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13 Brook. J. Int'l L. 249 (1987)

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GRAY MARKET GOODS: A LIGHTER SHADE OF BLACK

*Hugh C. Hansen**

I. INTRODUCTION

If a street vendor offers a famous brand-name product for a substantially lower price than one would expect, the average consumer's initial reaction might be that the product had been stolen or was "hot" — a product of the black market. While such discounted goods might indeed be stolen, sophisticated consumers have come to expect similar discounts in stores and mail-order houses throughout the country on goods not from the black market but rather from the "gray market."¹ These products, naturally enough, are called "gray market goods" or simply "gray goods."

Gray goods are brand-name products manufactured abroad which bear an authentic trademark authorized by the owner of the trademark in the market for which the goods are intended. The owner of the trademark is usually foreign. These goods are normally intended for markets outside the United States at the time of manufacture.² At some point, however, the gray goods are "diverted" or imported into the United States for the purpose of competing with the U.S. trademark owner's authorized goods.³

Historically, the importation of gray goods was rare and sporadic. As a consequence, the U.S. Customs Service's regula-

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1. "Gray" is used because while the sale of these goods is not clearly illegal, it is not clearly legal either. See *infra* notes 7, 8 and accompanying text. Of course, "grey" may also be used.

2. Occasionally, the goods are manufactured for a U.S. trademark owner who rejects them. The manufacturer then sells them to importers who distribute the goods in the United States. See *El Greco Leather Products Co. v. Shoe World Inc.*, 806 F.2d 392 (2d Cir. 1986).

3. When the U.S. trademark owner imports the products, the goods are also known as "parallel imports." *Vivitar Corp. v. United States*, 761 F.2d 1552, 1555 (Fed. Cir. 1985), *cert. denied*, 106 S. Ct. 791 (1986). This term has been used incorrectly as a synonym for gray goods. See Brief for Petitioner K-Mart Corp. at (i), 4, *K-Mart Corp. v. Cartier, Inc.*, Nos. 86-495, 86-624, & 86-625. (U.S. Sup. Ct. Feb. 21, 1987) [hereinafter *K-Mart Brief*]; cf. Tyson & Parker, *Parallel Importation of Copyrighted Phonorecords*, 10 N.C.J. INT'L L. & COMM. REG. 397, 397-98 (1985); Note, *Parallel Importing Under the Copyright Act of 1976*, 17 N.Y.U.J. INT'L L. & POL. 113, 114-115 (1984).

tions⁴ which permit their importation were ignored. Gray goods, as a legal topic, were confined to the backwaters of antitrust and intellectual property law. In the last few years, however, the importation of gray goods has become a growth industry and has generated numerous lawsuits⁵ and commentaries.⁶

While the initial growth in the gray market was spurred by the very high value of the U.S. dollar in international currency markets, it appears that now a permanent gray market network has developed that will make the subject of gray-goods importation one of importance for years to come regardless of the value of the dollar.⁷

4. See 19 C.F.R. §§ 133.21(a), (b), (c)(1)-(3) (1987).

5. Three actions alone have been filed attacking the Customs Service regulations. See *Olympus Corp. v. United States*, 792 F.2d 315 (2d Cir. 1986), *petition for cert. filed*, 55 U.S.L.W. 3372 (No. 86-757) (Nov. 6, 1986); *Coalition to Preserve the Integrity of American Trademarks v. United States*, 790 F.2d 903 (D.C. Cir. 1986), *cert. granted sub nom.*, *K-Mart Corp. v. Cartier, Inc.*, 107 S. Ct. 642 (1986) [hereinafter COPIAT]; *Vivitar Corp. v. United States*, 761 F.2d 1552 (Fed. Cir. 1985), *cert. denied*, 106 S. Ct. 791 (1986).

6. Writing about gray goods is, itself, a growth industry. One of the best commentaries on the subject is by a student author. See Note, *The Greying of American Trademarks: The Genuine Goods Exclusion Act and the Incongruity of Customs Regulations 19 C.F.R. § 133.21*, 54 *FORDHAM L. REV.* 83 (1985) [hereinafter *Greying of American Trademarks*]. The note takes a strong stand against gray goods (which coincides with this author's views). Its influence has been such that one supporter of gray goods felt compelled to attack it in its Supreme Court brief as being "one-sided." See Brief for Petitioner 47th Street Photo, Inc. at 46, *K-Mart Corp. v. Cartier, Inc.*, Nos. 86-495, 86-624 & 86-625 (U.S. Sup. Ct. Feb. 20, 1986) [hereinafter 47th Street Photo Brief]. To show that the Fordham Law School community is not "one-sided," there is a student note that takes an equally strong stand in support of gray goods. See Note, *Grey Market Goods and Modern International Commerce: A Question of Free Trade*, 10 *FORDHAM INT'L L.J.* 308 (1987).

7. One indication of this is the formation by U.S. trademark owners of an organization, Coalition to Preserve the Integrity of American Trademarks, or COPIAT, to oppose the importation of gray goods in legislative, administrative and judicial forums. See Eisler, *Gray-Market Mayhem: Its Makers v. Importers in Lobbying Onslaught*, IX *Legal Times*, Nov. 17, 1986, at 1, col. 1; Riley, "Gray Market" *Fight Isn't Black and White*, *THE NAT'L L.J.*, Oct. 28, 1985, at 1, col. 3.

Another indication of the staying power of the gray market is the vigorous defense of gray goods by two retailers who sell a significant amount of such goods, 47th Street Photo Inc. and K-Mart Corporation. 47th Street Photo is a New York retailer which also has a nationwide mail order business. K-Mart operates more than 2,000 "discount department stores" throughout the country and is said to purchase between \$250 and \$350 million of gray goods annually. *Olympus Corp. v. United States*, 627 F. Supp. 911, 916 n.1. (E.D.N.Y. 1985), *aff'd*, 792 F.2d 315 (2d Cir. 1986), *petition for cert. filed*, 55 U.S.L.W. 3372 (U.S. Nov. 6, 1986) (No. 86-757). Both companies have intervened in the three actions attacking the Customs Service's regulations and are active litigants in the current Supreme Court case, *K-Mart Corp. v. Cartier, Inc.* See K-Mart Brief, *supra* note 3; 47th Street Photo Brief, *supra* note 6.

A. Overview of Gray Goods Debate

Both those in favor of and those against gray goods claim to be acting in the interest of consumers. Supporters of gray goods claim that the importation of gray goods frustrates the efforts of multinational firms to price discriminate against U.S. consumers. If such firms seek to charge consumers in the United States a higher price than those in other countries, they argue that gray-market importation or "arbitrage" should be allowed, *i.e.*, the transfer of the products by unrelated third parties from the foreign country to the United States where they can be sold at prices below those charged by dealers authorized to sell the goods by U.S. trademark owners. Thus, they say, the gray market causes greater availability of the trademarked product and lower prices to U.S. consumers.

Opponents of the gray market dispute the claim that the United States trademark owners are engaging in price discrimination or the price-gouging of U.S. consumers. They claim that the only reason gray goods can be priced lower is that the importers are "free riding" on the efforts of the U.S. trademark owners which have to pay for advertisements to create and sustain the market as well as pre-sales service and post-sale warranties.⁸ These costs, they say, can amount to 27% of the retail price. Gray marketeers have none of these costs. U.S. trademark owners also argue that vigorous competition among the brand-name, trademarked products precludes price gouging which is not possible unless the seller has a monopoly or at least a very substantial market share. These conditions, they say, do not exist for these products.

Thus, the U.S. trademark owners argue that the gray mar-

8. Opponents of gray goods also deny that gray goods are necessarily priced lower than authorized goods. Many gray goods, they say, are priced the same or higher. See *Gray Market Imports: Hearings on § 2614 Before the Subcomm. on International Trade of the Senate Comm. on Finance*, 99th Cong., 2d Sess. 8-70 (1986) (statement of Robert Miller, President and Chief Executive Officer, Ritz Group Ltd.) My conversations with attorneys for gray-goods retailers confirm that availability is sometimes more important than the lower wholesale prices. Gray goods, for some retailers, are simply a way to sell a trademarked product that the U.S. trademark owner will not authorize them to sell. K-Mart, for instance, claims that "many trademark owners refuse to sell directly to price-competitive retailers including K-Mart." K-Mart Corp. Brief, *supra* note 3, at 6. U.S. trademark owners on the other hand, want control over who sells their products for a number of reasons including their belief that sales outside the authorized distribution chain result in lost prestige, which impairs the trademark's good will and diffuses the U.S. trademark owner's promotional efforts. See COPIAT, 598 F. Supp. at 850; *Greying of American Trademarks*, *supra* note 6, at 85 n.7.

ket is not indicative of price gouging but exists simply because the cost of transporting goods to the United States is less than the advertising and assorted costs of the U.S. trademark owner. The gray market will normally exist, therefore, for goods whose retail price is relatively high in relation to their weight and for which there is substantial brand-name advertising. Goods in this category include cameras, binoculars, watches, perfumes and cosmetics, and electronic goods.

The U.S. trademark owners oppose the gray market for a second reason. They say that gray goods deceive or confuse consumers about the source of trademarked products, and, therefore, about the quality of the product itself or the availability of warranties on those products. Consumers may assume that all goods bearing a particular trademark are physically identical, covered by uniform service warranties or are uniformly backed by the reputation of the same firm, regardless of who resells or distributes them. This is not true for gray goods. Most are not backed by factory authorized service, and, the trademark owners claim, that gray goods are often different in some physical way from the products intended for sale in the United States.⁹

B. *The Law Affecting Gray Goods*

U.S. trademark owners have attacked the sale of gray goods using the law of trademarks,¹⁰ contracts,¹¹ copyrights,¹² civil

9. Opponents of gray goods argue that some products may not meet American specifications. Cameras may be calibrated metrically or electronic goods may operate only on foreign voltage. Goods may not have been packaged for international shipment to the United States. Thus, moisture may lessen the effectiveness of detergents. The shipments, themselves, are not subject to the quality control of the trademark owner. Beverages may lose their flavor and batteries their effectiveness. Moreover, some products are simply made with different ingredients for the foreign markets. For instance, Pepsi-Cola has an entirely different taste and Procter & Gamble detergent does not have ingredients suited to the water conditions in this country. Other products may contain ingredients banned by various agencies in this country for health reasons. Further, gray market watches are opened and marked to comply with U.S. Customs regulations in non-sterile environments which may impair their performance.

10. *See, e.g.*, *Osawa & Co. v. B & H Photo*, 589 F. Supp. 1163 (S.D.N.Y. 1984) (construing Section 42 of the Trademark Act of 1946, 15 U.S.C. § 1124 (1982)); *International Armament Corp. v. Matra Manurhin Int'l, Inc.*, 229 U.S.P.Q. 450 (E.D. Va. 1986) (construing Section 32 of the Trademark Act of 1946, 15 U.S.C. § 1114 (1982)).

11. *See, e.g.*, *Johnson & Johnson Products, Inc. v. DAL International Trading Co.*, 798 F.2d 100 (3d Cir. 1986).

12. *See, e.g.*, *CBS Inc. v. Scorpio Music Distributors Inc.*, 569 F. Supp 47 (E.D. Pa. 1983), *aff'd mem.*, 738 F.2d 424 (3d Cir. 1984) (construing Section 602 of the Copyright Act of 1976, 17 U.S.C. § 602 (1982)).

RICO,¹³ tariffs¹⁴ and the International Trade Commission.¹⁵ Each side has had its victories but there has not yet been a decisive battle. While the use of civil RICO has perhaps put the most scare into those who sell gray goods because of the treble-damage provision, the most important legal battle to date is that now being waged in the Supreme Court by U.S. trademark owners, the sellers of gray goods and the U.S. Customs Service.

In *K-Mart Corp. v. Cartier, Inc.*,¹⁶ the Supreme Court is being asked to interpret Section 526 of the Tariff Act of 1930¹⁷ that on its face bans the importation of gray goods without the consent of the United States trademark owner.¹⁸ The United States Customs Service, however, interprets the Act to allow the importation of gray goods when the U.S. trademark owner licenses the mark abroad or is part of a multinational company that does.¹⁹ These have loosely been called "common control"

13. Racketeer Influenced and Corrupt Organizations Act ["RICO"], 18 U.S.C. §§ 1961-1968 (1982). See *Shulton, Inc. v. Optel Corp.*, No. 85-2925 (D.N.J. June 25, 1987) (available on Westlaw) (order denying motion to dismiss RICO counts) (Sarokin, D.J.). Cf. *United States v. Weinstein*, 762 F.2d 1522 (11th Cir. 1985) (criminal RICO conviction upheld where defendants through misrepresentations to manufacturers distributed pharmaceuticals sold for export in domestic market).

14. See, e.g., *Premier Dental Products Co. v. Darby Dental Supply Co.*, 794 F.2d 850, 858 (3d Cir. 1986) (construing Section 526(c) of the Tariff Act of 1930, 19 U.S.C. § 1526(c) (1982)).

15. See *In re Certain Alkaline Batteries*, 225 U.S.P.Q. 823 (Int'l Trade Comm. 1984), *disapproved*, 50 Fed. Reg. 1655 (Jan. 11, 1985), 225 U.S.P.Q. (BNA) 862 (1985), *appeal dismissed*, *Duracell, Inc. v. Int'l Trade Comm.*, 778 F.2d 1578 (Fed. Cir. 1985) (§ 337 of the Tariff Act of 1930, 19 U.S.C. § 1337 (1982)).

16. *Coalition to Preserve the Integrity of American Trademarks v. United States*, 598 F. Supp. 844 (D.D.C. 1984), *rev'd*, 790 F.2d 903 (D.C. Cir. 1986), *cert. granted sub. nom.*, *K-Mart Corp. v. Cartier, Inc.*, 107 S. Ct. 642 (1986).

17. 19 U.S.C. § 1526(a) (1982). The Tariff Act of 1930 reenacted the "Genuine Goods Exclusion Act" which was a part of the Tariff Act of 1922, ch. 356, tit. IV, § 526, 42 Stat. 858, 975.

18. There is no contention that the literal language would not allow U.S. trademark owners to bar gray goods. See, e.g., Brief for the Federal Petitioners at 11, *K-Mart Corp. v. Cartier, Inc.*, Nos. 86-495, 86-624 & 86-625 (U.S. Sup. Ct. Feb. 1987) [hereinafter U.S. Govt. Brief].

19. See 19 C.F.R. §§ 133.21(a), (b), (c)(1)-(3) (1987):

Restrictions on importation of articles bearing recorded trademarks and trade names.

(a) *Copying or simulating marks or names.* Articles of foreign or domestic manufacture bearing a mark or name copying or simulating a recorded trademark or trade name shall be denied entry and are subject to forfeiture as prohibited importations. A "copying or simulating" mark or name is an actual counterfeit of the recorded mark or name or is one which so resembles it as to be likely to cause the public to associate the copying or simulating mark with the recorded mark or name.

situations.

U.S. trademark owners in the common control category filed three separate actions attacking the Customs Service's regulations. The courts of appeals for the Federal Circuit²⁰ and Second Circuit²¹ upheld them; the D.C. Circuit struck them down.²² With the Customs Service subject to conflicting rulings, the Supreme Court had no choice but to grant certiorari and did so in the latter case.²³

C. Significance of Supreme Court Decision

For a number of reasons neither Congress nor the Executive Branch is likely to change the Customs Service regulations which permit the importation of gray goods, at least not in the near future.²⁴ The Supreme Court, on the other hand, in *K-Mart*

(b) *Identical trademark.* Foreign-made articles bearing a trademark identical with one owned and recorded by a citizen of the United States or a corporation or association created or organized within the United States are subject to seizure and forfeiture as prohibited importations.

(c) *Restrictions not applicable.* The restrictions set forth in paragraphs (a) and (b) of this section do not apply to imported articles when:

(1) Both the foreign and the U.S. trademark or trade name are owned by the same person or business entity;

(2) The foreign and the domestic trademark or trade name owners are parent and subsidiary companies or otherwise subject to common ownership or control (see Section 133.2(d) and 133.12(d));

(3) The articles of foreign manufacture bear a recorded trademark or trade name applied under authorization of the U.S. owner.

20. See *Vivitar Corp. v. United States*, 761 F.2d 1552, 1571 (Fed. Cir. 1985), *cert. denied*, 106 S. Ct. 791 (1986).

21. See *Olympus Corp. v. United States*, 792 F.2d 315, 320 (2d Cir. 1986), *petition for cert. filed*, 55 U.S.L.W. 3372 (No. 86-757) (Nov. 6, 1986).

22. See *Coalition to Preserve the Integrity of American Trademarks v. United States*, 790 F.2d 903, 905 (D.C. Cir. 1986), *cert. granted sub nom., K-Mart Corp. v. Cartier, Inc.*, 107 S. Ct. 642 (1986).

23. See *id.* All parties and intervenors agreed that the Court should grant certiorari. The respondent, COPIAT, argued that after granting certiorari the Court should summarily affirm without oral argument.

24. Absent Supreme Court intervention, present conditions strongly favor the maintenance of the status quo in which the Customs Service permits the importation of gray goods. Opponents of gray goods face the institutional inertia of Congress, which exists at least partly by design. (For instance, the framers of the Constitution intended that both bicameralism and a small, deliberative Senate would check legislative excesses by slowing the legislative process and thus providing "stability." See, e.g., *THE FEDERALIST* No. 63, at 385 (C. Rossiter ed. 1961) ("necessity of some institution [such as the Senate] that will blend stability with liberty"). Stability, of course, is another word for the status quo.)

In legal terms this institutional inertia means that there is a *de facto* presumption in favor of the status quo. In lay terms one might say that if Congress were a car, it would not move without a jump start. There are three sources which normally can provide this

Corp. v. Cartier, Inc.,²⁵ has the ability to dramatically affect the resolution of the gray-goods controversy. It needs only five votes to strike down the regulations and, thus, effectively to shut down the gray market. Also, this drastic effect would probably be the only thing that would move Congress and the Executive, themselves, to take action on the issue of gray goods.²⁶ Equally

type of start: public pressure, the Executive branch and the courts. The first two in the case of gray goods are unlikely to spur action.

As for public pressure, most members of Congress have more consumers and retailers of gray goods in their districts than they do "common control" U.S. trademark owners. It is always difficult to justify a vote that will raise prices of consumer goods. It is especially difficult when the policy that allows the lower-priced goods to be imported and sold has been in effect for decades and is currently approved by the Administration. Thus, the lobbying job facing COPIAT, *see supra* note 7, to overturn the Customs Service regulations through Congress is very difficult, if not impossible. COPIAT's efforts, in fact, might be reduced to a holding action, *i.e.*, lobbying against bills intending to ratify and codify the regulations. *See* S. 1097, 100th Cong., 1st Sess. (April 27, 1987) (introduced by Sen. Chafee and referred to Senate Committee on Finance).

The Administration is also unlikely to spur Congress into action because, as noted, it presently favors the customs service regulations and is defending them in the Supreme Court. *See* U.S. Govt. Brief, *supra* note 18. The President's Economic Policy Council, in conjunction with the Department of the Treasury and the Customs Service, did initiate a review of gray goods in 1984. It has not been concluded, at least officially. *See* 51 Fed. Reg. 22005, 30024 (1986); 49 Fed. Reg. 21453, 29509 (1984). After almost four years, this study has produced only silence which indicates a quiet death may have been prescribed. (The Antitrust Division of the Department of Justice, however, most likely does oppose gray goods. *See infra* note 52.) As for the courts and their potential impact on Congress, *see infra* note 26.

25. *Coalition to Preserve the Integrity of American Trademarks v. United States*, 790 F.2d 903, (D.C. Cir. 1986), *cert. granted sub nom., K-Mart Corp. v. Cartier, Inc.*, 107 S. Ct. 642 (1986).

26. An analogous situation occurred with regard to the *Betamax* case. *Sony Corp. of America v. Universal City Studios, Inc.*, 464 U.S. 417 (1984), *rev'g*, 659 F.2d 963 (9th Cir. 1981), *rev'g*, 480 F. Supp. 429 (C.D. Cal. 1979). Consumers had used video cassette recorders ("VCRs") to tape movies and television programs at home for years. Congress was content to allow this benefit for consumers at the expense of intellectual property owners to continue for much the same reasons that Congress is now content to allow gray-good consumers to benefit at the expense of the U.S. trademark owners. *See supra* note 24. When the district court upheld the status quo in its holding that the practice of "home-taping" did not violate the copyright law, 480 F. Supp. at 469, there was no movement in Congress to address the issue or disturb the status quo. In contrast, Congress jumped into action after the Ninth Circuit upset the status quo when it reversed the district court and held that (1) home-taping was a violation of the right to reproduce under the copyright law, 659 F.2d at 971-72, and (2) that Sony on remand might be barred from selling VCRs or forced to pay a royalty to copyright owners, *id.* at 977. Within days two bills were introduced in Congress. *See* H.R. 4808, S. 1758, 97th Cong., 1st Sess. (1981). Other bills soon followed and hearings were scheduled. (Congressional inaction is still the favored response, however, and when given an excuse, Congress will revert to it. Thus, when the Supreme Court granted certiorari in *Betamax*, Congress cancelled the hearings and suspended further action until the Court's resolution of the issue.) *See also infra* note 27.

important, if the Supreme Court reverses the D.C. Circuit and upholds the regulations, its decision, however narrow, will act to legitimize the gray market and make its status even more secure.²⁷

The legal issues before the Supreme Court are ones of statutory interpretation. Nevertheless, because Congress did not consider the current gray market issues when it enacted and reenacted Section 526, the Court is more likely than usual to allow its view of the merits to influence its statutory interpretation.²⁸ Thus, it becomes important to consider the merits of the gray-goods controversy.

27. Again, the *Betamax* case is analogous. See *supra* note 26. After the Supreme Court reversed the Ninth Circuit and restored the status quo, *Sony Corp. of America v. Universal City Studios, Inc.*, 464 U.S. 417 (1984), Congress lost all interest in the home-taping issue. This was so even though the Supreme Court's opinion was a controversial 5-4 decision. Moreover, the court had held only that "time-shifting" was a fair use and did not address the problems associated with the "librarying" of movies and television programs and their effect on copyright owners. Congressional inaction was, and is, in part due to the fact that in the popular mind, *Betamax* legitimized all forms of home-taping including "librarying" from broadcast and cable television. (In fact, under the Court's opinion such home-taping would probably be illegal.)

Nevertheless, it would be impossible today to move a bill through Congress that even questioned the legality of any form of home-taping. The constituent would surely wonder why if the Supreme Court had said the activity was legal, his representative was trying to prevent him from doing it or to make him pay for the right through royalties on VCRs or tapes. In short, Supreme Court validation of a consumer benefit, however narrow the holding, comes close to creating a birthright which Congress is unlikely to challenge. The situation would undoubtedly be the same for gray goods and the gray market.

28. Statutory interpretation can be a relatively straightforward exercise. What do the words of the statute say? If the words are not terms of art, apply them in their normal meaning. However, statutory interpretation has become much more complicated than that for a number of reasons. One is that a straightforward analysis sometimes produces results clearly at odds with the intent of the legislature. Therefore, exceptions have to be made for "absurd" results.

A more important reason is that some courts have taken on the role of problem-solvers, and have developed rules of statutory interpretation which allow them the flexibility to reach the "correct" result. Sometimes reaching the correct result means a result at odds with the words of the statute, and sometimes at odds with the intent of the legislature. See *Johnson v. Transportation Agency, Santa Clara County, California*, 107 S. Ct. 1442, 1459 (1987) (Stevens, J., concurring) (Court's affirmative action ruling at odds with Court's prior interpretation of statute as well as both language and intent of Congress).

Thus, in some situations while nominally interpreting a statute, courts have, in effect, displaced the legislature as law makers. In these situations, statutory interpretation as a process of applying the intent of the legislature is a legal fiction. When Congress has never considered the specific issue presented on appeal, the Court will undoubtedly feel even less compelled to take direction from the words of the statute.

II. UNDERLYING POLICIES OF THE GRAY GOODS CONTROVERSY

U.S. trademark owners and those who sell gray goods are engaging in a very serious and expensive struggle.²⁹ Which side is right about gray goods? In considering the gray-goods controversy it is easy to allow emotion and self-interest to cloud the issue. Desire for lower consumer prices, vague resentment of foreign manufacturers, dislike of brand-name advertising and promotion can and have made this issue more complicated than it is.³⁰ Resolution of the controversy only requires application of established antitrust and trademark policies.

A. Antitrust Policy

From an antitrust perspective the gray-goods controversy is simply a continuation of the debate over vertical-distribution restrictions.³¹ U.S. trademark owners are seeking to exclude unauthorized imports through Section 526 of the Tariff Act of 1930 in order to protect their exclusive territory, the United States. In the gray goods context, this becomes a vertical, territorial restriction when the U.S. trademark owners are distributors for foreign manufacturers.

The Supreme Court in the 1950s and 1960s followed a strong populist approach to antitrust.³² It sought to prevent any

29. Gray goods litigation is often heated with few settlements. It appears that U.S. trademark owners, who view those who sell gray goods as pirates, are willing to pay the costs of litigation both to establish a series of precedents and to increase the cost of doing business in the gray market. At least some of those who sell in the gray market, which is estimated at between \$6 billion and \$10 billion a year, appear to be equally determined. *See supra* note 7.

30. With a broad brush, and more than a little touch of xenophobia, K-Mart argues that the "foreign industries," which have already "destroyed" American competitors, are now trying to "use the Customs Service to enforce territorial restrictions which are designed to make American consumers pay higher prices than consumers anywhere else in the world for foreign merchandise." *See* Petition of K-Mart for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit at 16 & n.14, *K-Mart Corp. v. Cartier, Inc.*, No. 86-495 (Sept. 26, 1986). What "foreign industries"? Those that manufacture "cameras, watches and consumer electronics." *Id.* at n. 14. Ah, it is the Japanese again! This time it is an economic Pearl Harbor. The first wave wiped out our industry. The second wave is coming in to get the consumers. One can almost picture the incoming Minoltas at 0300.

31. For a good discussion of gray goods in the vertical-distribution antitrust context, see Miller, *Restricting the Gray Market in Trademarked Goods: Per Se Legality*, 76 TRADEMARK REP. 363 (1986). *See also, infra* note 41.

32. For the Warren Court especially, antitrust was a morality play. There was always a bad guy and a good guy. Bad was large and good was small. This had its roots in the populist approach to size set forth in BRANDEIS, *THE CURSE OF BIGNESS* (1934). Be-

arrangement that limited a small distributor's decision of what to sell or how much to sell for, even when it hurt consumers.³³ Exclusive vertical distribution agreements which limit the area a distributor can sell in and exclude others from distributing the product at all were an anathema.³⁴

At the other end of the antitrust-policy spectrum is the so-called Chicago School³⁵ which rejects all political policy goals including populist.³⁶ It focuses on consumer welfare which is enhanced by market efficiency. Vertical-distribution restrictions enhance market efficiency, as long as they are not a cover for horizontal agreements. Some proponents of the consumer-welfare approach advocate that all vertical restrictions, including geographic, should be *per se* legal.³⁷

The Supreme Court today has been greatly influenced by the Chicago School³⁸ but is not yet a true believer. It has rejected *per se* illegality for non-price vertical restrictions while maintaining it for vertical price restrictions.³⁹ It adopted a rule-of-reason rather than *per se* legality approach to non-price verti-

cause the economics and efficiencies of the marketplace are largely irrelevant to populist concerns, the Court was able to ignore economic theory and to view most issues in terms of black and white. This led to a series of *per se* rules throughout antitrust. In short, for the Warren Court the antitrust laws were not meant to promote competition but to protect and preserve the small competitor.

33. See *Albrecht v. Herald Co.*, 390 U.S. 145, 152-53 (1968) (newspaper's efforts to restrain exclusive distributor from overcharging customers *per se* illegal).

34. See *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967). In *Schwinn*, despite the government's rule of reason theory of illegality, the Court adopted a "bright line" rule of *per se* illegality for vertical restrictions:

Under the Sherman Act, it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it.

Id. at 379.

35. The so-called Chicago School was "founded" by the University of Chicago Law School professor Aaron Director who formulated and refined many of the doctrines. His students, some say disciples, have further developed the school in their writings. The most prolific of these is Richard Posner, now a U.S. Circuit Judge in the Court of Appeals for the Seventh Circuit. For Judge Posner's most recent effort in this regard, see Landes & Posner, *Trademark Law: An Economic Perspective*, 30 J. LAW & ECONOMICS (1987).

36. For the Chicago School, unlike the populist approach, *see supra* note 32, there is no good guy or bad guy in antitrust, only the marketplace. There is no "predatory" pricing, only competition. This approach comes close to finding most market practices, other than horizontal agreements not to compete, to be legal.

37. See Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6 (1981).

38. See *Matshushita Electric Industrial Co. v. Zenith Radio Corp.*, 106 S. Ct. 1348 (1986).

39. *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977).

cal restrictions.⁴⁰

Moreover, in adopting the rule-of-reason approach to non-price vertical restraints, the Court specifically recognized that such restraints "promote interbrand competition."⁴¹ Interbrand competition is that competition between brands. Intra-brand competition is that competition among wholesalers or retailers of the same brand. The Court correctly noted that interbrand competition "is the primary concern of the antitrust law."⁴² It is, after all, the lack of interbrand competition that leads to substantial market power and, perhaps, monopoly.

The proponents of the gray market argue that limitations on the importation of gray goods are for the purpose of price-gouging the American consumer.⁴³ As the Supreme Court has recognized, however, the manufacturer generally would prefer the *lowest* retail price, once its price to the dealers has been set, because a lower retail price means higher sales and higher manufacturer revenues.⁴⁴ Moreover, the U.S. trademark owner who

40. *Id.*

41. *Id.* at 54-55. Justice Powell, writing for the court, stated:

Vertical restrictions promote interbrand competition by allowing the manufacturer to achieve certain efficiencies in the distribution of his products. These "redeeming virtues" are implicit in every decision sustaining vertical restrictions under the rule of reason. Economists have identified a number of ways in which manufacturers can use such restrictions to compete more effectively against other manufacturers. See, e.g., Preston, *Restrictive Distribution Arrangements: Economic Analysis and Public Policy Standards*, 30 *Law & Contemp Prob* 506, 511 (1965). For example, new manufacturers and manufacturers entering new markets can use the restrictions in order to induce competent and aggressive retailers to make the kind of investment of capital and labor that is often required in the distribution of products unknown to the consumer. Established manufacturers can use them to induce retailers to engage in promotional activities or to provide service and repair facilities necessary to the efficient marketing of their products. Service and repair are vital for many products, such as automobiles and major household appliances. The availability and quality of such services affect a manufacturer's goodwill and the competitiveness of his product. Because of market imperfections such as the so-called "free rider" effect, these services might not be provided by retailers in a purely competitive situation, despite the fact that each retailer's benefit would be greater if all provided the services than if none did. (footnote omitted).

The Department of Justice has also recognized the procompetitive nature of vertical restrictions. See U.S. Dep't of Justice *Vertical Restraint Guidelines*, 50 *Fed. Reg.* 6264, 6266 (Feb. 14, 1985).

42. *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 52 n.19 (1977).

43. See *supra* note 3 and accompanying text.

44. See *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36, 56 n.24 (1977). "In this context, a manufacturer is likely to view the difference between the price at which it sells to its retailers and their price to the consumer as its 'cost of distribution,' which it

distributes the product could price-gouge only if it had very substantial market share. Otherwise, interbrand competition would prevent them from substantially raising prices, let alone gouging.⁴⁵ Following this reasoning, lower courts under the rule-of-reason approach have found non-price vertical restrictions legal *per se* absent market power in the seller.⁴⁶ There is no indication that any of the products which are subject to gray-good intrabrand competition are dominant in their respective

would prefer to minimize." *Id.* See also Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division [II]*, 75 YALE L.J. 373, 403 (1966); Note, 88 HARV. L. REV. 636, 641 (1975).

The Federal Trade Commission staff in response to Treasury Department request for comments, 51 Fed. Reg. 22,005 (June 17, 1986), has suggested that a foreign manufacturer might "be forced to price discriminate against U.S. consumers" if it faces contractual (or political) obligations in its home market with respect to price or price and quantity, is producing at capacity, and faces a lag in adding new capacity." See Comments of the FTC Bureaus of Competition, Consumer Protection and Economics on Gray Market Policy Options Facing the United States Customs Service 9 n.11 (Oct. 17, 1986). If this improbable factual scenario ever did occur, the manufacturer would only be able to effectively price discriminate if all its competitors also faced exactly the same scenario and, as a result chose to price discriminate. And even if all the competitors were similarly situated, and all were price discriminating, gray goods would still not be the appropriate answer for the reasons stated below. See notes 48-50 and accompanying text.

45. The Federal Trade Commission staff has suggested that the imposition of geographic restrictions by manufacturers "might conceivably" stem from the insistence of colluding retailers or wholesalers who are seeking to raise their profit margins. See Comments of the FTC Bureaus of Competition, Consumer Protection and Economics on Gray Market Policy Options Facing the United States Customs Service 12 (Oct. 17, 1986). This scenario is often raised to make a case for restricting vertical restraints. The collusion in this scenario, is, of course, a *per se* horizontal price-fixing violation of Section 1 which is subject to criminal prosecution and civil treble damages. (The Antitrust Division does actively prosecute price-fixing cases.) Considering the severity of the anti-trust offense, if this were a probable scenario, by now there should be a body of cases attacking the practice especially since the chances of such collusion remaining undetected are slim. There is no such body of cases. This is not surprising because the chance of such collusion working is slim and thus few distributors would be willing to take the risk even if they were so inclined to violate the law. Moreover, the scenario presupposes two factors that have not been shown to exist for the products in the gray market: (1) superior market bargaining power at the authorized distributor level vis a vis the manufacturers; and (2) a relationship among competing U.S. trademark owners that would take precedence over the trademark owner's relationship to its foreign manufacturer which is often the parent or a related company.

46. Market power in the seller is defined as the "power to raise prices significantly above the competitive level without losing all of one's business." *Valley Liquors, Inc. v. Renfield Importers Ltd.*, 678 F.2d 742, 745 (7th Cir. 1982). See also *General Leaseways, Inc. v. National Truck Leasing Assoc.*, 744 F.2d 588, 596 (7th Cir. 1984); *Jack Walters & Sons Corp. v. Morton Building, Inc.*, 737 F.2d 698, 702 (7th Cir.), *cert. denied*, 105 S. Ct. 432 (1984); U.S. Dep't of Just. Vertical Restraint Guidelines, 50 Fed. Reg. 6264, 6268 (1985) (firms with small market shares employing vertical restraints are not subject to scrutiny by the Antitrust Division).

markets.⁴⁷

But even if a product were truly dominant in its market and its U.S. trademark owner seller was engaged in price-gouging, gray goods and increased intrabrand competition would still not be the appropriate answer. The price-gouging of a dominant firm creates a high profit margin and the incentive for interbrand competitors to come into the market. Intrabrand competition caused by gray goods would reduce the price of the dominant product and, therefore, the likelihood of entry and effective interbrand competition.

Moreover, the future prospect of intrabrand gray-good competition for the products of the new entrants into the market would reduce the ability of those firms to seriously compete or even enter the market at all.⁴⁸ It can cost up to \$30 million to launch a new product nationwide.⁴⁹ Without the ability to limit the "free riding" almost inherent in intrabrand competition and, thus, recoup this initial cost, there would be few challenges to dominant firms. One of the goals of a competitive economy is the production of better mousetraps. These are the result of interbrand not intrabrand competition.⁵⁰

In short, as two courts of appeals⁵¹ and even the Depart-

47. In fact, there is vigorous interbrand competition in markets which attract gray goods such as perfumes, watches, cameras and electronic goods.

48. Even in *Schwinn*, the Supreme Court recognized that exceptions from the *per se* rule against vertical restraints might be appropriate for new entrants into the market. See *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365, 374 (1967).

49. See Fletcher, *Joint Registration of Trademarks and the Economic Value of a Trademark System*, 36 U. MIAMI L. REV. 297, 326 (1982).

50. An example illustrates the difference between the intrabrand (gray-goods) competition and interbrand competition. IBM was once truly dominant in the computer field. It is highly doubtful that either the consumer, or computer technology, would be better off today had there been greater price competition among authorized and unauthorized sellers of IBM equipment. Both the consumer and computer technology appear to be in better positions as a result of the entrance into the market of companies like Apple Computer which needed for entry, not only high IBM prices, but also vertical restrictions for its distributors who would then be willing to share the enormous entry promotion costs.

51. See *Premier Dental Products Co. v. Darby Dental Supply Co.*, 794 F.2d 850, 859 (3d Cir. 1986) (injunction barring importation of gray goods raises "no colorable" antitrust claim). In *Olympus Corp. v. United States*, 792 F.2d 315 (2d Cir. 1986), which upheld the Customs Service's gray-goods regulations on other grounds, Judge Oakes stated:

[W]e agree in large part with Judge Leval's statements in [*Osawa & Co. v. B & H Photo*, 589 F. Supp. 1163, 1178 (S.D.N.Y. 1984)] that section 133.21(c) is "unsound both as antitrust policy and as trademark law" . . . [*United States v. Arnold, Schwinn & Co.* was overruled by *Continental T.V., Inc. v. GTE Syl- vania Inc.*] and this alone would seem to make reassessment of section

ment of Justice⁵² have recently concluded, antitrust policy supports the restricted distribution that comes from barring the importation of gray goods.

B. Trademark Policy

A trademark is a symbol that allows a purchaser to identify goods or services that have been satisfactory in the past and reject goods or services that have failed to give satisfaction.⁵³ The trademark thus serves two goals: (1) the production of quality products; and (2) the reduction of the consumer's "search costs."⁵⁴

By fixing responsibility, a trademark allows the trademark owner to build good will⁵⁵ or, conversely, a bad reputation. Trademark law encourages the production of quality products by allowing the trademark owner to reap the benefit of the good will.

By fixing responsibility, a trademark also reduces the time a

133.21(c) appropriate at least insofar as those regulations rest on antitrust considerations.

Id. at 319-20.

52. See Brief for United States as Amicus Curiae, *Bell & Howell: Mamiya Co. v. Masel Supply Co.*, 719 F.2d 42 (2d Cir. 1983) (No. 82-7867). In this brief the Justice Department urged the Second Circuit to interpret Section 526 of the Tariff Act of 1930 as the D.C. Circuit later did in COPIAT, that is that Section 526 should be construed "in accord with the normal meaning of the statutory language." *Id.* at 9. This construction would, of course, allow U.S. trademark owners to bar the importation of gray goods. Significantly, this brief was written by the Antitrust Division in the Justice Department which obviously found no antitrust problems with the plain meaning of the statute.

This Justice Department amicus brief is not cited by any of the petitioners in *K Mart Corp. v. Cartier, Inc.*, including the Justice Department. The change in position is probably due to the nature of the Justice Department's representation. The Civil Division, not the Antitrust Division, has been in COPIAT from the outset. It is representing its client, the Customs Service, and is dutifully defending the Customs Service regulations. As an amicus, the Antitrust Division perhaps was more free to take a position based upon its own policy analysis. Although the U.S. Government now takes an opposite position from that of the Antitrust Division in the amicus brief, it is doing so on a straight statutory interpretation basis without regard to the underlying policies, including antitrust policy.

53. 1 J. McCARTHY, *TRADEMARKS AND UNFAIR COMPETITION* § 2:1, at 44 (2d ed. 1984).

54. *Id.*

55. "Good will may be defined as the favorable consideration shown by the purchasing public to goods known to emanate from a particular source." *White Tower System Inc. v. White Castle System of Eating Houses Corp.*, 90 F.2d 67, 69 (6th Cir.), *cert. denied*, 302 U.S. 720 (1937). This includes "public confidence in the quality of the product and in the warranties made on behalf of the product, and the 'name recognition' of the product by the public that differentiates that product from others." *Premier Dental Products Co. v. Darby Dental Supply Co.*, 794 F.2d 850, 853 n.3 (3d Cir. 1986).

customer must expend in collecting information about products. A trademark reduces search time, however, only if the consumer can expect that products with the same trademark will be the same.⁵⁶

Gray goods do not serve either of these goals. When gray goods are different from the authorized products,⁵⁷ they deceive the consumer and undercut the basic function of trademarks which is to allow the consumer to know what he or she is getting. Nor does informing the customer on the container or by notices that the product is a gray good alleviate the problem. The value of trademarks is greatly diminished, if not destroyed, if the consumer must read the fine print at every purchase. Consumer faith in consistent quality is essential to the functioning of trademarks. Gray goods that are different seriously erode this faith.

Gray goods that are different from the authorized product also sabotage the good will the U.S. trademark owner has established. When the importer knows that the gray good is different from the authorized product, it is essentially committing the basic unfair competition tort of passing off that has been condemned for hundreds of years.

Even when gray goods are identical to the authorized good, they still undermine trademark principles. This is because one purpose of trademark law, regardless of public confusion, is to prevent others from exploiting a trademark owner's hard-earned good will.⁵⁸ This type of protection, which is also a basis of mis-

56. *Cf. Falcon Rice Mill, Inc. v. Community Rice Mill, Inc.*, 725 F.2d 336, 384 (5th Cir. 1984):

"By ensuring correct information in the marketplace the [trademark] laws reduce losses caused by misunderstanding and deceit and thus permit consumers and merchants to maximize their own welfare confident that the information presented is truthful." *Id.*

57. *See supra* note 9 and accompanying text. *See also* *Model Rectifier Corp. v. Takachiho Int'l Inc.*, 221 U.S.P.Q. (BNA) 502, 503 (9th Cir. 1983) (missing and broken parts); *Selchow & Righter Co. v. Goldex Corp.*, 612 F. Supp. 19 (S.D. Fla. 1985) (different and sometimes offensive subject matter in Canadian gray market Trivial Pursuit); *Weil Ceramics & Class, Inc. v. Dash*, 618 F. Supp. 700 (D.N.J. 1985) (different warranties); *Osawa & Co. v. B & H Photo*, 589 F. Supp. 1163, 1167-68 (S.D.N.Y. 1984) (no warranty).

58. This purpose was made clear in the legislative history of the Lanham Act 15 U.S.C. § 1114 (1982). *See* H.R. REP. NO. 219 (1945) (accompanying H.R. 1654):

The purpose underlying any trade-mark statute is two fold. One is to protect the public so it may be confident that, in purchasing a product bearing a particular trademark which it favorably knows, it will get the product it asks for and wants to get. *Secondly, where the owner of a trade-mark has spent energy, time and money in presenting to the public the product, he is protected*

appropriation law,⁵⁹ derives from the dislike of the "free rider," an "economic parasite who must be enjoined by the law."⁶⁰

In short, the Customs Service regulations which allow the importation of gray goods are "unsound" as trademark policy.⁶¹

III. CONCLUSION

There is no question that gray goods can lead to lower prices and greater availability of quality brand-name items. For some, that appears to be enough to place them in favor of gray goods.⁶² Yet, even assuming that lower prices and greater availability are always desirable,⁶³ the question remains whether the means used to achieve those ends are appropriate.

For instance, the same results, lower prices and greater

in his investment from its misappropriation by pirates and cheats. This is the well-established rule of law protecting both the public and the trade-mark owner.

Id. at 2 (emphasis added) (quoted in Brief Amicus Curiae of the United States Trade-mark Ass'n, *K-Mart Corp. v. Cartier, Inc.*, Nos. 86-495, 86-625 (U.S. Sup. Ct. May 7, 1987) p. 8 [hereinafter U.S.T.A. Brief]).

This aspect of trademark law rarely gets explicit recognition in the case law. That it is a remaining, if often unstated, purpose is illustrated by the emblem cases. *See e.g.*, *Boston Pro Hockey Ass'n v. Dallas Cap & Emblem Mfg., Inc.*, 510 F.2d 1004, 1012 (5th Cir.), *cert. denied*, 423 U.S. 868 (1975); *University of Pittsburgh v. Champion Products, Inc.*, 686 F.2d 1040, 1047 (3d Cir. 1982), *cert. denied*, 459 U.S. 1087 (1982). *But see* *International Order of Job's Daughters v. Lindenburg & Co.*, 633 F.2d 912, 918-19 (9th Cir. 1980).

59. *See, e.g.*, *International News Service v. Associated Press*, 248 U.S. 215 (1918).

60. 1 J. MCCARTHY, TRADEMARKS AND UNFAIR COMPETITION § 2:1, at 47 (2d ed. 1984). The principle of "territoriality" establishes that there may be good will in the United States trademark owner separate and apart from that of the manufacturer. For an excellent discussion of territoriality and good will and their relation to gray goods, see *Osawa & Co. v. B & H Photo*, 589 F. Supp. 1163, 1171-73 (S.D.N.Y. 1984). *See also* U.S.T.A. Brief *supra* note 58, at 7.

61. *See Olympus Corp. v. United States*, 792 F.2d 315, 319 (2d Cir. 1986).

62. *See, e.g.*, *Parfums Stern, Inc. v. United States Customs Serv.*, 575 F. Supp. 416, 421 (S.D. Fla. 1983):

[T]here is adequate evidence that the public has the benefit of lower prices in that those products offered by the John Doe Defendants are usually less expensive than those sold by Plaintiff through its authorized distributors. Therefore, it appears that the Court would be doing the public a disservice by preventing the dissemination of what appears to the Court, uncontroverted, to be equally good, yet less expensive, legitimate Oscar de la Renta fragrance products.

Id.

63. They are not always desirable. Lower prices caused by intrabrand competition can reduce interbrand competition. Lack of control over retail distribution can hurt the proper promotion of the product as well as jeopardize safety and quality control. *See Continental T.V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 55 n.23 (1977).

availability, are also achieved when a truck carrying trademarked goods is hijacked and the goods sold to consumers on the streets, and sometimes in the stores. No one would or should approve of stealing goods even if the lower price benefits or pleases the consumer.

The gray market exists because in essence it hijacks the good will and promotional efforts of the U.S. trademark owners. Good will is a form of property.⁶⁴ Yet because it is intangible property, its taking is harder to detect. If good will were tangible property, the gray market would be seen more clearly for what it is, a version of the black market.⁶⁵

Our laws with regard to trademarks and commerce should provide incentives for those who create and produce. They should seek to prevent consumer confusion. And they should enforce basic notions of commercial morality. Support for gray goods accomplishes none of these goals. Such support merely favors those who reap what others sow.

64. *See, e.g.*, 1 J. MCCARTHY, TRADEMARKS AND UNFAIR COMPETITION § 2.8 at 75 (2d ed. 1984).

65. In one sense, the gray market is even worse than the black market because at least in the black market the products are identical. Because of physical differences or differences in warranties of gray goods, the gray market undercuts the basic trademark principle that trademarks allow a buyer to know what he or she is getting.

