribute its product through an independent distributor when vertical integration is more efficient. This distortion does not arise directly from extending TM protection to cover gray goods, but rather from the fact that the protection is limited to independent distributors. As discussed in the previous section, the Tariff Act, as interpreted by customs regulations, does not permit the establishment of national exclusive territories when the U.S. TM owner is corporately affiliated to the foreign manufacturer (the "common control exception"). This gives an incentive for the manufacturer to assign the American TM not to a subsidiary but to an independent distributor.

The rationale behind the "common control exception" is that preventing gray goods is easier when a distributor is company-owned. If an integrated firm cannot prevent gray goods, the argument goes, it has not tried hard enough, or it is simply engaged in international price discrimination. An independent domestic distributor, on the other hand, is less able to stem the supply of gray goods. Moreover, the courts may have difficulty identifying independent, local goodwill when the two firms are vertically integrated. Hence, while a contract with ET rights on the sale of a trademarked good might be supported in court, the distributor would not benefit from customs exclusion if it were a subsidiary of the foreign manufacturer.[36]

The reasoning for this rule is misguided.[37] First, there are many instances in which parent companies efficiently decentralize distribution and production decisions with their

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[35] It is worth remarking that assigning a trademark cannot be a hollow transaction and still benefit from the Customs exclusion under S. 526. If the assignment is not accompanied by an independent development of goodwill on the part of the U.S. mark holder, then the assignment is said to be an assignment in gross and is invalid.

[36] Comparison of this rule with the antitrust treatment of vertical integration is interesting. Under antitrust law, a vertically integrated firm is usually *less* constrained by law in achieving the optimal organization than is a non integrated manufacturer entering into vertical contracts with distributors. For example, vertically integrated firms are not restricted in their internal pricing, advertising, and servicing arrangements; whereas a non integrated manufacturer is constrained from setting resale price maintenance and other vertical restraints.

[37] There has been much criticism of the common control exception: Judge Leval, writing on a gray market case, observed that "Antitrust questions are far too complex to be reasonably decided by reference to a

subsidiaries, which then invest in local goodwill. Another distributor or unauthorized importer may have the incentive to free-ride on that goodwill. Many of the "self-help" measures such as centralizing advertising, warranties, and other services may be more expensive than decentralization, and in any case, this solution of decentralization should apply equally to organizations developed around independent firms.

Second, the argument that international price discrimination is easier to achieve with subsidiaries than independent firms when markets are segmented is not convincing. If contracts are enforceable, then any diverting distributor could be punished, whether a subsidiary or an independent firm. If these contracts are not enforceable since arbitrage between distributors is difficult to control, then the manufacturer can vertically integrate into distribution in the country with the more elastic demand and distribute through an independent firm in the inelastic-demand country. Integration may prevent resale of the low-price good into the high-price country, but it would be unlikely that a subsidiary (that distributes the product in the relatively low-price country under an international price discrimination scheme) would ever need to seek protection from gray goods. In any case, this putative advantage of integration would be constrained by unauthorized importers of the goods.

It is difficult to determine empirically how significant these distortions may be, owing to the subtlety of the hypotheses and the difficulty of inferring causality. However, it seems likely that the incentive of benefiting from Customs exclusion of gray market goods has had significant effects on corporate structures and distributional arrangements.

IV. A POLICY ON GRAY MARKETS

The essence of the previous section is that TM law as a tool in supporting exclusive territories may be privately distortionary, relative to the choices that would be made if the manufacturer were unconstrained in its decisions. In this section, we show that the current laws in the U.S. are also socially inefficient, and offer an alternative.

A. The Policy Recommendation

The policy of protecting distributors from gray goods that we recommend does not invoke TM law:

> *Recommendation 2: TM rights should include protection from counterfeit goods and the right to develop the TM, but not the right to exclude genuine goods imported from foreign distributors within the international distribution system.*

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short questionnaire on corporate ownership," and concluded that the Customs regulation was "unsound as antitrust policy and as trademark law." (*Osawa v. B & H Photo*, 589 F. Supp. at 1178.)

This view that TM protection should not be extended to include gray goods is not based on the usual "more competition is better" reasoning in the literature or on any special affection for the idea of "universality", but follows from two principles: (1) Manufacturers should have the widest -- and most efficient -- selection of contractual arrangements, allowing firms the flexibility to contract separately for exclusive territories and assignment of trademarks; subject to (2) The law should prevent welfare-reducing restrictions contracts.

The policy prescription we recommend involves the coordination of three areas of the law: contracts, torts, and antitrust. This combination of laws for enforcing ET (restrictions on gray goods) is superior to TM laws according to both criteria laid out above since it is more effective in preventing anti-competitive uses of ET and it is less distortionary to the manufacturer's design of its distribution system. Under this view, TM laws form only one component of the set of laws which govern distributional relationships. If the manufacturer wishes to segment markets, then territorial restrictions should be included explicitly in the contract. That is, the policy we propose "unties" TM from ET and from corporate structure so that the various contractual arrangements can be chosen separately.

Under this policy, a distributor granted an exclusive territory in its contract could appeal to contract law to enforce it in the event that an authorized distributor or the manufacturer sells the good outside of its territory. Inconveniently, since contract law does not permit a distributor to file a suit against a party outside the contract, the law offers few avenues outside the Lanham Act to stop gray marketers. Nevertheless, as we discuss below, manufacturers can police the distribution system to prevent supplies to gray marketers and may in some cases be able to turn to the common law of unfair competition to prevent gray marketers who are free-riding.

As noted in *Recommendation 1*, manufacturers should be allowed to employ territorial restrictions except when third parties outside of the contract are harmed by more than the manufacturers gain. Anti-competitive implications of gray market exclusion should be evaluated under the competition laws of the country into which gray goods are imported. Consistent with the treatment of exclusive territories in competition policy cases, the burden of proof that gray good exclusion is socially harmful should reside with the gray marketer or violator of the ET contract.

We have described how the policy should respond to decisions by the manufacturer to exclude gray goods through contractual means (ET). We turn to the situation in which the manufacturer chooses competition among its distributors rather than territorial segmentation. If competition between distributors is privately efficient, it should

be presumed that it is efficient for consumers. That is, if ET had been necessary to encourage investment in the product, the TM owner would have offered it or the distributor would have insisted on it.

Some courts have tended to take a paternalistic view toward the local distributor who has purchased a TM from an "opportunistic" manufacturer, starting in the U.S. with *Bourjois v. Katzel*.[38] We argue that protecting individuals from entering into unprofitable contracts is not the mandate of the law. The policy toward gray goods should generally not constrain intrabrand competition more than is desired by the original TM owner (as revealed through the decision to segment territories); such government intervention would simply raise prices. If protection from differentiated products bearing the same TM were necessary, then one would expect the original owner to have provided for this through ET.[39]

ET is not a difficult clause to contract for, and the private incentives for establishing ET, outlined in Section II, should be reasonably evident to the original TM owner. If ET has not been specified but perhaps should have been (for example, if the gray goods differ significantly from the domestic TM good), rather than banning the importation of the gray goods, possible solutions include mandatory labeling of product differences, as under some state laws.[40] This approach mitigates consumer confusion without eliminating the (possibly efficient) competition between distributors. The message here is that the law should not presume to rewrite private contracts, except in blatant cases of deception or misrepresentation.

B. The Identification Problem

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[38] *A. Bourjois & Co., Inc. v. Katzel,* 260 US 689 (1923).

[39] An exception to this rule might occur when contracts are incomplete, in which case courts may want to intervene to exclude gray goods, even when this protection has not been privately contracted. The "freedom-to-contract" perspective of the law assumes that the ability of TM owners to set up efficient contracts is perfect (and therefore that the role played by law, apart from implementing explicit contracts, is inefficient). An alternative perspective to the "freedom-to-contract" one is that the law should complete contracts, when necessary. There are cases in which the original TM owner, had it anticipated the fact situation, would have guaranteed ET. That is, ET is part of the privately efficient (more) complete contract that would have been written in the absence of contracting costs. For example, suppose there is unanticipated appreciation of the dollar. If gray goods are permitted, consumers may become confused: gray goods, indistinguishable from the American good but with different characteristics, may be imported. Because the foreign TM owner did not anticipate this currency fluctuation, it may not have taken the necessary precautions (e.g., different TMs on the products or ET) to protect its TM product from consumer confusion. Given the problem of incomplete contracting, a case for providing protection from gray goods may be justified under the consumer confusion criterion of TM law even when the distributor has not been given ET status. The court should be circumspect in exercising this interventionist rule; for example, it should be restricted to cases in which the gray products are considerably different, thus causing confusion and harm to the distributor's goodwill.

[40] e.g. N.Y.Gen.Bus.L. § 218-aa, and *California Civil Code,* §§1797-8 *et seq*.

Our "freedom-of-contract" policy outlined above turns on the perspective that the law should attempt to maximize the set of feasible contracts for the privately efficient design of organizations when they are also socially efficient. However, there are at least two problems of implementation that must be considered. As noted in *Recommendation 1*, ET (or gray market exclusion) is not always socially efficient; in such cases, our policy recommends that competition be permitted through the free flow of gray goods. The problem facing competition authorities is to identify the motivation behind the inclusion of territorial restrictions in the contract.

In gray good cases, the courts have attempted to identify when the motivation behind territorial division is a welfare-improving one by determining the existence and value of local goodwill. The judgments made by courts as to the value of goodwill appear to have depended on the complexity of the product; for example, electronics require local special services, while exclusive distributors of simpler goods such as clothing, toothpaste, soap, batteries, toys, and perfume need more evidence to convince the court of their local contributions.

Attempting to measure local goodwill is difficult at best, and may be misleading. The presence of local goodwill is neither necessary nor sufficient for ET to be an efficient arrangement. Rather than attempting to identify if ET is established for socially efficient reasons, courts should try to establish if it is contracted for socially *inefficient* reasons. In particular, a necessary condition for successful price discrimination or collusive behavior is significant market power.[41] Competition between manufacturers in the relevant market should alleviate concerns over restrictions in intrabrand competition.

A correlation seems to exist between products that are sold in non-competitive markets (where price discrimination or collusion could be a threat) and those that require local goodwill. Conversely, products in highly competitive markets do not seem to require investment in specific assets. For example, markets for razors, soap, lotion, dolls, and toothpaste are competitive, but free-riding on local goodwill hardly seems to be relevant in these cases. Hence, exclusive territories, if observed, would be hard to justify from a social perspective. Investment in specific assets and local services is necessary for products in more concentrated markets such as electronics, computers, and watches. High market concentration does not imply significant market power if potential entry limits the price

[41] Market power is the power to control prices or exclude rivals. However, short-run market power is not exclusionary in itself; its practice often attracts firms into the market. To maintain market power in long-run, the firm must be able to exclude rivals. Market share is often used as a proxy for market power, but the accuracy of this measure depends on defining correctly the relevant market. This requires a careful account of goods that are substitutes in consumption, substitutes in production, the excess capacity of firms in the market and the potential for entry of new competitors.

that the monopolist can charge. Even if the TM owner/manufacturer has significant market power, exclusive territories may be welfare-increasing if consumers benefit from added services and information under ET.

Some argue that courts should be particularly lenient when trademarked goods differ in some characteristics since protecting consumers from misrepresentation is the primary intent of TM law. However, caution is required in allowing gray market exclusion for this reason. If a ban on gray goods were allowed whenever products differed, it could pay the manufacturer to differentiate its product only slightly across countries in order to disguise a more anticompetitive motive for eliminating competition between its distributors.[42]

The problem of identifying the motivation for ET is not an easy task; however, it is a challenge that courts have to face commonly in domestic competition cases. The economic analysis of territorial restrictions in which the benefits of providing the right incentives are balanced against the costs of facilitating anticompetitive behavior, is equivalent to the task faced by courts in vertical competition policy cases.[43] However, courts which adjudicate cases based on TM laws fail to undertake this balancing act.

C. Problems of Enforcement

Our policy recommends that contractual solutions be used, instead of TM law, to enforce ET (or the exclusion of gray goods). Contracts that specify territorial restrictions are intended to prevent exclusive distributors from selling in each others' territories. A problem of private enforcement of these contracts may arise when the original TM owner has sold the TM to two different firms in the two countries and it no longer has much interest in policing the contractual guarantees originally offered.

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[42] Several gray goods have been excluded under TM law based on what appeared to be minimal differences. For example, Venezuelan Pepsi was excluded from Puerto Rico because of can size and product promotion; Spanish Cabbage Patch dolls were excluded from the US because of language; various products were excluded from Canada because of English-only instructions; Heinz ketchup was barred from Canada because of a slightly different U.S. formula.

[43] We do not provide an analysis of the tradeoffs here; rather, we refer to a prolific literature in this area and the references therein: F. Mathewson AND R. Winter *An Economic Theory of Vertical Restraints*, 15 RAND JOURNAL OF ECONOMICS (1984) 27-38; F. Mathewson AND R. Winter, *The economics of vertical restraints in distribution*, in F. MATHEWSON AND J.STIGLITZ, EDS., NEW DEVELOPMENTS IN THE ANALYSIS OF MARKET STRUCTURE (1986); F. Mathewson AND R. Winter, *Territorial restrictions in franchise contracts*, 32 ECONOMIC INQUIRY (APR. '94) 181-92; R. Posner *The next step in the antitrust treatment of restricted distribution: Per se legality,* 48 UNIVERSITY OF CHICAGO LAW REVIEW 6 (1981); P. Rey AND J.Stiglitz, *The Role of Exclusive Territories* (unpublished manuscript 1986); P. Rey AND J. Tirole *The logic of vertical restraints*, 76 AMERICAN ECONOMIC REVIEW 921 (1986); and B. White, *Black and white thinking in the gray areas of antitrust: the dismantling of vertical restraints regulation,* 60 GEORGE WASHINGTON LAW REVIEW (Nov. 1991) 1-67.

To be effective, the exclusive contract must prevent authorized distributors from selling to would-be gray marketers. However, since gray marketers cannot be identified *ex ante*, such restrictions on sales are difficult to enforce. While remedies under contract law may protect authorized distributors with territorial rights from infringing parties to the contract, it is virtually powerless against third-parties outside of the contract (importers of gray goods). One possible solution is for the authorized distributor to make a case of common law unfair competition against the gray marketer. Two approaches have been tried (unsuccessfully) in courts by authorized distributors facing gray market competition. One plaintiff argued that the gray marketer had intentionally interfered with contractual relations between it and the manufacturer.[44] Since this tort requires malicious intention on the part of the gray marketer, it seems an unlikely defense against such competition. The second approach focuses on the free-riding on services provided by the authorized distributor. A distributor claimed that the parallel importer did not need to invest in showrooms only because consumers were able to visit authorized dealers. Having ascertained which model they wanted to buy from the explanations and demonstrations of the authorized dealers, consumers would then buy from the cheaper gray marketer.[45] In this case, the trial judge noted that the services of the authorized distributor were not being "misappropriated in any legal sense," and, since "common law unfair competition must be grounded in either deception or appropriation of the exclusive property of the plaintiff"[46] dismissed the claim. But since it is *appropriation* of services, and not *misappropriation,* which forms the basis for the claim, we feel that this defense against gray marketers may yet be possible in cases in which there is blatant free-riding on the services provided by the authorized distributor -- exactly the class of cases in which gray goods are undesirable. However, while the common law tort of unfair competition may provide some protection to distributors, aside from the difficulty of showing "unfair competition," this legal remedy is indirect: only the individual perpetrator is stopped, rather than gray goods in general. As Schwartz notes, "challenging individual distributors of infringing imported products, often in different parts of the U.S., has been likened to 'stamping out brushfires'."[47]

Another possible approach to stopping gray marketers is through the claim of "unjust enrichment," when a gray marketer has profited "unjustly" at the expense of the

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[44]*DEP Corporation v. Interstate Cigar Company Inc.*, 622 F.2d 621 (1980).
[45]*H.L.Hayden of N.Y. v. Siemens Medical Systems*, 672 F.Supp. 724 (1987) at 752.
[46]*Societe Comptoir de l'Industrie Cotonniere Etablissements Boussac v. Alexander's Dep't Stores Inc.*, 299 F.2d 33, at 36 (1962).
[47]M. Schwartz, *Patent protection through discriminatory exclusion of imports,* REVIEW OF INDUSTRIAL ORGANIZATION (1991).

authorized distributor who has invested in marketing the product. This argument was attempted (unsuccessfully) in the Israeli Supreme Court, and may perhaps be applicable in the United States.[48]

Many opponents of gray goods have argued that nonprivate means are required to preserve efficient organizations, calling for an unconditional ban on all gray goods. According to such arguments, Customs exclusion of gray goods is merely a sensible and cost-effective way of protecting vertical restraints, since other legal remedies (such as the tort of unfair competition) are not sufficiently powerful to deter "harmful" gray goods. Even if one were to accept this argument, three problems arise. First, as discussed above, TM laws fail to take into consideration the motivation for the exclusive territory they are enforcing. Second, they promote inefficient distribution systems because of the special advantages that they confer on products protected by trademarks and copyrights, and because of the "common control exception" of TM law. Finally, if tort and contract law and internal policing of the distribution system are inadequate to control gray market imports from other countries, then they must be equally deficient for protecting domestic exclusive territories. It is not clear why international ET should be favored with a greater level of protection than domestic arrangements are able to obtain.

However, in light of legitimate enforcement concerns, we recommend that when ET is contractually specified, courts should be sympathetic to plaintiffs in complaints of contractual violation or unfair competition by gray marketers, subject to an examination of the reason for the ET. Protection might be strengthened under these laws if contractual obligations were more closely scrutinized. For example, if the distributor's contract specified some obligation such as quality control, the court might be more inclined to find misrepresentation by the gray marketer under tort law.[49]

This combination of contracting and tort law is more consistent and more flexible than extending TM rights to protect exclusive territories. The later approach will encourage the inefficient assignment of TMs in order to achieve the desired ET protection, with the resulting vertical restraints being immune from antitrust scrutiny. In contrast, if

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[48]*Leybovitch v. Eliyahu*, Request for Appeal 371/89, [1990] PDI 44(II), 309. For applicability of this argument to the United States, see GADI RUBIN, PARALLEL IMPORTATION, (Dissertation, University of Toronto) 1996.

[49]In Canada, courts have shown sympathy to authorized distributors who had a specified obligation which the gray marketer could and did not meet: for example, the distributor for Commodore products was required to undertake quality control measures, while the distributor for Mattel had a minimum sales requirement. See *Commodore Business Machines v. 116772 Canada Inc.,* 1983 C.S. (Que.) 1186 and *Mattel Canada Inc. v. GTS Acquisitions and Nintendo of America Inc.* 27 CPR 3d 358 (Federal Court, 1989).

ETs are treated as distinct from TM assignment under the law, the manufacturer can provide its distributors with exclusive territories without having to share its TM rights.

V. CONCLUSIONS

The policy prescription involves the coordination of three areas of the law -- contract, tort and antitrust -- while being consistent with the fundamental objectives of TM laws: preventing consumer confusion and protecting firms' goodwill. At the same time, the use of contract and tort law for enforcing exclusive territories respects the message of modern competition policy, that inter- and intrabrand competition should be balanced to maximize welfare.

Our policy towards gray goods rests on several principles. The first principle is that laws should operate so as to provide flexibility for the manufacturer to organize the distribution of its product in the most efficient manner. Second, when contracts are complete, they should generally be enforced. If the manufacturer/TM owner sees a role for impeding gray goods, then it should segment markets through contractual assignment of exclusive territories. These contracts would be enforced under the law of contracts and torts; in particular, contracts protect exclusive distributors from an opportunistic manufacturer or an authorized distributor that may or may not conspire with a third party, and common law gives some protection to exclusive distributors from unfair competition by importers. Of course, anti-competitive vertical arrangements should receive no such support.

If competition between TM owners across borders is privately efficient, then the presumption should be that it is also socially efficient. In most cases, intrabrand competition should not be constrained by more than is desired by the original owner. Since the objectives of agents (distributors) may diverge from those of the organization, a distributor given TM ownership/user rights might attempt to protect its territory, if given the legal right, in situations where intrabrand competition is efficient from the perspective of the entire organization. Our recommendation based on the principle of "flexibility and freedom in contracting" has the joint effect of *allowing* competition among distributors, and lessening inefficient distortions in organizational structures caused by the "common control exception."

While the policies in most countries have been determined unilaterally, that is, with domestic interests in mind, recent multilateral discussions (such as those on NAFTA, GATT, and the EU) have made import-control rights and market segmentation important international issues. For example, the approach in Canada and in the U.S. that favors granting import-control rights to TM owners, has influenced other countries such as

Mexico, where protection has historically been weak.[50] The European Union, however, remains cautious about granting these rights: Article 36 of the EEC treaty states that intellectual property can be protected as long as it is not "a means of arbitrary price discrimination or a disguised restriction on trade between Member States."[51]

The policy derived in this paper has also been determined under the assumption of domestic welfare maximization. Except when gray goods are excluded to enforce an international price discrimination scheme, however, this policy is generally consistent with global welfare maximization. Under this exception, trading partners may want to harmonize their policies towards one that excludes gray goods in order to encourage the development of brand name products and to ensure their availability in markets with high demand elasticity.

The debate on gray goods raises an important question which has been the focus of international discussions on intellectual property rights: *Are import-control rights granted to intellectual property owners compatible with free trade?* The policy we propose towards gray goods is consistent with free trade. Free trade has been established as an important policy goal in the U.S. and in Canada; therefore, we argue that genuine goods should not be restricted by TM laws. We echo the EU message on gray goods: protectionism should not be concealed behind a convenient interpretation of TM laws.

Our rule of flexibility and constrained "freedom-in-contracting" may, however, support international market segmentation in some instances. This may appear at first glance to be a barrier to trade. But in fact it is not. A barrier to trade would arise if interbrand competition were being discouraged. Indeed, product differentiation is an important source of gains from trade when there are economies of scale in production and/or distribution. If economies of scale are present, the number of brands that domestic firms can produce for the domestic market is limited; however, free trade in different-brand goods can expand the set of products available to consumers. As noted above, to

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[50] Intellectual property laws have been reformed as part of the Salinas program for economic reform. In January 1990, Mexico relaxed regulations regarding licensing agreements. Some of the important changes include (1) licensors may require that materials be purchased from specific suppliers and sources; (2) licensees may be required to keep proprietary information confidential after the agreement has expired; (3) licensee and licensor are free to determine the level of royalty fees; and (4) licensor may exercise more control over the operations of the licensee to maintain quality. On June 27, 1991, the Mexican Congress enacted a new law on patents and trademarks. Compulsory licenses were eliminated and the term of registration was extended from five years to ten years. These reforms may have a significant impact on trade and investment in Mexico. Enforcement, however, still remains an issue. During the NAFTA negotiations, the US has pushed for greater enforcement of intellectual property laws in Mexico and higher penalties for counterfeit goods.

[51] Article 85(1) of the *EEC Treaty* (Treaty of Rome).

the extent that the reduction of intrabrand competition encourages interbrand competition internationally, these goals of free-trade are achieved by the policy.

More importantly, as Anderson *et al* point out, ET differs from barriers to trade in a fundamental way: firms can choose the best distribution system for their products under the recommended policy.[52] That is, the manufacturer can choose whether or not to invoke exclusive territory protection; it is not forced to use it. Our policy recommends that the manufacturer be given the flexibility to choose competition between its distributors. Under a tariff, it would not have that choice. Moreover, under this approach, the foreign firm can choose to locate production in the lowest-cost countries and sell the product through local distributors. A tariff would inefficiently bias the organization towards decentralized production. Laws that allow TM owners to design the distribution system efficiently yield market outcomes that may look very different from policies that create trade barriers.

[52] See R. Anderson, P. Hughes, S. Khosla, AND M. Royane, *Intellectual Property Rights and International Market Segmentation: Implications of the Exhaustion Principle,* BUREAU OF COMPETITION POLICY (unpublished manuscript, 1990) for a discussion of the relationship between intellectual property rights and international trade barriers.