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# GRAY-MARKET IMPORTS: CAUSES, CONSEQUENCES AND RESPONSES

MICHAEL S. KNOLL\*

*This article explores the issue of gray-market imports. The author explains the four causes of gray-market imports and explores the possibility of private remedies in order to stem the flow of these imports. The article then turns to the possibility of protection in the public sector by discussing pertinent statutory provisions and the development of the case law in this area.*

## A PERSPECTIVE ON GRAY-MARKET IMPORTS

In recent years, there has been dramatic growth in the size of the gray market, otherwise referred to as the parallel-import market.<sup>1</sup> This growth, contemporaneous with a strong rise in the

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1. According to one estimate, sales of gray-market goods totalled \$6 billion in 1984. Boyer, *The Assault on the Right to Buy Cheap Imports*, FORTUNE, Jan. 7, 1985, at 89. The watch and camera industries have claimed to be especially hard hit. It has been estimated that nearly 20 percent of the reflex cameras sold in the United States in 1984 were sold through the gray market. PHOTOGRAPHIC TRADE NEWS, Mar. 5, 1984, at 14. Similarly, Seiko claims that one out of four Seiko watches sold in the United States are sold on the gray market, which would imply that as much as \$100 million in sales are diverted annually away from authorized Seiko dealers by gray market imports. *Seiko's Battle Against the Grey Market*, MODERN JEWELER, Oct. 1983, at 44. Data on the growth of the gray market are much harder to obtain than are estimates of its size. The Coalition to Preserve the Integrity of American Trademarks (COPIAT) conducted a survey of its members and compared estimates of their sales lost to diversion with their United States sales in 1982 and 1983 for products that are affected by gray-market imports. According to COPIAT, the ratio of lost sales to annual sales rose from 13.6 percent in 1982 to 17.3 percent in 1983. During this same period the sales of COPIAT companies' products subject to diversion rose by seven percent, while sales lost to diversion rose by 36 percent. COLLADO ASSOCIATES, INC., THE ECONOMIC IMPACT OF DIVERSION 36-37 (1984) [hereinafter COLLADO ASSOC.].

dollar relative to most other major currencies,<sup>2</sup> has produced a flood of litigation.<sup>3</sup> The gray market consists of imports of genuine trademarked goods<sup>4</sup> that the U.S. trademark owner has authorized for sale abroad but not for sale in the United States, and that compete in the same market with genuine goods the trademark owner has authorized for sale in the United States. Thus, gray-market goods are not counterfeit goods,<sup>5</sup> but they are goods that the U.S. trademark owner has not approved for sale in the United States. Gray-market imports tend to be brands with reputations for high quality,<sup>6</sup> and include a wide range of products, including MAMIYA cameras, SEIKO watches, YVES ST. LAURENT perfume,

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2. LEXECON INC., THE ECONOMICS OF GRAY-MARKET IMPORTS 57-69 (1985) [hereinafter LEXECON INC.]. An increase in the value of the dollar relative to currencies of other nations increases the relative value of investments made in the United States, such as the value of U.S. distributors' investments in marketing, warranty programs, and product quality. The result is increased incentives for importation of gray-market goods that take a free ride on U.S. marketing investments or that are inferior to the U.S. trademarked goods. *Id.* at 63-64. See also *Assault on the Right to Buy Cheap Imports*, FORTUNE, Jan. 7, 1985, at 89 (rising dollar has led to an increase in gray-market imports); but see *Dollar's Drop Drubs Gray Marketeers*, Wash. Post, May 4, 1986, at F3, col. 4 (declining dollar has significantly reduced gray-market imports). U.S. exchange rates with several major trading partners are printed in the ECONOMIC REPORT OF THE PRESIDENT 373 (1986) (Table B-105).

3. See, e.g., *Olympus Corp. v. United States*, 627 F. Supp. 911 (E.D.N.Y. 1985), *aff'd*, 792 F.2d 315 (2d Cir. 1986); *Coalition to Preserve the Integrity of American Trademarks v. U.S.*, 598 F. Supp. 844 (D.D.C. 1984), *rev'd*, 790 F.2d 903 (D.C. Cir. 1986) [hereinafter *COPIAT*]; *Vivitar Co. v. United States*, 593 F. Supp. 420 (Ct. Int'l Trade 1984), *aff'd*, 761 F.2d 1552 (Fed. Cir. 1985); *Osawa & Co. v. B & H Photo*, 589 F. Supp. 1163 (S.D.N.Y. 1984); *Bell & Howell: Mamiya Co. v. Masel Supply Co.*, 548 F. Supp. 1063 (E.D.N.Y. 1982), *vacated*, 719 F.2d 42 (2d Cir. 1983) [hereinafter *Bell & Howell*]; *Model Rectifier Corp. v. Takchiho Int'l*, 221 U.S.P.Q. (BNA) 502 (9th Cir. 1983); *Certain Alkaline Batteries*, 49 Fed. Reg. 45,275 (Int'l Trade Comm. 1984), USITC Pub. 1616, Inv. No. 337-TA-165, (Nov. 1984) [hereinafter *Duracell*].

4. Alternate terms for unauthorized trademarked goods include gray-market, parallel, or diverted goods.

5. The gray-market issue is similar to the issue of counterfeit merchandise. Unlike counterfeit goods, which are produced by an unauthorized party and bear an unauthorized trademark that is identical to the U.S. trademark, gray-market goods are genuine goods that are stamped with the U.S. trademark with the permission of the domestic trademark owner. For a discussion of the counterfeit goods issue, see *The Effect of Foreign Product Counterfeiting on U.S. Industry*, USITC Pub. 1479, Inv. No. 332-158 (Jan. 1984).

6. See *Dam, Trademarks, Price Discrimination, and the Bureau of Customs*, 7 J.L. & ECON. 48 (1964).

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MERCEDES-BENZ automobiles, DOM PERIGNON champagne, BACCARAT crystal, and DURACELL batteries.<sup>7</sup>

Gray-market merchandise enters the United States through independent importers who purchase the goods abroad from either wholesalers or retailers after the goods have left the control of the manufacturer.<sup>8</sup> The importers then ship these goods to the United States, where they are sold to retailers for resale to the public.<sup>9</sup> Gray-market imports typically arise when the U.S. price for a brand is higher than the foreign price by a large enough amount that the importer can both cover the cost of importing the brand into the United States and earn a reasonable return.<sup>10</sup> Gray-market imports occur in three distinct situations:

1. Goods produced in the United States for export, which are then imported back into the United States without the authorization of the U.S. trademark owner;<sup>11</sup>
2. Unauthorized imports competing with domestically produced goods;<sup>12</sup> and
3. Unauthorized imports competing with authorized imports.<sup>13</sup>

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7. Auerbach, *The Gray Market: Where a \$200 Watch Can Be Bought For \$140*, Wash. Post, Dec. 16, 1984, at L1, col. 1. According to COPIAT, many other industries are suffering from gray-market imports. These include apparel, boats, china, cosmetics, crystal, electronic equipment, food, pharmaceuticals, semiconductors, tires, and toys. COLLADO ASSOC., *supra* note 1, at 39-40.

8. Gray-market merchandise also enters the United States through foreign wholesalers that sell to domestic retailers. See LEXECON INC., *supra* note 2, at 41-43.

9. Gray-market merchandise is usually, but not always, sold at a lower price than the authorized product. See Auerbach, *supra* note 7, at L3, col. 1.

10. *But see* LEXECON INC., *supra* note 2, at 26-30.

11. In the *Duracell* investigation by the U.S. International Trade Commission, there was an allegation that some batteries were exported from the United States and then re-imported. See *Duracell*, *supra* note 3.

12. *Duracell* involved the importation into the United States of batteries produced by a Belgian subsidiary of the U.S. parent for sale in Europe, which competed with the identical batteries produced in the United States by an unincorporated division of the same parent. *Id.* at 5-6.

13. Of the three situations listed above, this one has generated the most litigation, and is probably the situation under which a majority of gray-market goods enter the United States. For example, both the *Bell & Howell* and the *Osawa* cases involved the unauthorized importation of photographic equipment, produced abroad and intended for sale abroad, into the United States in competition with photographic equipment produced abroad and imported into the United States through authorized channels. See, e.g., *Bell & Howell: Mamiya Co. v. Masel Supply Co.*, 548 F. Supp. 1063, 1066 (E.D.N.Y. 1982); *Osawa & Co. v. B & H Photo*, 89 F. Supp. 1163, 1164 (S.D.N.Y.

The Genuine Goods Exclusion Act, originally enacted as section 526 of the Tariff Act of 1922, permits the owner of a registered U.S. trademark to exclude genuine goods produced abroad that bear an identical trademark by recording its trademark with the U.S. Customs Service (Customs).<sup>14</sup> The Department of the Treasury

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1984). This situation is probably the most common because the gray-market goods travel only as far as the authorized goods. In contrast, when the goods are produced in the United States, exported to Europe, and then reimported by independent importers, the gray-market goods must cross the Atlantic twice, whereas the authorized goods can go directly from the U.S. plant to the U.S. consumer.

14. 19 U.S.C. § 1526 (1982). This section reads:

(a) Except as provided in subsection (d) of this section, it shall be unlawful to import into the United States any merchandise of foreign manufacture if such merchandise, or the label, sign, print, package, wrapper, or receptacle, bears a trademark owned by a citizen of, or by a corporation or association created or organized within, the United States, and registered in the Patent and Trademark Office by a person domiciled in the United States, under the provisions of sections 81 to 109 of Title 15, and if a copy of the certificate of registration of such trademark is filed with the Secretary of the Treasury, in the manner provided in section 106 of said Title 15, unless written consent of the owner of such trademark is produced at the time of making entry.

(b) Any such merchandise imported into the United States in violation of the provisions of this section shall be subject to seizure and forfeiture for violation of the customs laws.

(c) Any person dealing in any such merchandise may be enjoined from dealing therein within the United States or may be required to export or destroy such merchandise or to remove or obliterate such trademark and shall be liable for the same damages and profits provided for wrongful use of a trademark, under the provisions of sections 91 to 109 of Title 15.

(d)(1) The trademark provisions of this section and section 1124 of Title 15, do not apply to the importation of this article accompanying any person arriving in the United States when such articles are for his personal use and not for sale if (A) such articles are within the limits of types and quantities determined by the Secretary pursuant to paragraph (2) of this subsection, and (B) such person has not been granted an exemption under this subsection within thirty days immediately preceding his arrival.

(2) The Secretary shall determine and publish in the Federal Register lists of the types of articles and the quantities of each which shall be entitled to the exemption provided by this subsection. In determining such quantities of particular types of trade-marked articles, the Secretary shall give such consideration as he deems necessary to the numbers of such articles usually purchased at retail for personal use.

(3) If any article which has been exempted from the restrictions of importation of the trade-mark laws under this subsection is sold within one year after the date of importation, such article, or its value (to be recovered from

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(Treasury), however, has promulgated regulations denying U.S. trademark owners the right to compel Customs to exclude genuine trademarked goods produced abroad when the owner of the foreign trademark is related to the U.S. trademark owner of has applied the trademark with the authorization of the U.S. trademark owner.<sup>15</sup> In accordance with these regulations, Customs

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the importer), is subject to forfeiture. A sale pursuant to a judicial order or in liquidation of the estate of a decedent is not subject to the provisions of this paragraph.

(4) The Secretary may prescribe such rules and regulations as may be necessary to carry out the provisions of this subsection . . . .

19 U.S.C. § 1526 (1982) (Subsection (e) omitted).

15. 19 C.F.R. § 133.21(b), (c) (1985). Section 133.21 reads:

(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.

(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 of trade name are owned by the same person or business entity;

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

(4) The objectionable mark is removed or obliterated prior to importation in such a manner as to be illegible and incapable of being reconstituted, for example by:

(i) Grinding off imprinted trademarks wherever they appear;

(ii) Removing and disposing of plates bearing a trademark or trade name;

(5) The merchandise is imported by the recordant of the trademark or trade name or his designate;

(6) The recordant gives written consent to an importation of articles otherwise subject to the restrictions set forth in paragraphs (a) and (b) of this section, and such consent is furnished to appropriate Customs officials; or

(7) The articles of foreign manufacture bear a recorded trademark and the

does not prevent most gray-market merchandise from entering the United States.

The fundamental issue is: what should be the policy of the United States toward gray-market imports.<sup>16</sup> Because many people are reluctant to permit the government to enforce trade restrictions,<sup>17</sup> a showing that gray-market imports harm U.S. trademark owners is not sufficient to justify a restriction on gray-market imports. Thus, this paper deals with the two propositions that must be established to justify any governmental restriction on gray-market imports: that gray-market merchandise injures the economy as a whole, and that U.S. trademark owners are incapable of preventing the harm from gray-market imports, or may do so only at a much greater cost than the federal government can.

Before making the argument that the government should restrict gray-market imports, the first section addresses the traditional argument for allowing gray-market imports into the United States, and reveals that it is based on an erroneous view of trademarks and restrictive distribution arrangements. The second section discusses the economic causes and consequences of gray-market imports. It begins with a general discussion of trademarks, and then addresses the four causes of gray-market imports: free riding on the trademark owner's goodwill, free riding on services, the importation of inferior-quality goods, and arbitraging international price differences. Gray-market imports that result from the first three causes harm the economy because they reduce both the number and quality of goods introduced into the U.S. market and because they reduce the incentives for U.S. and foreign firms to develop export markets. Only gray-market imports that result from arbitrage are beneficial to the economy. In this section, this

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personal exemption is claimed and allowed under § 148.55 of this chapter.

19 C.F.R. § 133.21 (1985) (Subsection (d) omitted).

16. The federal government has been studying the matter for several years. *See* Treasury, OMB Seen Backing Some Restrictions on 'Grey Market' Imports, 3 Inside U.S. Trade (Inside Washington), at 9 (Apr. 26, 1985); Solicitation of Economic Data Notice, 49 Fed. Reg. 21,453-56 (1984); Solicitation of Public Comment Notice, 51 Fed. Reg. 22,005-07 (1986).

17. The possibilities for abuse when governments interfere in international trade have been well documented over the last 210 years. *See generally*, A. SMITH, THE WEALTH OF NATIONS (Book IV, chapters II & III) (1776).

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paper argues that arbitrage is probably only a minor cause of gray-market imports, and that gray-market imports are injurious to the economy as a whole, thus satisfying the first proposition required to justify a restriction on gray-market imports. The third section discusses the high cost of private remedies and the efficiency of a number of proposed public remedies. It demonstrates that only a ban on gray-market goods enforced by the federal government can deal with the problem effectively, thus satisfying the second proposition required to justify government intervention. The fourth section reviews the law on gray-market imports, and finds a strong basis there for excluding gray-market imports. It also finds that Customs' regulations should be struck down as an unreasonable interpretation of section 526 and an improper exercise of Customs' enforcement discretion. Finally, the fifth section presents the conclusions.

### *The Traditional View of Gray Markets*

Gray markets are frequently applauded on antitrust grounds.<sup>18</sup> Proponents of the gray market begin by noting that the incentive for transshipping arises because the trademark owner charges a higher price in the domestic market than in the foreign market. According to this view of gray-market merchandise, arbitrage allows importers to break down the barriers that separate the two markets.<sup>19</sup> Thus, supporters of the gray market argue that preventing the importation of gray-market goods would construct a barrier between the two markets, allowing the trademark owner to engage in monopolistic price discrimination.<sup>20</sup> In its simplest form, this argument is based on an incorrect view of trademarks,

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18. See, e.g., Dam, *supra* note 6, at 57; *The Assault on the Right to Buy Cheap Imports*, *supra* note 1, at 89 (William Niskanen, a senior member of the Council of Economic Advisors, has said, "I just don't understand why in the world the U.S. government should become an instrument for enforcing price discrimination between U.S. and foreign markets.").

19. Even if a trademark owner has market power, the net welfare effect of allowing the monopolist to price discriminate is uncertain. See F. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 320-22 (2d ed. 1980). Here, however, there would be a reason to prevent monopoly price discrimination because gray-market imports will enter the United States only when the U.S. price is higher than the foreign price. Thus, U.S. consumers would be hurt by price discrimination that benefited the foreign supplier and foreign consumers.

20. See Dam, *supra* note 6, at 45.



one that assumes that any price differences result from monopoly power conferred by the trademark and not from the local goodwill embodied in the trademark.

Some supporters of the gray market develop the following argument: in order for a manufacturer to engage in monopolistic price discrimination, the manufacturer must have market power;<sup>21</sup> the trademark provides the market power;<sup>22</sup> therefore, because the owner of a trademark has the exclusive right to use that trademark on goods in commerce,<sup>23</sup> the trademark owner has a monopoly. For example, only Seiko can sell SEIKO watches and thus Seiko monopolizes SEIKO watches. Consequently, by allowing the owner of the trademark to separate the two markets, a ban on gray-market merchandise prevents buyers in the high-priced territory from purchasing the same merchandise either directly from sellers in the low-priced territory or from buyers in the low-priced territory who bought the merchandise intending to resell it. Because arbitrage is prevented, the trademark owner can charge different prices in the separate markets. Thus, a ban on gray-market imports would allow the trademark owner to engage in monopolistic price discrimination.<sup>24</sup>

The fallacy of this argument is that a trademark does not confer market power on its owner.<sup>25</sup> The owner of a trademark, unlike the owner of a patent, cannot prevent potential competitors from making the same or a similar product. As long as a competitor does not affix a confusingly similar trademark to its merchandise, it can manufacture and promote the same or a similar product. Thus, any alleged failure to enter the market is an indication not of the trademark owner's monopoly power, but of market competition. Unless there are barriers to entry,<sup>26</sup> an entrepreneur would

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21. See J. HIRSHLEIFER, *PRICE THEORY AND APPLICATIONS* 350-52 (2d ed. 1980).

22. For an economic argument that a trademark is a source of monopoly power, see E. CHAMBERLAIN, *THE THEORY OF MONOPOLISTIC COMPETITION* 61-64 (1962).

23. 15 U.S.C. § 1114 (1982).

24. See Dam, *supra* note 6, at 48.

25. For an economic argument why a good reputation would not confer market power on its owner or serve as a barrier to entry, see generally Shapiro, *Premiums for High Quality Products as Returns to Reputations*, 98 Q.J. ECON. 659, 678 (1983).

26. A barrier to entry is a condition that makes the costs of entry higher for new firms than for existing firms. G. STIGLER, *ORGANIZATION OF INDUSTRY* 67 (1968). Barriers to entry improve the chances that the firms already in the market will be able to charge monopoly prices. See R. POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE* 48-50 (1976).

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enter the market if the expected return from promoting a new trademark justified the investment.<sup>27</sup> Thus, the absence of new trademarks indicates the consumers' unwillingness to pay the trademarked items' promotional cost.<sup>28</sup> Therefore, since trademarks are not legally created monopolies, it would be inappropriate to conclude that gray-market imports are always the result of monopolistic price discrimination.<sup>29</sup>

*United States v. Guerlain, Inc.*<sup>30</sup> illustrates the erroneous view, as applied to the gray market, that trademarks are legally created monopolies, which give their owners the opportunity to earn monopoly profits. In *Guerlain*, the Department of Justice charged each of the three defendants, Guerlain, Parfums Corday, and Lanvin Parfums, with attempting to monopolize and monopoliz-

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27. Although the problem of monopolistic price discrimination is probably minimal in the context of gray-market goods, there might be some cases in which it occurs. In order to prevent market segmentation in these cases, it might be desirable to establish a procedure that would deny a trademark owner the right to exclude genuine merchandise from entry into the United States, if it could first be shown by the Antitrust Division of the Department of Justice that the trademark owner was engaging in monopolistic price discrimination. The burden on the party seeking to deny the trademark owner the right to exclude should be heavy because the probability of monopolistic price discrimination is small.

28. See R. CRASWELL, TRADEMARKS, CONSUMER INFORMATION, AND BARRIERS TO COMPETITION 21-23 (1979) (Federal Trade Commission Policy Planning Issues Paper). For a discussion of the relationship among trademarks, advertising, and competition, see F. SCHERER, *supra* note 19, at ch. 14.

29. A related argument posits the requisite market power in product differentiation. For a discussion of the relationship between product differentiation and market power, see F. SCHERER, *supra* note 19, at ch. 14. This argument first recognizes that gray-market goods are not fungible goods, but rather are differentiated brands of goods. The argument maintains that market power exists because of the trademark, product differentiation, and consumer preferences across brands. The flaw in this argument is that consumer preferences cannot give the manufacturer of a brand the market power to charge persistently anticompetitive prices in the U.S. market. Brand loyalty might explain short-run market power, but if advertising can create brand loyalty and thereby somewhat insulate a manufacturer from competition, all products would be heavily advertised. See R. POSNER, *supra* note 26, at 92-93. Gray-market imports would then affect all brands within a class, and not only those with the best reputations. Arguments have also been made that a first-mover, that is, the first firm in an industry, has a competitive advantage. See F. SCHERER, *supra* note 19, at 260, 384, 427-28, 445-47; O. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 34-35 (1975). I am, however, unaware of evidence suggesting that gray-market imports affect the brands of first-movers more than those of later entrants.

30. 155 F. Supp. 77 (S.D.N.Y. 1957), *vacated*, 358 U.S. 915 (1958).

ing the importation into and sale within the United States of trademarked perfumes, in violation of the Sherman Act.<sup>31</sup> The *Guerlain* defendants were all U.S. corporations with a close association to the French company that had originated the trademark and first marketed the goods.<sup>32</sup> In each case, the French company gave its associated U.S. company exclusive distribution rights for the U.S. market, and transferred to the U.S. company its trademark rights. In accordance with section 526, each of the defendants filed their trademarks with the Bureau of Customs to prevent the unauthorized importation of products bearing those trademarks.<sup>33</sup> The government contended that such a use of section 526 constituted a violation of section 2 of the Sherman Act.<sup>34</sup>

According to the *Guerlain* court, a charge of illegal monopolization required a finding of both monopoly power and intent to monopolize.<sup>35</sup> The court reasoned that because a quality perfume could not sell without a famous name, the availability of the identical perfume without a recognized and respected trademark would have a negligible effect on the well-known brand.<sup>36</sup> Therefore, the court found that each of the defendants had monopoly power over the market consisting of its own trademarked product. Judge Edelstein made this finding, even though he noted that "about 90 different manufacturers sell over 408 perfumes of different names in the United States and of these manufacturers, 61 sell toilet goods in the same price range as the toilet goods sold by defendants."<sup>37</sup> Judge Edelstein also noted that of all the perfume sold in the defendants' price range, the CORDAY brands combined accounted for 1.7 percent of the market, the GUERLAIN brands for 2.9 percent and the LANVIN brands for 5 percent.<sup>38</sup> Monopoly power, which is the ability to maintain price substan-

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31. *Id.* at 79.

32. *Id.*

33. *Id.*

34. Section 2 of the Sherman Act reads in pertinent part as follows: "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony . . . ." 15 U.S.C. § 2 (1982).

35. *Guerlain*, 155 F. Supp. at 83.

36. *Id.* at 84-85.

37. *Id.* at 84 n.22.

38. *See id.* at 88-98.

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tially above the competitive level, requires more than a miniscule market share.<sup>39</sup> Based on the facts in *Guerlain*, it cannot be denied that each brand competed against other well-known brands and, therefore, that none of the defendants had monopoly power.<sup>40</sup> Thus, although a quality perfume needs a well-known name to succeed in the market, the existence of a trademark is not a source of monopoly power. Consequently, the gray-market imports were not a response to monopoly pricing of perfume in the United States.

Furthermore, the current jurisprudence on vertical restraints suggests that a ban on the importation of gray-market goods would not be anticompetitive. Although granting a U.S. trademark owner the right to exclude the genuine articles that bear the owner's trademark would restrain trade, such a restraint would effectively amount to a vertical, nonprice restraint.<sup>41</sup> Since 1977, the U.S. Supreme Court's approach to vertical, nonprice restraints has been to examine them under a rule of reason.<sup>42</sup>

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39. See R. POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE* 102 (1976).

40. See Lavey, *Patents, copyrights, and trademarks as sources of market power in anti-trust cases*, 27 *ANTITRUST BULL.* 433, 434-35 (1982) (to determine whether the owners of a trademark has an economic monopoly a court should look beyond the exclusive legal right, define the relevant market and measure its competitiveness). The differentiated pricing of perfume in the United States and France reflects the greater retail success of some perfumes in one country or the other. See *LEXEGON INC.*, *supra* note 2, at 54-55.

41. Private restraints on trade are classified as vertical or horizontal and as price or nonprice. A vertical restraint is a restriction agreed to by parties on different levels of the distribution stream, such as an agreement between a manufacturer and a retailer. A horizontal restraint is a restriction agreed to by parties at the same level of the distribution stream, such as an agreement between two manufacturers of the same product. A price restraint is a restriction on selling prices, whereas a nonprice restraint is a restriction on some other aspect of the movement of goods. The restriction from enforcing section 526 would be vertical, as opposed to horizontal, because the trademark owner would be deciding how to distribute its product, rather than agreeing with one or more competitors on how they would divide the market. The restriction is also a nonprice restraint because it gives different entities the exclusive right to sell the goods in different countries.

42. The Supreme Court adopted the rule-of-reason standard for vertical, nonprice restraints in *Continental T.V., Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977). Prior to the Court's decision in *Sylvania*, vertical, nonprice restraints had been held *per se* illegal. *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967). For a discussion of vertical restraints following the Supreme Court's decision in *Sylvania* see Bork, *Vertical Restraints: Schwinn Overruled*, 1977 *SUP. CT. REV.* 171; Posner, *The Rule of Reason and the Economic Approach: Reflections on the Sylvania Decision*, 45 *U. CHI. L. REV.* 1 (1977).

Vertical restraints on competition are generally considered to be procompetitive, not anticompetitive, especially when there is significant competition among different brands, because they allow competition in merchandise distribution. Vertical restraints do not restrict competition among competing brands.<sup>43</sup> Therefore, it is unlikely that consumers would be injured by a ban on gray-market imports through persistently higher prices because, if it were profitable to do so, either importers would import similar foreign products that do not bear trademarks identical to U.S. trademarks, or manufacturers would go abroad and produce items for export to the United States.<sup>44</sup>

#### ECONOMIC CAUSES AND CONSEQUENCES OF GRAY-MARKET IMPORTS

The causes and consequences of gray-market imports are intimately bound up with the role that trademarks play in the development and manufacture of goods and their subsequent promotion and sale in the United States. Therefore, in order to understand how gray-market imports impair the system of trademarks and injure the economy, it is necessary to understand how trademarks function.

##### *How Trademarks Function*

Trademarks are not a unique feature of the U.S. economy, but are a common feature of all developed economies, including the nonmarket economies.<sup>45</sup> By allowing consumers to gather infor-

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43. Several prominent commentators have suggested that exclusive distribution agreements should be held lawful in all cases. Bork, *supra*, note 42; Easterbrook, *The Limits of Antitrust*, 63 TEX. L. REV. 1 (1984); Liebler, *Interbrand "Cartels" Under GTE Sylvania*, 30 UCLA L. REV. 1 (1982); Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6 (1981). All of their arguments should apply with as much force to the gray-market issue.

44. The inquiry that restrictions that can be privately enforced are procompetitive, but restrictions that are enforced by governments are anticompetitive is a false one. The distinction should focus on the effect of the restriction on competition, rather than on the most appropriate means of enforcing the restriction.

45. See J. MCCARTHY, TRADEMARKS AND UNFAIR COMPETITION § 2:1 (1984) (the People's Republic of China has a system of compulsory trademark registration); F. SCHERER, *supra* note 19, at 378 (Soviet economic planners have found that requiring "consumer goods manufacturers to imprint their individual production marks on products helped guard against deteriorating quality standards").

## GRAY-MARKET IMPORTS

mation, trademarks provide the impetus for the introduction and maintenance of high-quality goods in the marketplace. Trademarks allow consumers to identify the products of one source and distinguish them from those of other sources.<sup>46</sup> When consumers can distinguish among different brands of the same product,<sup>47</sup> they can collect information about the individual brands, rather than just about the general product.<sup>48</sup> This allows consumers to purchase the brands they like and avoid those they do not.<sup>49</sup>

Consumers who are pleased with a brand will pay more for it than they will pay for a brand of lower or less-certain quality.<sup>50</sup> This premium, which is the return to the trademark owner for its investment, provides the manufacturer with the incentive to produce high-quality goods and to maintain their quality.<sup>51</sup> The trademark owner's investment includes not only the cost of promoting the product, but also the cost of producing and maintaining a quality product.<sup>52</sup> With a distinctive trademark,<sup>53</sup> the

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46. Section 45 of the Lanham Act defines a trademark by its identifying function. A trademark is defined to include "any word, name, symbol, or device or any combination thereof adopted and used by a manufacturer or merchant to identify his goods and distinguish them from those manufactured or sold by others." 15 U.S.C. § 1127 (1982).

47. The term "brand" is used to refer to the products sold under a given trademark.

48. R. CRASWELL, *supra* note 28, at 7.

49. F. SCHERER, *supra* note 19, at 378 ("if there were no brand names and trademarks, the consumer might never be sure who made a product and would have difficulty rewarding through repeat purchases manufacturers who achieve high quality or cater to his or her special tastes"); Statement by William F. Baxter, before the Senate Committee on the Judiciary concerning S. 2428 (Sept. 15, 1982), quoted in J. MCCARTHY, *supra* note 45, at 44-45 ("[T]rademarks play a crucial role in our free market economic system. By identifying the source of goods or services, marks help consumers to identify their expected quality and, hence, assist in identifying goods and services that meet the individual consumer's expectations . . ."); A. MILLER & M. DAVIS, *INTELLECTUAL PROPERTY IN A NUTSHELL* 147 (1983) ("[T]oday, trademark law allows a buyer to assert a preference in his or her purchasing . . ."); J. GILSON, *TRADEMARK PROTECTION AND PRACTICE* § 1.03[3] (1985) ("[T]o consumers, trademarks play a vital role. They permit the selection of products or services which are desired and the avoidance of those which are not . . .").

50. Shapiro, *supra* note 25, at 659.

51. J. MCCARTHY, *supra* note 45, § 2:1 ("[T]rademarks fix responsibility. Without marks, a seller's mistakes would be untraceable to their source. Therefore, trademarks create an incentive to keep up a good reputation for a predictable quality of goods"); *see* Shapiro, *supra* note 25, at 660-61.

52. These costs can be substantial; they include the costs of developing the product, providing warranty services, and promoting the product, including brand advertising.

trademark owner fully internalizes the benefits of any changes in the product's quality.<sup>54</sup> The capitalized value of the flow of future premiums is the goodwill associated with the trademark. In market equilibrium, the expected present value of the stream of premiums will just compensate the trademark owner for its investment.<sup>55</sup> Because consumers recognize the trademark, the goodwill is associated with the trademark and not with the trademark owner.<sup>56</sup>

If there were no trademarks, the goods available on the market would be of much lower quality.<sup>57</sup> Without trademarks, different brands of the same product would be indistinguishable. As a result, consumers would gather only general information about the product and would not be able to collect individual brand information. No producer, then, would get the entire benefit from its quality improvements. Similarly, a producer would be able to externalize the cost of reduced quality over all producers of the same product. Because consumers would not be able to distinguish one brand from another, their only basis for making a selection would be price. In order to compete for customers, therefore, producers would reduce quality in order to cut costs. Thus,

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Gray-market importers do not bear any of these costs, but they benefit from them. A COPIAT survey of its members found that on average its members spent an amount equal to 19.3 percent of their annual sales on brand advertising. This number is probably an upperbound since COPIAT is actively involved in the fight against gray-market imports. COLLADO ASSOC., *supra* note 1, at 13.

53. A distinctive trademark is a mark that distinguishes goods from one source from those of other sources.

54. See R. CRASWELL, *supra* note 28, at 7.

55. See Klein & Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981); Shapiro, *supra* note 25, at 659.

56. J. MCCARTHY, *supra* note 45, § 2:7; A. MILLER & M. DAVIS, *supra* note 49, § 13.1.

57. As J. Thomas McCarthy has observed:

It cannot be blithely assumed that brands are unimportant because most branded goods on the market appear to be of a generally acceptable quality. Of course, goods of uniformly poor quality soon disappear from the market. A maker of a shoddy product can only fool some of the people some of the time. The generally high uniformity of quality that exists may itself be the result of the use of brands and trademarks. Only by observing a trademarkless environment could one see the importance of marks.

J. MCCARTHY, *supra* note 45, § 2:1 (emphasis in original).

## GRAY-MARKET IMPORTS

without trademarks, there would be a race to manufacture poorer-quality goods.<sup>58</sup>

The preceding two paragraphs present two discrete scenarios: a world with perfect trademarks in which producers have an incentive to produce high-quality goods, and a world without trademarks in which producers race to produce low-quality goods. The real world, however, represents an intermediate state of affairs in which trademark owners capture only some portion of the flow of premiums from the goodwill they have developed. Trademark law, especially the doctrine of trademark infringement, attempts to ensure that the trademark owner captures as much of the returns from its trademark's goodwill as possible. Gray-market imports, however, divert some portion of the premiums from the trademark's goodwill, and thus interfere with the functioning of the trademark system.

### *The Free-Rider Problem*

Independent importers will find a market for gray-market goods in the United States when the U.S. price is sufficiently higher than the foreign price to make transshipping profitable.<sup>59</sup> There are four possible causes of persistent price differences, and thus of gray-market imports, three of which involve free riding.<sup>60</sup> Free riding occurs when benefits are enjoyed by individuals who can avoid paying for them. A classic example of free riding involves

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58. As Richard Craswell has observed:

If there were no trademarks and consumers could learn only about the quality distribution of the industry as a whole, a manufacturer would gain little or nothing from improving his product's quality. Consumers would be unable to recognize high- or low-quality brands, so sales would tend to go to manufacturers who reduced their price by cutting corners on quality. The result would be a race to produce inferior products, rather than competition to produce better ones.

R. CRASWELL, *supra* note 28, at 7.

59. See *supra* notes 8-10 and accompanying text.

60. Those who benefit from the services without incurring the costs are called free-riders by economists. For a discussion of the free-rider problem, see J. HIRSHLEIFER, *supra* note 21, at 561-65. In the context of gray-market imports both arbitrage and free-riding involve shipping goods from a low-priced to a high-price territory. With free riding the price difference is a result of different levels of investment, whereas with arbitrage the price difference is a result of price discrimination.



national defense. Whereas all members of an alliance benefit from their mutual defense because any member's threat of retaliation reduces the threat of attack against each, each member is tempted to take a free ride on the efforts of the others by reducing its defense spending. Thus, unless there is an independent means of inducing the members to contribute, some will contribute less than their share, and less than the optimal amount of defense will be provided.<sup>61</sup> The free-rider problem is central to an understanding of the gray market. The trademark owner and the authorized dealers make the investments and provide the services that increase the desirability of the brand, and from which importers, retailers, and purchasers of gray-market merchandise benefit, but for which they do not pay.

*The First Cause of Gray-Market Imports: Free Riding on Reputation*

The first cause of gray-market imports is free riding on the U.S. trademark owner's reputation. By diverting sales away from the trademark owner's authorized distribution network to that of the unauthorized importers, gray-market importers appropriate some of the return from the trademark's goodwill. Each time the authorized distribution channel loses a sale to the unauthorized distribution channel, the trademark owner loses its premium for providing a product of high and consistent quality. The redirection of this premium is generally recognized by the law as unfair.<sup>62</sup> In addition, permitting a gray-market importer to take a free ride on the trademark owner's reputation reduces future trademark owners' incentives to provide quality products.

A U.S. trademark is associated with a level of goodwill in the United States. This same trademark will also be associated with a level of goodwill in other countries where it is used. This goodwill is created by the trademark owner through a costly investment in product development, marketing and quality control.<sup>63</sup> The trademark owner must also convince the public that it will maintain a constant level of quality. In addition, if the product is of high quality, and thus expensive to produce, it must convince consumers that it is worth its high price. Thus, the

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61. M. OLSON, *THE LOGIC OF COLLECTIVE ACTION* 1-52 (1971); Olson & Zeckhauser, *An Economic Theory of Alliances*, 48 *REV. ECON. & STAT.* 267 (1966).

62. See A. MILLER & M. DAVIS, *supra* note 49, at 180-183.

63. See *supra* notes 50-55 and accompanying text.

goodwill associated with a trademark will depend on the amount of the investment and the effectiveness of that investment. Therefore, there is no reason to expect the level of goodwill to be the same in two separate markets.<sup>64</sup>

The perfume market, for example, is highly competitive, and OPIUM by Yves St. Laurent accounts only for a small portion of that market; thus, any price difference for OPIUM between markets is likely to be the result of the size and effectiveness of the investments. OPIUM, which is manufactured in France, can be purchased retail in Paris and shipped to the United States for \$69 an ounce, including freight and customs. In the United States, the same perfume has a wholesale price of \$96 an ounce and retails for \$160 an ounce.<sup>65</sup> When OPIUM is sold in the United

64. In order for goodwill developed by the U.S. trademark owner to be the cause of gray-market imports, the United States must be a separate and distinct market. Market boundaries and national boundaries are not always coextensive, but they often are because the exchange of information and goods tends to occur more freely within a nation than between nations. Many nations have a single national language, and contiguous nations frequently have different languages. In addition, the media, whether it is print, radio, or television, is often limited by national boundaries. Furthermore, there are a number of reasons why goods might not flow freely between two countries, thereby making the two countries separate markets. First, and most conspicuously, tariffs or quotas frequently hinder trade between two countries. Second, other nontariff barriers, such as emission and safety standards for automobiles or testing requirements for pharmaceuticals, can prevent the free flow of goods between nations. Third, the cost of transporting goods between two countries, which includes exchange rate risk and the cost of complying with Customs' regulations, tends to justify treating different nations as separate markets. Finally, countries have separate and different legal systems, especially antitrust laws, trademark laws and licensing requirements. See *infra* notes 135-141 and accompanying text. All of these reasons would tend to cause trademarks to embody different amounts of goodwill in different countries. Treaties, international agreements, and the U.S. Supreme Court have recognized that an identical trademark can represent different amounts of goodwill in separate national markets. Paris Convention for the Protection of Industrial Property, art. 6(3), Mar. 20, 1883, as revised July 14, 1967, 21 U.S.T. 1583, T.I.A.S. No. 6923 (entered into force Aug. 25, 1973, 24 U.S.T. 2140, T.I.A.S. No. 7727). Article 6(3) of the Paris Convention, to which the United States is a signatory, provides that "[a] mark duly registered in a country of the Union, shall be regarded as independent of marks registered in the other countries of the Union, including the country of origin." *Id.* See Dernberg, *Territorial Scope and Situs of Trademarks and Goodwill*, 47 VA. L. REV. 733 (1961); *Osawa & Co. v. B & H Photo*, 589 F. Supp. 1163, 1171 (S.D.N.Y. 1984). This principle—that trademarks are national, not universal—is called the principle of territoriality and in U.S. law is derived from Justice Holmes' opinion for the U.S. Supreme Court in *A. Bourjois & Co. v. Katzel*, 260 U.S. 689 (1922).

65. *The Gray Market: Where a \$200 Watch Can Be Bought for \$140*, Wash. Post, Dec. 16, 1984, at L1, col. 1.

States, the authorized U.S. distributor, Charles of the Ritz, loses his premium from OPIUM's U.S. goodwill.<sup>66</sup>

The story is the same—only the magnitude changes—when the U.S. and foreign trademark owners are related. If Charles of the Ritz is independent of the French trademark owner, then Charles of the Ritz will lose its entire premium when a gray-market bottle of OPIUM is sold in the United States. If, however, Charles of the Ritz is part of Yves St. Laurent, then Yves St. Laurent still earns its French rather than its U.S. premium. In order for transshipping to be profitable to independent importers, however, the U.S. price must exceed the French price by more than the cost of shipping. Because both the authorized and unauthorized product must be shipped to the United States, there will be an incentive to transship when the U.S. premium is higher than the French premium. Therefore, even when the U.S. and foreign trademark owners are related, the combined owner of the U.S. and foreign trademarks will still lose part of its premium from gray-market imports.

The gray-market importer gets a free ride because the trademark owner makes the investment that creates the premium, whereas the gray-market importer captures the premium without making any investment.<sup>67</sup> The trademarked good's premium is

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66. Charles of the Ritz's premium on OPIUM is the difference between its cost and the \$96 wholesale price.

67. A similar practice was condemned by the Supreme Court in the leading case on unfair competition, *International News Service v. Associated Press*, 248 U.S. 215 (1918), as both unfair and illegal. In that case, the International News Service (INS) was copying news gathered and prepared by the Associated Press (AP) from bulletin boards and early East Coast editions of papers subscribing to its service. INS argued, using the exhaustion doctrine, that once AP published the news it had collected it lost all rights to that news and could no longer prevent INS from using it. The Supreme Court, however, rejected INS's argument and enjoined it from taking the news from bulletin boards and early editions on the grounds of unfair competition. Justice Pitney characterized INS's behavior as follows:

In doing this defendant, by its very act, admits that it is taking material that has been acquired by complainant as the result of organization and the expenditure of labor, skill, and money, and which is salable by complainant for money, and that the defendant in appropriating it and selling it as its own is endeavoring to reap where it has not sown, and by disposing of it to newspapers that are competitors of complainant's members is appropriating to itself the harvest of those who have sown. *Stripped of all disguises, the process amounts to an unauthorized interference with the normal operation of complainant's*

## GRAY-MARKET IMPORTS

the trademark owner's return on its investment promoting the trademark and developing and maintaining a high quality product.<sup>68</sup> Gray-market imports reduce the flow of premiums to the trademark owner.<sup>69</sup> The redirection of such premiums is a cost to future trademark owners because the expected returns from investing in trademarks and trademarked merchandise will decline.

The current lax policy toward gray-market imports reduces a manufacturer's expected return from developing and promoting a product. A manufacturer deciding today whether to develop a new line of merchandise, therefore, will anticipate a diminished flow of future premiums if it expects gray-market importers to import its products. Such a manufacturer will probably respond by making a smaller investment in marketing, by producing a lower-quality product, or by withdrawing from research and development. As a result, some products might never be introduced into the marketplace, whereas others will be introduced at a lower level of quality than they would otherwise be. Because both the premium and the opportunities for transshipping are greater the higher the product's quality, the possibility of gray-market imports reduces the expected return from providing a high-quality prod-

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*legitimate business precisely at the point where the profit is to be reaped, in order to divert a material portion of the profit from those who have earned it to those who have not, with special advantage to defendant in the competition because it is not burdened with any part of the expense of gathering the news. The transaction speaks for itself, and a court of equity ought not to hesitate long in characterizing it as unfair competition in business.*

*Id.* at 239-40 (emphasis added).

68. This is the economic concept of equilibrium. Economists call the premium a quasi-rent. See Klein & Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 626-29 (1981).

69. The goodwill of a mark is often developed over a long period of time. It also depreciates, but only slowly, unless something occurs to sharply reduce the desirability of the brand in the estimation of consumers. Thus, the premium earned by a manufacturer today is likely to be the result of an investment made in the past. Consequently, a comparison of the investments currently being made by a trademark owner in different countries is not sufficient to determine whether there is the same amount of goodwill in the two countries. Furthermore, even if the investments were correctly compared, it is quite possible that a brand would have a better reputation in one country than in another. This could be because investments in goodwill are generally more effective in one country or because one investment just turned out to be better than the other.

uct more than it reduces the return from providing a low-quality product. Thus by redirecting the trademark owner's premium, gray-market imports will reduce the average quality of goods on the market.<sup>70</sup>

*The Second Cause of Gray-Market Imports: Free Riding on Services*

The second cause of gray-market imports is free riding on services. National distributors, regional wholesalers, or local retailers often provide services that increase the demand for their products. Those that provide these services, and incur the cost of doing so, can be taken advantage of by those that do not provide them, unless the former can exclude consumers who do not purchase from them. If exclusion is not possible, a discounter can undercut the authorized dealers while benefiting from the services they provide. Such discounters are said to take a free ride on the services of the authorized dealer. In order to understand this cause of gray-market imports and how it injures the domestic economy, it is necessary to understand why trademark owners often restrict the distribution of their products.<sup>71</sup>

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70. *Id.* There are two reasons to expect that permitting gray-market imports will lead to a reduction in the quality of goods in the market. First, goods that command a large premium in the United States are more likely to be sold elsewhere at a low enough price to justify the cost of transportation than are goods that command a small premium. Thus, permitting gray-market imports into the United States will reduce the potential gains from developing high-quality goods relative to the potential gains from producing low-quality goods. Second, gray-market imports, by reducing the trademark owner's premium, will reduce the trademark owner's incentive to maintain the quality of its brand, and may even induce the owner to intentionally debase the product. The trademark owner's premium is an important mechanism for assuring that the trademark owner maintains the quality of its product. If the price of a high-quality product just covers its cost of production, then producers of such goods could gain by cutting quality and earning a profit until consumers learned of the deception. The discounted flow of premiums these manufacturers earn, if high enough, can deter them from cutting quality because they will lose this flow if they cheat. Gray-market goods, which reduce the premium, lower the cost to the manufacturer of cheating, and thus make cheating more likely. *See id.* Thus, even genuine gray-market goods of the same quality as the authorized goods can induce manufacturers to reduce the quality of their already existing goods. *See id.*

71. In recent years, the large and growing literature on restricted distribution agreements has had a significant impact on the judicial treatment of such agreements. For a recent overview of the arguments why manufacturers would impose vertical restraints, see T. OVERSTREET, *RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE* §§ II-IV (Bur. of Econ. Staff Report to the Fed. Trade Comm. 1983).

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A trademark owner benefits by having its product available in many outlets because it is easier for consumers to purchase the brand, which, in turn, increases sales. In addition, the greater the number of retail outlets that sell a given brand, the greater the competition among retailers. This competition reduces the dealer mark-up on the product, thereby increasing both the brand's overall sales and profits. Thus, if a trademark owner chooses to restrict the distribution of its brand, it must receive a benefit that it values more than increased retailer competition and ease of purchase. A trademark owner restricts distribution in order to induce its distributors and dealers to provide special services they would not otherwise provide.<sup>72</sup>

The classic argument for providing special services involves retailers.<sup>73</sup> A trademark owner that wants to market a product successfully must promote the brand. Furthermore, the desirability of many products increases when the seller provides services. Such services might include educating potential consumers about the product, repairing the product under warranty, or maintaining an inventory of accessories that can be used with the product. Many of these services can be provided more efficiently by the distributors and retailers than by the trademark owner. Competing retailers, however, have little incentive to market the brand or to provide special services because the actions undertaken and paid for by any one retailer will benefit many retailers. Since a retailer who makes such an investment would not receive all of the benefits from its investment, the retailer lacks the incentive to make the investment, or at least to make as large an investment as the trademark owner would desire.<sup>74</sup>

A camera company, for example, might have found that its dealers market its camera more efficiently when they take the time to show potential customers how the camera works.<sup>75</sup> Indeed, if some retailers provided this service and others did not, rational consumers would go, first, to the retailers providing the service

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72. *Id.*

73. Telser, *Why Should Manufacturers Want Fair Trade?*, 3 J.L. & ECON. 86 (1960).

74. See T. OVERSTREET, *supra* note 71, at 49-51.

75. Having retailers charge customers directly for this service will probably not be practical because consumers cannot gauge how valuable this service is to them before they buy it, and have no incentive to pay for it after they have consumed it. See *id.* at 51 n.3.

in order to learn about the different brands, and then, to a discount house that did not provide the service to make their purchases. The full-service retailer would find that it was losing paying customers and that its usual mark-up did not cover the costs for the services provided. If it wanted to continue to provide the services, it would have to increase its mark-up, which would cause it to lose even more customers to discounters. In response, it would have to raise its mark-up even more. Such a retailer would eventually have to stop providing the services. The situation would be the same for all of the company's full-service retailers. Eventually, the company would find that none of its retailers would be willing to provide the desired services.<sup>76</sup>

If the company wants services provided, it must protect the dealers that provide them from low-cost dealers that do not. One way of protecting dealers' margins would be through resale price maintenance (RPM), a policy by which the manufacturer sets a minimum retail price for its product. RPM allows a company to prevent its dealers from competing by cutting services and charging lower prices; that is, it allows the company to force dealers to compete through the provision of services.

Although substantial academic opinion says that RPM should be legal,<sup>77</sup> it is still per se illegal.<sup>78</sup> Manufacturers, therefore, have turned to nonprice restraints to protect dealers' margins and to ensure the provision of special services. The most common techniques used to induce the provision of services fall under the rubric "exclusive distribution."<sup>79</sup> These techniques include exclusive distributorships, authorized dealers, and location clauses. According to current antitrust law, these techniques are judged under a rule of reason, and will be upheld if reasonable.<sup>80</sup>

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76. *See id.* at 49.

77. For a list of authorities, see *id.* at 13 n.1.

78. *See California Retail Liquors Dealers Association v. Midcal Aluminum, Inc.*, 445 U.S. 97, 102 (1980).

79. Vertical restraints can be used to protect dealer margins and the manufacturer can require the dealer provide special services. Gray-market goods, which enter the United States through unauthorized channels, can be sold at lower prices than their domestic counterparts, because the retailers of gray-market goods do not have to provide the special services. Instead, the gray-market retailer can allow the authorized dealer to provide pre-sale services and then sell the merchandise at a lower price. The additional markups that result from the special services provide one incentive for parties to import gray-market goods. This is especially true when the goods are imported from markets where these services are not provided.

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

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Retailers of gray-market imports frequently get a free ride on the services provided by authorized distributors, wholesalers, and dealers. The retailer of gray-market merchandise does not have to provide any services, even though the distributor can legally induce all retailers into providing them. For example, because retailers of gray-market cameras do not have to maintain an inventory of accessories, the purchaser of a gray-market camera can buy his accessories from an authorized dealer that maintains a large stock. Free-riding retailers of gray-market merchandise get the benefit of these services without paying for them.<sup>81</sup> This reduces the returns to those in the authorized distribution chain, thereby making it more difficult for the manufacturer to require the provision of services. Thus, gray-market imports are likely to reduce the level of services provided to the consumer.<sup>82</sup>

In addition to gray-market retailers getting a free ride on the services provided by U.S. retailers, gray-market importers get a free ride on the services provided by the U.S. distributor-trademark owner. Some distributors provide services directly, either instead of or in addition to the services provided by their retailers.<sup>83</sup> While distributors pay for these services from the proceeds of their sales, retailers and consumers pay for these services through higher prices. Gray-market importers, however, do not pay for these services when they purchase goods abroad because the price of the goods abroad will not include the cost of the services provided by the U.S. trademark owner.<sup>84</sup> By taking sales

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81. One argument made by gray-market retailers is that they also advertise and provide services. See *Osawa & Co. v. B & H Photo*, 589 F. Supp. 1163, 1167 (S.D.N.Y. 1984). This response misses the point. Although retailers of gray-market imports advertise, they do not advertise to promote the brand, but rather to publicize their low prices. *Id.* More generally, because they are beyond the reach of the trademark owner, they do not have to provide the same kind and level of services as the authorized dealers. Because the trademark owner can only induce its dealers to provide these services through the use of vertical restraints, it is very unlikely that retailers of gray-market imports will voluntarily provide the same services.

82. These services benefit consumers who in general value them at least as much as it costs retailers to provide them. See R. POSNER & F. EASTERBROOK, *ANTITRUST* 213 (2d ed. 1981). If consumers were not willing to pay for these services, then competition among manufacturers would lead to their elimination.

83. These services include clinics and brand advertising. *Osawa*, 589 F. Supp. at 1176.

84. The gray-market importer may pay abroad for services that are not used. It cannot, however, be assumed that a related United States trademark owner is not



away from the authorized chain of distribution, gray-market importers will increase the cost to the U.S. distributor-trademark owner of providing services, which will most likely reduce the services provided.

*The Third Cause of Gray-Market Imports: Importation of Inferior-Quality Goods*

The third and most damaging class of gray-market goods is inferior-quality gray-market merchandise. Inferior-quality goods not only redirect the premium away from the trademark owner, but also injure the trademark owner's goodwill, reducing the expected future stream of returns that flow from the trademark. When a consumer purchases an inferior-quality item, his estimate of the brand's quality declines.<sup>85</sup> This reduces the goodwill the trademark owner enjoys and, as a result, the premium the brand can command in the future.<sup>86</sup> Inferior-quality gray-market goods arise in two forms: identically produced goods that become inferior to the authorized goods because of improper care during importation, and foreign goods of inherently different quality than the domestic goods.

There is good reason to expect that gray-market importers will not take as much care as the trademark owner and authorized

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thereby injured, because the level of services might be greater in the United States. This is likely to be true because the gray-market importer will not import the product unless the U.S. price is sufficiently above the foreign price to justify the expense of transshipping. Alternatively, if the foreign distributor is the source of the gray-market goods, the price will not include the cost of foreign services.

85. See R. CRASWELL, *supra* note 28, at 7, and discussion, *infra* notes 92-99 and accompanying text.

86. As Justice Holmes observed in *Bourjois*:

Ownership of the goods does not carry the right to sell them with a specific mark. It does not necessarily carry the right to sell them at all in a given place. If the goods were patented in the United States a dealer who lawfully bought similar goods abroad from one who had a right to make and sell them there could not sell them in the United States. . . . The monopoly in that case is more extensive, but we see no sufficient reason for holding that the monopoly of a trade mark, so far as it goes, is less complete. *It deals with a delicate matter that may be of great value but that easily is destroyed, and that therefore should be protected with corresponding care.*

*Bourjois & Co. v. Katzel*, 260 U.S. 689, 692 (1922) (emphasis added).

## GRAY-MARKET IMPORTS

distributors.<sup>87</sup> Unlike the trademark owner that receives the benefits of its quality control, as well as the losses from its shortcomings, the gray-market importer does not receive all of the benefits from his quality control. If the gray-market importer takes appropriate care, then the consumers who purchase the goods he imports will have a good opinion of the brand, and may even repurchase it. On the other hand, if the gray-market importer takes inadequate care, then the brand's reputation will suffer and there will be fewer repurchases. Because any one gray-market importer supplies only a small share of the market, he receives a small amount of the benefit from the brand's enhanced reputation if he takes appropriate care. On the other hand, since the gray-market importer can easily turn his attention to importing other goods, he can avoid almost all of the costs of improper handling.<sup>88</sup> The gray-market importer, therefore, cannot internalize all of the benefits of proper handling, whereas he can externalize much of the costs of improper handling.<sup>89</sup> This is the free-rider problem once again.<sup>90</sup> Thus, it is reasonable to expect that gray-market goods will often receive inadequate care during importation.<sup>91</sup>

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87. See *Osawa & Co. v. B & H Photo*, 589 F. Supp. 1163, 1172-73 (S.D.N.Y. 1984).

88. This is not to say that there are no market forces to encourage proper care. The gray-market importer has its own reputation to protect. The crucial point is not that the gray-market importer has no incentive to take care, but that its actions will affect the trademark owner's reputation and it does not have the same incentive that the trademark owner has to protect the goodwill of the trademark.

89. See *Adolph Coors Co. v. A. Genderson & Sons, Inc.*, 486 F. Supp. 131 (D. Colo. 1980), for an analogous situation in a purely domestic context. In *Coors*, a beer wholesaler made an unauthorized sale of trademarked beer without following strict quality control standards designed to maintain the quality of the product. The sale was held to constitute statutory and common-law trademark infringement, by damaging the manufacturer's reputation and diluting the distinctive quality of its trademark and tradename which served as a guarantee of the quality of the beer. See also *Duracell*, *supra* note 3, at 7-20; see generally Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

90. The importer who sells inferior quality gray-market merchandise takes a free ride on the trademark owner's reputation. Thus, a gray-market importer of Dom Perignon champagne who does not take proper care of his cargo will still benefit from the care taken by the authorized importer because consumers cannot distinguish between authorized and unauthorized bottles.

91. This result is likely to be true as long as the level of care affects the quality of the product and if the affected qualities cannot be ascertained before purchase. In

Gray-market imports whose quality is inferior to the higher-quality authorized product also harm U.S. trademark owners. A manufacturer may have several reasons for using the same trademark in more than one country.<sup>92</sup> Although the manufacturer might choose to use the same trademark in two or more countries, it may prefer to market slightly different products in different countries, in order to cater to local tastes. The product in one country might actually be of lower quality than the product in another country, or it might simply be of different but not necessarily lesser quality.<sup>93</sup> In either case, the unauthorized importation of the genuine product will harm the goodwill of the domestic trademark owner.

Some of the problems with gray-market goods include foreign language instruction manuals,<sup>94</sup> metric components that cannot be replaced in the United States, warranties not valid in the United States,<sup>95</sup> out-of-season merchandise,<sup>96</sup> and "seconds" quality merchandise that had already been rejected.<sup>97</sup> A consumer who associates certain qualities with a brand is likely to be disappointed when the inferior-quality gray-market import is different, and, consequently, he will reduce his estimate of the brand's quality.<sup>98</sup> As a result, the consumer will be less willing

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*Duracell* there was an allegation that importers were not properly handling the gray-market batteries. The Commission, however, refused to find that there was any measurable difference between the authorized and unauthorized batteries. *Duracell*, *supra* note 3, at 30; see also *Osawa*, 589 F. Supp. at 1168-70.

92. See *infra* notes 126-134 and accompanying text.

93. For example, a soft drink manufacturer might use the same trademark in two different countries, but produce a sweeter drink in one of these countries in order to cater to slightly different tastes. See Russell, *In the Glare of the Rising Sun*, TIME, Oct. 13, 1986, at 71.

94. *Osawa*, 589 F. Supp. at 1168.

95. *Id.* at 1167.

96. *Monte Carlo Shirt, Inc. v. Daewoo Int'l (America) Corp.*, 707 F.2d 1054 (9th Cir. 1983).

97. *El Greco Leather Products Co. v. Shoe World, Inc.*, 599 F. Supp. 1380 (E.D.N.Y. 1984).

98. A common problem with gray-market imports is that they are often not covered by U.S. warranties. A consumer who buys a camera and then discovers that it is not covered by a domestic warranty has been misled about a valuable element of the purchase. Thus, Judge Leval found that purchasers of gray-market MAMIYA cameras expected them to be covered by Bell & Howell's warranty and would become hostile to the MAMIYA trademark if their warranty claims were not honored. See *Osawa*, 589 F. Supp. at 1169.

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to purchase that brand in the future, decreasing the domestic trademark owner's sales.<sup>99</sup>

### *The Fourth Cause of Gray-Market Imports: Arbitraging International Price Differences*

The fourth cause of gray-market imports is arbitraging monopoly price differences. Price discrimination occurs when the ratio of price to marginal cost is different across markets.<sup>100</sup> In any market, this ratio depends on the elasticity of demand facing a given producer. The less elastic is demand, the greater is the ratio of price to marginal cost.<sup>101</sup> Therefore, price discrimination against the U.S. market is rational only if the manufacturer faces a less elastic demand curve in the United States than abroad.<sup>102</sup>

If a monopolist were practicing price discrimination against U.S. consumers, then independent importers would have an incentive to purchase the product abroad, import it into the United States, and sell it to U.S. consumers. If the U.S. trademark owner could not exclude gray-market imports, arbitrage would eventually raise the price abroad and reduce the price in the United States until they were equal.<sup>103</sup> As a result, U.S. welfare would increase because the gray-market imports would have reduced the anti-competitive U.S. price.<sup>104</sup>

Monopoly is widely recognized to be inefficient and socially harmful.<sup>105</sup> If a monopolist were using section 526 to segregate

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99. The harm from inferior quality gray-market merchandise depends on consumers being confused about the source of the merchandise, whereas the harm from gray-market merchandise in general exists whether or not there is consumer confusion.

100. Price discrimination includes the practice of charging a different price for the same product to different consumers even though the cost of sale to each of them is the same. Price discrimination, however, does not include the practice of charging a different price to different consumers when the differences can be accounted for by differences in the cost of sale. See R. POSNER, *supra* note 26, at 62.

101. J. HIRSCHLEIFER, *supra* note 21, at 351-56.

102. *Id.*; see also R. POSNER, *supra* note 26, at 62.

103. Strictly speaking, arbitrage will make the price difference disappear only when there are zero transportation and transaction costs. When these costs are positive, arbitrage will drive the price difference down so that the price in the high-priced market exceeds the price in the low-priced market by the total transportation and transaction costs. See J. HIRSCHLEIFER, *supra* note 21, at 236-49.

104. See generally F. SCHERER, *supra* note 19, at ch. 11.

105. See R. POSNER, *supra* note 26, at ch. 2; J. HIRSCHLEIFER, *supra* note 21, at 344-48.

markets in order to discriminate against the U.S. market, some form of remedial action might be appropriate. Supporters of gray-market imports have generally assumed that monopolistic price discrimination is the source of all gray-market imports.<sup>106</sup> This is incorrect because there are at least three other sources of gray-market imports.<sup>107</sup> If the U.S. price exceeds the foreign price because the product has a better reputation in the United States, because more services are provided in the United States, or because a higher-quality product is sold in the United States, then the price difference is not a result of price discrimination. As long as other manufacturers produce competitive products, there is no reason to assume that any price differences are not the result of differences in reputation or services that the trademark owner has provided to consumers.<sup>108</sup> Consequently, gray-market imports that result from monopolistic price discrimination are limited to instances in which the trademark owner has a monopoly in the product market.<sup>109</sup>

In order for a seller to maintain a monopoly in a U.S. product market, other firms must be prevented from entering the market and driving down the price.<sup>110</sup> Whether a seller has market power is an empirical question that must be determined on a case-by-case basis. There are, however, several reasons to expect that U.S. manufacturers generally do not have greater market power in the United States than in the foreign markets from which gray-market goods come.<sup>111</sup> First, barriers to international trade are

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106. See, e.g., Dam, *supra* note 6, at 48.

107. See *supra* text accompanying notes 62-99.

108. See LEXECON INC., *supra* note 2, at 50-56.

109. See *supra* text accompanying notes 20-29.

110. See R. POSNER, *supra* note 26, at 59.

111. When the trademark owner has a monopoly in both the domestic product market and the foreign product market, then gray-market imports will prevent monopoly price discrimination, but perhaps not monopolistic pricing. Preventing the trademark owner from segregating the two markets will destroy its monopoly power only when the foreign market is competitive. Furthermore, a trademark owner that has monopoly power in a domestic market, if it has met the conspiracy requirement, would be guilty of a violation of the Sherman Act:

Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a felony, and, on conviction thereof, shall be punished by

## GRAY-MARKET IMPORTS

generally significantly lower in the United States than abroad for most commodities.<sup>112</sup> Second, there is little evidence to suggest that product markets are more concentrated in the United States than elsewhere. The available data, in fact, support the opposite conclusion.<sup>113</sup> Third, many industries plagued with gray-market imports are neither highly concentrated nor generally considered to be characterized by anticompetitive pricing.<sup>114</sup> Therefore, monopolistic price discrimination is not likely to be a very important cause of gray-market imports.

### *The Effects of Gray-Market Imports on the Development of International Markets*

By reducing the return to manufacturers that develop and promote high-quality products, gray-market imports will not only reduce the quality and number of goods in the marketplace and the level of associated services,<sup>115</sup> they will also affect the development of international markets. Denying U.S. trademark owners the right to exclude genuine merchandise bearing the identical trademark and intended for sale abroad will reduce the willingness both of U.S. companies to enter foreign markets and of foreign companies to enter the U.S. market.

When an established U.S. company decides to market its product in a foreign country in which it is not yet established, it can either develop a new trademark or promote the original. Benefits on both the cost and demand sides favor promoting the original

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fine not exceeding one million dollars if a corporation, or if any other person, one hundred thousand dollars, or by imprisonment not exceeding three years, or by both said punishments, in the discretion of the court.

Sherman Act § 2, 15 U.S.C. § 2 (1982). Therefore, the complaint against restricting gray-market imports is misdirected. The real cause for concern is the monopoly in the product market in the United States. Price discrimination is a secondary concern. To the extent that gray-market imports are the result of monopolistic price discrimination, relief under the antitrust laws directly aimed at the monopoly in the product market is the appropriate remedy.

112. Deardorff & Stern, *The Economic Effect of Complete Elimination of Post-Tokyo Round Tariffs*, in *TRADE POLICY IN THE 1980's* 674-75 (Table 20.1) (W. Cline ed. 1983); Noguees, Olechonski, Winters, *The Extent of Nontariff Barriers to Industrial Countries' Imports*, 1 *WORLD BANK ECON. REV.* 181, 191-94 (1986).

113. F. SCHERER, *supra* note 19, at 50-54.

114. *See* LEXECON INC., *supra* note 2, at 26-56.

115. *See supra* notes 62-99 and accompanying text.

trademark. The domestic company's original trademark, even though it is not as well known abroad, still has some value that makes it worth promoting. If the goods intended for sale abroad are imported into the United States, the company's return from the goodwill it has established in the United States will decline as sales are taken away by the gray-market imports. Thus, the domestic corporation's return from developing the foreign market decreases when gray-market goods cannot be excluded. Consequently, if the U.S. trademark owner cannot exclude genuine merchandise bearing the identical trademark, it will be less likely to enter a foreign market because its expected profit will fall.

Similarly, a foreign corporation's profit from entering the U.S. market will be lower if it is unable to exclude gray-market imports.<sup>116</sup> A foreign manufacturer, therefore, will hesitate to enter the U.S. market if it cannot exclude gray-market imports. As a result, U.S. consumers may pay higher prices and face a reduced selection of goods.

#### *Summary*

This section has presented the four causes of gray-market imports. Three of these causes—free riding on goodwill, free riding on services, and inferior quality merchandise—suggest that gray-market goods are injurious to the U.S. economy. Furthermore, the first two of these causes do not depend upon consumer deception; only the third cause does. Only gray-market imports that arbitrage international price differences increase competition in the U.S. market. However, for there to be persistent price differences that result from market power, there must be barriers to entry into the market. It seems unlikely that these barriers are higher in the United States than elsewhere. Thus, the fourth cause is probably not a very important cause of gray-market imports. Finally, the four causes are not mutually exclusive, and any or all can contribute in a given situation.<sup>117</sup>

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116. At least one camera manufacturer has tried, without success, to prevent gray-market imports by selling different models in the United States and abroad. *See* COLLADO Assoc., *supra* note 1, at 36-37.

117. A camera manufacturer, for example, could conceivably have a better market reputation in the U.S. than abroad; could require its dealers to maintain larger inventories in the U.S.; could sell a superior model in the U.S.; and could have greater market power in the United States. In such a case, all four causes would contribute to gray-market imports of the camera.

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### RESPONSES TO GRAY-MARKET IMPORTS<sup>118</sup>

The current U.S. approach to gray-market imports is based on section 526 of the Tariff Act of 1930,<sup>119</sup> and the regulations promulgated by the U.S. Department of the Treasury under section 526(d).<sup>120</sup> The current regulations allow a domestic trademark owner to exclude gray-market imports only if the domestic trademark owner is unrelated to the foreign trademark owner and if the foreign goods do not bear a trademark licensed by the domestic trademark owner. On the other hand, if the domestic and the foreign trademark owners are related or if the foreign goods bear a trademark licensed by the domestic trademark owner, then the domestic trademark owner does not have the right to exclude the goods.<sup>121</sup> Private means of preventing gray-market imports, such as using different trademarks or denying warranty service to gray-market goods, are legal.<sup>122</sup>

The illogic of the current policy is that the relationship between the U.S. trademark owner and the foreign trademark owner is unrelated to the underlying cause of the gray-market imports.<sup>123</sup> A manufacturer can have market power and engage in price discrimination regardless of the relationship between the domestic and the foreign trademark owners.<sup>124</sup> Similarly, a trademark will

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118. For a discussion of the options being considered by the administration, see *Inside U.S. Trade*, *supra* note 16, at 1, 8-10.

119. 19 U.S.C. § 1526 (1982). See note 14 *supra* for the text of the statute.

120. 19 C.F.R. § 133.21 (1985). See note 15 *supra* for the text of the regulations.

121. *Id.*; see also *Osawa & Co. v. B & H Photo*, 589 F. Supp. 1163, 1177 (S.D.N.Y. 1984).

122. See *infra* notes 126-141 and accompanying text. To the best of my knowledge, such policies have never been the basis of an antitrust suit. The use of section 526, however, was the basis for the *Guerlain* antitrust case. See *supra* notes 30-40 and accompanying text.

123. *Osawa*, 589 F. Supp. at 1177-78.

124. Calvin Collier, a former Chairman of the Federal Trade Commission, has argued that this distinction is rational. He begins by noting that monopolistic price discrimination, which is the practice of charging different prices to customers in different markets, allows a monopolist to increase its profits. An obvious condition for price discrimination is that the manufacturer's goods be sold in both markets. In addition, a manufacturer can price discriminate only if it can separate the foreign and domestic markets. Customs' approach would not allow related parties to sell in the two markets and still keep the markets separate. Thus, he argues that the current policy deters price discrimination. Speech by Calvin Collier, *Competition Policy and Parallel Imports*, Second Annual Judicial Conference, United States Court of International Trade (Oct. 23,



always represent the local goodwill, and a trademark can be supported with different services or denote different goods in different countries, regardless of the relationship between the two trademark owners.<sup>125</sup>

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1985). The problem with this argument is that monopolistic price discrimination is not facilitated by having a related U.S. trademark owner. A foreign manufacturer with market power, or a foreign cartel, can practice price discrimination against U.S. consumers with an unrelated U.S. trademark owner as easily as with a related one. The foreign manufacturer only has to charge the U.S. trademark owner a higher price for the good in order to earn its anticompetitive profit. For example, assume the competitive European price for a widget in local currency is equivalent to \$5, but the U.S. monopoly price is \$10. Further, assume that dealers' sales-related costs are \$2 a unit and that distribution costs are \$1 a unit on both sides of the Atlantic. If the foreign manufacturer owned both distributors, then it would charge European retailers \$3 and U.S. retailers \$7, and its out-of-pocket expenses would be \$1 a unit. Now, if there were an independent U.S. distributor, the foreign manufacturer would charge the distributor \$6 a unit, but it would have no out-of-pocket expenses for the widgets sold in the United States. As a result, the manufacturer's sales and profits would be exactly the same in the two sets of circumstances. Although the relation between the U.S. and the foreign trademark owner has nothing to do with the ability to price discriminate, the foreign trademark owner's control over its foreign chain of distribution does; the farther down the chain of distribution is the first sale to an independent party, the easier is price discrimination. Breaking down the barrier that separates the two markets is more difficult the greater the manufacturer's control of its chain of distribution because lot sizes decrease and unit prices increase down the chain of distribution. The net effect is to make it more expensive for independent importers to assemble a commercial lot when they have to make their purchases from retailers instead of wholesalers. See R. POSNER & F. EASTERBROOK, *ANTITRUST* 874-75 (2d ed. 1981). Customs' regulations, however, have never considered the extent of the foreign trademark owner's vertical integration in its home market. *Id.*

125. Essentially this justification was adopted by the Second Circuit in *Olympus* when it argued that the regulations permit the Customs Service to distinguish between cases where the trademark owner has independent domestic goodwill and those where the trademark owner is engaged in price discrimination:

The administrative difficulties inherent in requiring the Customs Service to exclude gray market goods make clear why Customs has long and consistently interpreted section 526 to allow it to refuse to exclude the goods. Absent this bright line for administrative enforcement, the Customs Service would expand resources excluding goods when later private litigation could disclose that the markholder lacked isolable domestic good will and was merely engaging in price discrimination or other behavior questionable as a matter of antitrust law. Regulations that attempted to permit exclusion only of goods the markholders of which possessed discrete domestic good will would, as Judge Sifton pointed out, place the Customs Service "in the position of having to determine at the time of border crossing whether the domestic trademark holder had

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### *Private Solutions*

The current U.S. policy towards gray-market goods allows a U.S. trademark owner to prevent the importation of gray-market goods when the owner can do so purely through private means. The most obvious way that U.S. trademark owners could attempt to reduce gray-market imports is by using different trademarks in the United States and abroad. Thus, one of the arguments for not imposing any government restrictions on gray-market imports is that the trademark owners brought the problem of gray-market goods on themselves, because they used identical trademarks in their domestic and foreign markets.<sup>126</sup> A manufacturer that sells its product in two or more markets may use different marks in various countries.<sup>127</sup> Third parties would then be less likely to import the goods intended for sale abroad because the imports with an unknown trademark would be less highly valued than the identical goods with the recognized trademark.

There are two problems with this argument. First, the manufacturer gains several advantages from using the same trademark

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developed an independent public image in this country." (citation omitted)

Olympus Corp. v. United States, 792 F.2d 315, 320 (2d Cir. 1986). The Second Circuit is incorrect. The regulations do not identify instances where price discrimination is more likely to occur. A foreign trademark owner can discriminate against U.S. consumers just as easily by charging U.S. customers a higher price as by charging a U.S. distributor a high price. *Supra* note 117. If, however, what the Second Circuit means is that the U.S. trademark owner has promoted the brand and has provided the services to support it, then such activities can occur as easily with a related U.S. trademark owner as with an independent one. *Compare Olympus*, 792 F.2d 315, with *Osawa & Co. v. B & H Photo*, 589 F. Supp. 1163 (S.D.N.Y. 1984).

126. See *COPIAT*, *supra* note 3, at 14 ("Defendants . . . argue that once a trademark owner has authorized the foreign manufacturer to apply the trademark to goods, the trademark owner himself has introduced the articles into commerce and cannot thereafter unreasonably restrict the use of the product.").

127. It can be argued that the cost of gray-market imports to trademark owners must be small because they could have avoided the problem by using different trademarks in the United States and abroad. This, however, is not accurate. First, the large sums of money being spent by trademark owners litigating gray-market cases and trying to persuade Congress and the Executive would suggest otherwise. More importantly, the failure to choose to promote different trademarks is the result of a decision often made many years ago. At the time, the trademark owners may have underestimated the likelihood and significance of the potential problem. It cannot be concluded today, therefore, that because the costs of choosing to use different trademarks many years ago would have been low, that the costs to trademark owners from gray-market imports is low.

at home and abroad that would be lost if a different trademark were used in each country.<sup>128</sup> Thus, even if a manufacturer could prevent transshipping by using different marks at home and abroad, the law should not encourage this. Because trademarks are expensive to develop,<sup>129</sup> a manufacturer, by using the same trademark at home and abroad, may be able to achieve significant cost savings. In order to prevent all possible transshipping, however, a manufacturer must use a different trademark and traddress in each country. Thus, the costs of developing trademarks and traddress are reduced when the same trademark and traddress can be used throughout the world.<sup>130</sup>

The advantages of using the same trademark at home and abroad, furthermore, are probably larger on the demand side than on the cost side. Because national boundaries can be significant barriers to the flow of information, a trademark recognized and highly regarded in one country might have only the most faint recognition in a second country, where the manufacturer is not yet selling its product. Several reasons exist, however, that support the manufacturer's use of the same trademark in the domestic and foreign markets. Whatever small amount of goodwill the trademark has in the country the manufacturer is yet to enter would be lost if the manufacturer were to use a different trademark. In addition, advertising in media that reach more than one country would be more effective if the same trademark were used in both countries.<sup>131</sup> Moreover, people who travel or live abroad would not be able to purchase their favorite brand unless they were aware that the manufacturer used different trademarks in different countries.<sup>132</sup>

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128. See J. GILSON, *supra* note 49, § 1.03[5].

129. For a discussion of what is involved in establishing trademark rights in the United States, see J. GILSON, *supra* note 49, § 3.

130. The manufacturer can also save on the cost of advertising when the same trademark is used throughout the world because the same advertising campaign may be used in two or more countries. However, with a different trademark and tradename in each country, the manufacturer might have to use a different campaign in each country.

131. For example, during the recent World Cup in Mexico, the stands surrounding the playing field were turned into billboards for well-known brands, to be seen on television sets around the world. Such advertising would not be possible unless the same trademark were used throughout much of the soccer-playing world.

132. Using the same trademark in all countries in which the good is sold will allow the manufacturer to internalize the benefits from the goodwill it has developed. If different marks were used in different countries, then some of the goodwill would be lost.

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The second flaw in the argument that U.S. trademark owners brought the problem of gray-market imports on themselves by using identical trademarks in their domestic and foreign markets is that a manufacturer might not be able to protect itself from the harm caused by gray-market imports simply by using different trademarks at home and abroad.<sup>133</sup> Under current U.S. intellectual property law, a retailer could probably advertise the product as a gray-market import manufactured by the foreign trademark owner in the same plant as the product bearing the domestic trademark.<sup>134</sup> Therefore, the gray-market importer would still benefit from the goodwill and services associated with the mark.

A second way to try to stop transshipping is to use private contracts. Manufacturers could require their distributors to agree not to sell to gray-market importers. Many countries, however, enforce laws that prevent manufacturers from using private contracts to restrict transshipping. The two most important examples of such laws are the antitrust laws of the Economic Community (EC) and the licensing restrictions of foreign countries. In contrast to current U.S. antitrust law, which permits manufacturers to impose nonprice, vertical restraints if reasonable,<sup>135</sup> the antitrust law of the EC treats both price and nonprice, vertical restraints as illegal *per se*.<sup>136</sup> Thus, the antitrust laws of the EC prevent U.S. trademark owners from requiring that their distributors not sell their trademarked merchandise to importers for sale abroad and from terminating those distributors that knowingly sell to gray-market importers.<sup>137</sup>

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133. See *infra* text accompanying notes 150-153.

134. See *infra* notes 148-150 and accompanying text; J. GILSON, *supra* note 49, § 5.09[3].

135. See, e.g., *Continental T.V., Inc. v. GTE Sylvania, Inc.*, at 58 (manufacturers may impose vertical restrictions when no anticompetitive effects are shown to result).

136. Article 85(1) of the Treaty of Rome prohibits agreements "which have as their object or result the prevention, restriction or distortion of competition within the Common Market . . ." Treaty of Rome, 298 U.N.T.S. 47-48 (entered into force Jan. 1, 1958). This clause has been interpreted as prohibiting export restrictions in contracts between private parties, except in narrow circumstances. See Kinkeldey, *Pitfalls of Trademark Licensing in the EEC*, 72 TRADE-MARK REP. 145 (1982).

137. See J. GILSON, *supra* note 49, § 9.01(4) (articles 85 and 86 of Rome Treaty prohibit granting of exclusive territorial trademark licenses). Moreover, by outlawing vertical restraints, the EC makes it difficult for manufacturers to induce retailers to provide special services. Thus, it is likely that U.S. brands are supported by more services than their EC counterparts, thereby providing an incentive for gray-market importers to divert goods from the EC to the United States.

In addition to the antitrust laws of the EC, a number of countries have licensing provisions that prevent U.S. trademark owners from enforcing a ban on exports to the United States. In order to conduct business in many countries, a foreign trademark owner must license its trademark.<sup>138</sup> In many of these countries where licensing is a legal or economic necessity, trademark licenses must be registered with the government to be enforceable.<sup>139</sup> The laws in these countries frequently prohibit the registration of a license that contains any export restrictions, including restrictions that apply to the licensor's own country.<sup>140</sup> In order to do business in many countries, therefore, the foreign trademark owner must give up the right to prevent the product's exportation, even to countries where the chain of distribution exists.<sup>141</sup>

Foreign antitrust and licensing restrictions strengthen the case for adopting a public law solution to the gray-market problem. Because of the EC antitrust law, a U.S. firm that wants to sell in the EC will be unable to use private means to prevent gray-market imports. Similarly, the harm resulting from foreign licensing regulations that hinder the entry of U.S. firms into foreign markets can be alleviated by a strong gray-market policy.

#### *Alternative Public Remedies*

Apart from the private means available to trademark owners, there are several proposals that deal directly with the problems of gray-market goods. One proposal would require retailers to disclose to potential purchasers that they sell gray-market goods. This approach, called labeling, is inadequate to deal with gray-market imports because it could only prevent the sale of inferior-quality gray-market goods. A second proposal would require obliterating the trademark on gray-market goods. This approach, termed

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138. In some countries licensing is required by law, whereas in others it is not required by law but is a practical necessity. For example, high tariffs or nontariff barriers can make importation infeasible and domestic laws requiring local ownership can prevent the foreign trademark owner from establishing a branch operation or subsidiary. See COLLADO ASSOC., *supra* note 1, at 72.

139. J. GILSON, *supra* note 49, § 9.01[4].

140. See J. GILSON, *supra* note 49, § 9.01(4) (many countries require trademark license agreements to be recorded in the local trademark office or other governmental agency).

141. J. GILSON, *supra* note 49, § 9.01[4].

## GRAY-MARKET IMPORTS

demarking, theoretically could prevent a free ride on the services and reputation associated with the trademark, while allowing arbitrage to occur where there is market power. In practice, however, demarking is likely to be much less effective. A third proposed solution to the gray-market problem is to use private legal remedies. This is the approach adopted by the Federal Circuit in *Vivitar Corp. v. United States*, when it held that Customs was not required to exclude gray-market imports, but U.S. trademark owners could pursue their private law remedies.<sup>142</sup> The fourth proposal is a ban on gray-market goods. Only a ban would adequately protect the interests of U.S. trademark owners.

### *Labeling*

The first proposal—labeling—requires disclosure. Under the labeling approach, gray-market retailers would inform potential customers that the product is not authorized by the U.S. trademark owner.<sup>143</sup> Such a requirement would not prevent gray-market imports that take a free ride on a domestic trademark owner's reputation or the services provided to consumers. At most, labeling can only prevent confusion.<sup>144</sup> Although confusion is often involved with gray-market merchandise, the problem with gray-market goods is not that consumers are confused, but that they know what they are getting.<sup>145</sup> Therefore, labeling cannot prevent the harm caused by gray-market imports.<sup>146</sup>

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142. *Vivitar Co. v. United States*, 761 F.2d 1552, 1569-70 (Fed. Cir. 1985); see also *Olympus Corp. v. United States*, 792 F.2d 315, 320-21 (2d Cir. 1986).

143. See *COLLADO ASSOC.*, *supra* note 1, at 61-64.

144. Labeling will not even be able to prevent confusion when the item is inexpensive, the expected injury from purchasing an unauthorized item is small, and the trademark is well recognized and highly regarded. In these cases labeling is likely to be ineffective because consumers are unlikely to read the labels. See *Duracell*, *supra* note 3, at 40.

145. The Court of International Trade made this mistake in *Vivitar* when it declared that the owner of the trademark "could protect itself against free riding by using marketing and labeling practices to make clear that goods plaintiff sells abroad are not supported by the same services as those plaintiff sells in the United States." *Vivitar*, 593 F. Supp. 420, 435 (Ct. Int'l Trade 1984), *aff'd*, 761 F.2d 1552 (Fed. Cir. 1985).

146. This mistake was made in a similar situation by Justice Holmes in his concurring opinion in *International News Service* in which Justice Holmes stated that the only remedy available to AP was to have INS acknowledge that the news was collected by AP. Such a solution would not have stopped INS from copying the news, because the subscribers of INS probably did not care who gathered the news, but only that the news they received was accurate. *International News Service*, 248 U.S. 215, 248 (1918) (Holmes, J., concurring).

*Demarking*

The second proposal—demarking—requires that the gray-market importer obliterate the trademark on the product. This proposal is aimed precisely at the injury caused by gray-market imports. The free riding and inferior-quality goods causes of gray-market imports all rely on the strength of the domestic trademark (whereas the monopolistic price discrimination rationale is based on the product itself). If the imported merchandise did not bear the U.S. trademark, the merchandise would not benefit from the goodwill or services associated with the trademark. In addition, consumers would not be fooled into purchasing inferior-quality goods based on the trademark. Finally, competing goods would not be kept out when the trademark owner engaged in monopolistic price discrimination.<sup>147</sup>

Although a remedy that prevented consumers from associating the goods with the trademark would solve the problems raised by gray-market goods, demarking does not prevent consumers from making this association. There are several reasons to expect that demarking will not prevent consumers from learning the source of the merchandise. The most obvious problem with demarking involves goods that prominently display trademarks. Clothing—especially sports shirts—and leather goods—especially handbags—most readily come to mind as goods that would not be susceptible to demarking because obliterating the trademark would destroy the goods. Moreover, a policy of demarking would encourage manufacturers to increase the prominence of their trademarks on

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147. One argument made against a demarking proposal is that it denies consumers information that would be valuable to them. It is argued that consumers have the right to know the source of the goods they buy, and that demarking denies them this right. See, e.g., Collier, *supra* note 124. The difficulty with this argument is that there is no such absolute right. Avoiding consumer confusion is only one of the purposes of trademark law. The other is protecting the goodwill of trademark owners. In this instance, the consumer's interest in information is in conflict with the trademark owner's interest in protecting its goodwill. Furthermore, there is no deception in this case. Deception occurs when consumers buy goods from one source but believe the goods to be from another source. This does not happen when goods are demarked. Instead, consumers do not know the source of the goods, but they know they do not know the source. Thus, there is no deception. Furthermore, there is no policy against selling well-known goods without a trademark. This is commonly done by firms that produce a product under a trademark and produce the same product without a trademark so that it can be sold by retailers under their own trademarks.

the goods they sell abroad,<sup>148</sup> thus making the remedy less effective.<sup>149</sup>

The applicability of this remedy, furthermore, is likely to be limited. Demarking will probably be effective against inexpensive goods that all look the same, such as batteries, but not against expensive goods with observable differences, such as automobiles. For example, if DURACELL batteries were imported into the United States in a black casing without the distinctive copper top and without a trade name on them, they would not be recognized as DURACELL batteries. On the other hand, a MERCEDES-BENZ automobile without the three-pointed emblem and with the name MERCEDES-BENZ obliterated would still be recognized for what it was. In the latter case, demarking would not be an effective remedy because the product could still be recognized.<sup>150</sup>

The final reason why demarking would be ineffective against gray-market imports is that the current state of intellectual property law would probably not prevent a retailer from using the trademark in truthful advertising in a manner that would allow it to take a free ride on the trademark owner's goodwill. Thus, in the DURACELL battery example, a retailer could probably say that the batteries were manufactured by Duracell in Belgium.<sup>151</sup> Of course, a demarking policy would increase the cost to retailers of selling gray-market goods,<sup>152</sup> but there is no reason to expect that these costs would be high enough to deter gray-market importation.<sup>153</sup>

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148. Christopher DeMuth has argued that demarking would be effective because trademarks that are clearly displayed are in danger of losing their trademark rights. C. DEMUTH, *GRAY-MARKET COMPROMISE: DEMARKING VS. LABELING* 10 (1985). This is incorrect. As long as a trademark's distinctiveness is maintained, there is no danger of its being lost just because it is prominently displayed or frequently used. See A. MILLER & M. DAVIS, *supra* note 49, at 207.

149. DeMuth, however, suggests that if demarking was not required on goods that prominently display their trademarks, then trademark owners would have an incentive to stop displaying their trademarks, which would increase the effectiveness of demarking. C. DEMUTH, *supra* note 148, at 10.

150. Price is likely to be an important element as well. The more expensive the article, the greater the incentive to learn about the source.

151. See, e.g., *Prestonettes, Inc. v. Coty*, 264 U.S. 359 (1924); *Champion Spark Plug Co. v. Sanders*, 331 U.S. 125 (1947); *Smith v. Chanel, Inc.*, 402 F.2d 562 (9th Cir. 1968); J. GILSON, *supra* note 49, § 5.09[3].

152. See C. DEMUTH, *supra* note 148, at 4 n.3.

153. The gray-market importer will still be able to take a free ride on the U.S.



*Private Law Remedies*

A third proposal is to permit U.S. trademark owners to pursue their private remedies in federal court. Section 526(c) authorizes U.S. trademark owners to enjoin importers and retailers from dealing in trademarked goods of foreign manufacture imported into the United States without the consent of the trademark owner.<sup>154</sup> Similarly, the Lanham Act authorizes U.S. trademark owners to enjoin violations of the Act and recover damages.<sup>155</sup>

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trademark owner's reputation as long as it costs the retailer less to convince consumers that its batteries are DURACELL batteries than the premium associated with DURACELL batteries.

154. Section 526(c) provides a private right of action for a party injured by a violation of section 526(a). The text of section 526, 19 U.S.C. § 1526 (1982), can be found in footnote 14, *supra*. See *Vivitar Co. v. United States*, 761 F.2d 1552, 1570 (Fed. Cir. 1985).

155. The Lanham Act contains two provisions that U.S. trademark owners could use to seek private remedies against importers and retailers of gray-market goods. Section 32(1) of the Lanham Act provides a private right of action for U.S. trademark owners who are harmed by anyone who offers for sale goods bearing a mark that infringes a registered trademark:

Any person who shall, without the consent of the registrant— use in commerce any reproduction, counterfeit, copy, or colorable imitation of a registered mark in connection with the sale, offering for sale, distribution, or advertising of any goods or services on or in connection with such use is likely to cause confusion, or to cause mistake, or to deceive . . . shall be liable in a civil action by the registrant for the remedies hereinafter provided.

15 U.S.C. § 1114(1) (1982). Section 43(a) of the Lanham Act created a federal law of unfair competition with a private right of action:

*Any person who shall affix, apply, or annex, or use in connection with any goods or services, or any container or containers for goods, a false designation of origin, or any false description or representation, including words or other symbols tending falsely to describe or represent the same, and shall cause such goods or services to enter into commerce, and any person who shall with knowledge of the falsity of such designation of origin or description or representation cause or procure the same to be transported or used in commerce or deliver the same to any carrier to be transported or used, shall be liable to a civil action by any person doing business in the locality falsely indicated as that of origin or in the region in which said locality is situated, or by that of origin or in the region in which said locality is situated, or by any person who believes that he is or is likely to be damaged by the use of any such false description or representation.*

15 U.S.C. § 1125(a) (1982) (emphasis added). Section 43(b) of the Lanham Act allows a party injured by a violation of section 43(a) to have the offending goods denied entry

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Neither an award of damages nor an injunction would adequately protect U.S. trademark owners because both of these remedies are applied only against individual importers and not against the goods. Thus, with an injunction, the complaining trademark owner must identify every individual importer to stop all gray-market imports. This is likely to be very expensive, if not impossible, because the number of importers can be large, and because many importers will attempt to avoid detection and invocation of U.S. jurisdiction. Moreover, because it is easy to become an importer of gray-market merchandise, if the trademark owner is successful in enjoining one importer, another importer will take its place. Thus, injunctions against individual importers would not be effective against a widespread pattern of importation. An award of damages also suffers from the problem that the importing can be done by judgment-proof corporations, rather than by individuals.<sup>156</sup>

### *A Ban on Gray-Market Imports*

The most drastic proposal that deals with gray-market imports would grant U.S. trademark owners the right to exclude gray-market imports. Such a ban would prevent gray-market imports

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into the United States:

(b) Any goods marked or labeled in contravention of the provisions of this section shall not be imported into the United States or admitted to entry at any customhouse of the United States. The owner, importer or consignee of goods refused entry at any customhouse under this section may have recourse by protest or appeal that is given under the customs revenue laws or may have the remedy given by this chapter in cases involving goods refused entry or seized.

15 U.S.C. § 1125(b) (1982). Section 34 of the Lanham Act authorizes broad injunctive relief for a violation of the act, 15 U.S.C. § 1116 (1982), and section 35 permits a plaintiff to recover damages from an intentional infringer, 15 U.S.C. § 1117 (1982). The questions of whether gray-market imports violate sections 32(1) and 43(a) of the Lanham Act, in addition to section 42, are discussed. *See infra* notes 304-308 and accompanying text.

156. U.S. trademark owners might also file in federal district court and seek to have all unauthorized imports excluded. *See Vivitar*, 761 F.2d at 1570. Such a remedy, at best, could only delay relief and make it more costly. Alternatively, if trademark owners were frequently denied relief on grounds such as a lack of confusion, *see Monte Carlo Shirt, Inc. v. Daewoo International (America) Corp.*, 707 F.2d 1054 (9th Cir. 1983), then the private law remedies would be inadequate to protect against free riding.

that take a free ride on the domestic trademark owner's reputation or services, as well as inferior-quality gray-market merchandise. It would also, however, prevent gray-market goods that result from monopolistic price discrimination from entering the United States. To the extent that gray-market imports arbitrage such international price differences, a ban on gray-market imports would be costly to society.<sup>157</sup> This article, however, suggests that there is little likelihood that gray-market imports are, to any substantial degree, the result of monopolistic price discrimination.<sup>158</sup> Consequently, the costs from a ban on gray-market imports are likely to be small.

There may be, however, some cases in which gray-market goods result from attempts to engage in monopolistic price discrimination. In such cases, a ban would be inappropriate, and it might be more efficient to allow these gray-market goods into the United States.<sup>159</sup> The determination whether there is such market power must be made on a case-by-case basis under antitrust law, which is better suited to deal with questions of anticompetitive behavior than is trademark law.

Antitrust law should be used to make the determination whether the trademark owner can exclude the goods because the appropriate question to ask is whether the U.S. trademark owner has a monopoly in the product market.<sup>160</sup> Only in this case could a ban on gray-market imports be used to engage in monopolistic price discrimination for an extended period of time. Since the inquiry has nothing to do with consumer confusion or goodwill, trademark principles are particularly ill-suited considerations on which to base this determination. Consequently, trademark law principles cannot be used to distinguish cases where a ban on gray-market imports fosters monopoly pricing from those where it does not.

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157. See *supra* notes 100-104 and accompanying text.

158. See *supra* notes 100-114 and accompanying text.

159. Because competition in the product market prevents monopoly pricing, only the goods should be admitted. There is no reason to allow the trademark to be used. At the very least, labeling would be required in order to prevent consumer confusion. The anticompetitive behavior of a trademark owner is no justification for deceiving consumers who want to purchase the trademark owner's goods.

160. The inquiry into whether a trademark owner has a monopoly in a U.S. product market should concentrate on whether there are barriers to entry that could prevent other firms from entering the market if the trademark owner tried to maintain an anticompetitive price. See R. POSNER, *supra* note 26, at 58-59.

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### *Private and Public Enforcement Compared*

The cost and effectiveness of enforcing a ban on gray-market imports favors a public remedy. Goods imported into the United States must enter through Customs for processing. The incremental cost of asking importers what trademarks their goods carry and comparing these with a list on file is low.<sup>161</sup> In contrast to government enforcement, the costs of private enforcement would be large. A number of private techniques that could be used to prevent gray-market imports are illegal in countries where they would have to be implemented to be effective.<sup>162</sup> Secondly, the private law remedies are likely to be both ineffective and costly against a widespread pattern of importation because just about anyone can import gray-market merchandise and because litigation can be expensive.

Currently, a registration fee of \$190 must be paid to the Commissioner of Customs to record a trademark with the Treasury and to obtain the benefits of section 42 of the Lanham Act and section 526 of the Tariff Act.<sup>163</sup> In order to ensure an efficient level of enforcement, it would be appropriate to make the registering trademark owners pay registration fees that cover the full cost of enforcement.<sup>164</sup>

Such a government policy, furthermore, is not government protectionism whereby the government insulates U.S. producers from competition. Rather, the government would be enforcing private property rights—the right of a U.S. trademark owner to the exclusive use of its mark<sup>165</sup>—because the government can enforce these rights more effectively than can U.S. trademark owners. The policy would not be protectionist because there would be no restriction on the kinds or quantities of goods that could be imported into the United States. Moreover, the policy would not create a new right in domestic producers to be free from competition; it would only enforce an existing trademark right

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161. On the other hand, it would be very expensive to enforce a similar scheme entirely within the United States. For example, merchandise that goes from California to New York does not have to pass through a customshouse, but can enter New York in any one of myriad ways without stopping.

162. See *infra* notes 135-141 and accompanying text.

163. 19 C.F.R. § 133.13(b) (1985).

164. See *LEXECON INC.*, *supra* note 2, at 90-91.

165. 15 U.S.C. § 1114 (1982).

that benefits all U.S. trademark owners, regardless of whether their merchandise is produced domestically or imported.

### MODERN TRADEMARK LAW PRINCIPLES

Modern U.S. trademark law, a review of early cases dealing with gray-market imports, and the statutory provisions protecting the rights of U.S. trademark owners reveal a foundation from which gray-market imports may be excluded.

#### *Appropriating Goodwill*

The principle that the goodwill symbolized by a trademark is to be protected has been recognized by the courts, by Congress, and by commentators.<sup>166</sup> In a widely quoted passage from *Mishawaka Rubber & Wollen Mfg. Co. v. S. S. Kresge Co.*,<sup>167</sup> the U.S. Supreme Court, per Justice Frankfurter, held that a trademark owner was protected against competitors attempting to expropriate the goodwill associated with the trademark:

The protection of the trade-name is the law's recognition of the psychological function of symbols. If it is true that we live by symbols, it is no less true that we purchase goods by them. A trademark is a merchandising short-cut which induces a purchaser to select what he wants, or what he has been led to believe he wants. The owner of a mark exploits this human propensity by making every effort to impregnate the atmosphere of the market with the drawing power of a congenial symbol. *Whatever the means employed the aim is the same—to convey through the mark, in the minds of*

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166. See *Duracell*, *supra* note 3, at 7-20. At common law, the only function of a trademark was to distinguish the source of origin of one good from the source of origin of another good, so consumers would not be confused about similar products. As a result, there could not be an infringement unless the distinctiveness of the trademark was impaired, which is to say, there had to be confusion with respect to the source of origin of the defendant's goods. This view of trademark law changed with the enactment of the Lanham Act which adopted several elements of the common law of unfair competition into federal trademark law. See J. GILSON, *supra* note 49, § 5.01. Trademark rights are now protected against dilution. This is known as the anti-dilution theory of trademark law, and has turned trademarks into property *in gross*. A. MILLER & M. DAVIS, *supra* note 49, §§ 13.1-13.2.

167. 316 U.S. 203 (1942).

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*potential customers, the desirability of the commodity upon which it appears. Once this is attained, the trade-mark owner has something of value. If another poaches upon the commercial magnetism of the symbol he has created, the owner can obtain legal redress.*<sup>168</sup>

Judicial relief is granted because the trademark owner has established its goodwill through a substantial investment. No competitor may expropriate this goodwill by using a confusingly similar mark.<sup>169</sup>

In its description of the two-fold purpose of trademark law, Congress recognized the trademark owner's right to the return from its investment. The Senate Report on the Lanham Act states:

One [purpose of trademark law] 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 which it asks for and wants to get. Secondly, *where the owner of a trademark has spent energy, time, and money in presenting to the public the product, he is protected in his investment from its misappropriation by pirates and cheats. This is a well established rule of law protecting both the public and the trade-mark owner.*<sup>170</sup>

To protect trademark owners, Congress included a general unfair competition claim within the Lanham Act,<sup>171</sup> and extended

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168. *Id.* at 205 (emphasis added).

169. In *Hanover Star Milling Co. v. Metcalf*, 240 U.S. 403 (1916), the Court stated:

The redress that is accorded in trade-mark cases is based upon the party's right to be protected in the goodwill of a trade or business . . . . Where a party has been in the habit of labeling his goods with a distinctive mark, so that the purchasers recognize goods thus marked as being of his production, others are debarred from applying the same mark to goods of the same description, because to do so would in effect represent their goods to be of his production and *would tend to deprive him of the profit he might make through the sale of the goods which the purchaser intended to buy. Courts afford redress or relief upon the ground that a party has a valuable interest in the good-will of his trade or business, and in the trademarks adopted to maintain or extend it.*

*Id.* at 412 (emphasis added).

170. S. REP. NO. 1333, 79th Cong., 2d Sess. 3 (1946), reprinted in 1946 U.S. CODE CONG. & ADMIN. NEWS 1274 (emphasis added).

171. The text of section 43(a) of the Lanham Act can be found in footnote 155, *supra*.

the prohibition against confusingly similar trademarks to cover any confusion, not only confusion about the source of origin.<sup>172</sup>

Moreover, in order to ensure that the goodwill symbolized by the trademark will be protected, a domestic trademark owner can enjoin another's use of a similar trademark on noncompeting merchandise by proving a likelihood of confusion, without having to show that the noncompeting merchandise is of such poor quality that the mark will be tainted by the association. A showing of trademark confusion is sufficient to enjoin the use of the mark because a trademark owner should not have to tolerate having its goodwill held hostage by another firm. Thus, Judge Learned Hand, in his now classic statement of the injury from using another's trademark on noncompeting merchandise, has stated:

[I]t has of recent years been recognized that a merchant may have a sufficient economic interest in the use of his mark outside the field of his own exploitation to justify interposition by a court. *His mark is his authentic seal; by it he vouches for the goods which bear it; it carries his name for good or ill. If another uses it, he borrows the owner's reputation, whose quality no longer lies within his own control. This is an injury, even though the borrower does not tarnish it, or divert any sales by its use; for a reputation, like a face, is the symbol of its possessor and creator, and another can use it only as a mask. And so it has come to be recognized that, unless the borrower's use is so foreign to the owner's as to insure against any identification of the two, it is unlawful.*<sup>173</sup>

The broader view of the scope of trademark protection has also won support among commentators. Thus, Jerome Gilson has

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172. The text of Section 32(1) on the Lanham Act, 15 U.S.C. § 1114(1) (1982), can be found in footnote 155, *supra*. In 1962, the Lanham Act was amended to delete the italicized phrase in the infringement standard that the defendant's use of the mark be "likely to cause confusion, or to cause mistake, or to deceive purchasers as to the source of origin of such goods or services." This deletion is generally interpreted as expanding the scope of the standard for infringement. J. GILSON, *supra* note 49, § 5.01.

173. *Yale Electric Corp. v. Robertson*, 26 F.2d 972 (2d Cir. 1928); see also *James Burroughs Ltd. v. Sign of the Beekeeper, Inc.* 540 F.2d 266, 276 (7th Cir. 1976) (It is not necessary to show that the trademark owner's reputation is harmed by another's use of a similar mark, "the owner of a mark is damaged by a later use of a similar mark which places the owner's reputation beyond its control, though no loss in business is shown."); J. GILSON, *supra* note 49, § 5.05[2].

or colorable imitation of a registered mark in connection with the sale, offering for sale, distribution, or advertising of any goods or services on or in connection with which such use is likely to cause confusion, or to cause mistake, or to deceive . . . shall be liable in a civil action by the registrant from the remedies [provided in this Act].<sup>178</sup>

Trademark confusion occurs when consumers incorrectly believe the U.S. trademark owner stands behind the gray-market goods. Thus, purchasers of gray-market MAMIYA cameras may believe that Mamiya's U.S. warranty comes with the camera,<sup>179</sup> or that the merchandise is being sold through the usual channel, having been given the usual careful handling.<sup>180</sup> Such a consumer may be disappointed if he discovers that he has purchased something other than what he bargained for.<sup>181</sup> Thus, the likelihood of confusion as to the proper chain of distribution can satisfy the test for trademark infringement.<sup>182</sup> This conclusion is supported by the 1962 amendment to section 32 which deleted the phrase "source of origin of [defendant's] goods and services" from the standard for trademark confusion, thereby making any kind of trademark confusion actionable.<sup>183</sup>

With unlabeled gray-market imports, there would be the likelihood of confusion as to the identity of the party that distributed the goods in the United States. A case can be made that even properly labeled gray-market goods satisfy the likelihood-of-confusion standard. This is understood when one considers a gray-market DURACELL battery that is clearly labeled as an unauthorized import. Assume the gray-market battery only lasted 90 percent as long as the average authorized DURACELL battery. The consumer may not know that his battery was short-lived, and thus may think that DURACELL batteries are short-lived. Alternatively,

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178. 15 U.S.C. § 1114(a) (1982).

179. In *Osawa*, Judge Leval found that purchasers of gray-market MAMIYA cameras often do not know they are buying gray-market cameras, and thus fully expect them to be covered by warranty. *Osawa & Co. v. B & H Photo*, 589 F. Supp. 1163, 1167-68 (S.D.N.Y. 1984).

180. *Id.*; *Duracell*, *supra* note 3, at 28-29.

181. *Duracell*, *supra* note 3, at 30-31.

182. *Id.* at 26-33. *Contra* *Monte Carlo Shirt, Inc. v. Daewoo International America Corp.*, 707 F.2d 1054, 1058 (9th Cir. 1983) (no confusion possible with genuine goods).

183. *See* J. MCCARTHY, *supra* note 45, at 46-47 n.3; *supra* note 172.



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he may notice that the battery died early. He still does not know whose fault it is. It could be because the unauthorized importer did not handle the battery correctly; however, it could also be that the battery was defective. The consumer might want to know the reason for the problem, and the likelihood of confusion standard should allow him to know.<sup>184</sup>

### *The Bourjois Decisions*

*Bourjois v. Katzel* was the first of two gray-market cases to reach the U.S. Supreme Court.<sup>185</sup> In that case, the plaintiff, a New York corporation, had purchased in 1913 from a French company the latter's entire business for face powder in the United States, including the goodwill and the U.S. registered trademarks JAVA and BOURJOIS. The French company manufactured the powder in France, and the plaintiff packed and sold it in the United States.<sup>186</sup> The French company also packed its face powder in France for domestic sale. The defendant, a third party related to neither the U.S. company nor the French company, bought powder in France that had been packed by the French company, and imported it in the original boxes into the United States. The packaging used by the French manufacturer resembled the packages used by the

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184. The significance of the Supreme Court's opinion in *Prestonettes, Inc. v. Coty*, 264 U.S. 359 (1924), should be limited by the expansion of trademark rights. Coty sold face powder under the registered trademark Coty, and *Prestonettes* purchased this powder and rebottled it. Coty sought to restrain *Prestonettes*' use of the Coty trademark. The district court issued a decree that allowed the defendant to put on the face powder bottle "Prestonettes, Inc., not connected with Coty." *Id.* at 367. The court of appeals issued an absolute injunction against the use of the Coty mark on the rebottled powder in consideration of the delicate nature of the powder. The Supreme Court found the circuit court's decree too broad. The Court concluded that the district court's decree was appropriate because it was adequate to prevent confusion since consumers would know that the contents were manufactured by Coty and repackaged by *Prestonette*. *Id.* at 369. *Prestonettes* predated the passage of the Lanham Act by more than 20 years. The Lanham Act, however, as amended covers more than confusion as to the source of origin, it covers any kind of confusion. Thus, the Supreme Court's holding that the disclosure was adequate to prevent confusion does not apply to the broad definition of confusion. Nonetheless, even the more recent cases generally permit the use of another's trademark in truthful advertising. See *supra* note 151 and accompanying text. These cases, however, do not acknowledge that the goodwill of the trademark owner might still be harmed by improper handling.

185. 260 U.S. 689, 690 (1923).

186. *Id.*

plaintiff, except that the French boxes bore the label *POUDRE DE RIZ DE JAVA*, rather than simply *POUDRE DE JAVA*.<sup>187</sup> The defendant sold the imported power through a retail pharmacy in New York City.<sup>188</sup>

The central issue in *Katzel* was whether defendant infringed the plaintiff's U.S. trademark by selling face powder manufactured by the same French firm that supplied plaintiff.<sup>189</sup> The U.S. Court of Appeals for the Second Circuit, citing favorably a series of earlier circuit court cases, held that there was no infringement, and concluded that "[i]f the goods sold are the genuine goods covered by the trade-mark, the rights of the owner of the trade-mark are not infringed."<sup>190</sup>

The U.S. Supreme Court, in a short and cryptic opinion written by Justice Holmes, reversed the court of appeals, and held that the defendant's sale of French face powder infringed plaintiff's trademark.<sup>191</sup> The Court concluded that the French company would not have been able to sell its U.S. business to the plaintiff unless it had agreed not to compete with the plaintiff. Thus, the Court stated:

After the sale the French manufacturers could not have come to the United States and have used their old marks in competition with the plaintiff. That plainly follows from the statute authorizing assignments. If for the purpose of evading the effect of the transfer, it had arranged with the defendant that she should sell with the old label, we suppose that no one would doubt that the contrivance must fail.<sup>192</sup>

The Court also explicitly rejected the notion that the defendant had the right to sell the powder in the United States simply because the boxes and powder were the genuine product of the French company. The Court stated:

Ownership of goods does not carry the right to sell them with a specific mark. It does not necessarily carry the right

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187. *Id.* at 691.

188. *Bourjois & Co. v. Katzel*, 275 F. 539, 540 (2d Cir. 1921), *rev'd*, 260 U.S. 689 (1923).

189. *Katzel*, 260 U.S. at 691.

190. *Bourjois*, 275 F. at 543.

191. *Katzel*, 260 U.S. at 691.

192. *Id.*

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to sell them at all in a given place. If the goods were patented in the United States a dealer who lawfully bought similar goods abroad from one who had a right to make and sell them there could not sell them in the United States.<sup>193</sup>

The Supreme Court explained that the trademark did not simply indicate the French manufacturer, but represented the plaintiff and its goodwill:

[The trademark] deals with a delicate matter that may be of great value but that easily is destroyed, and therefore should be protected with corresponding care. It is said that the trade mark here is that of the French house and truly indicates the origin of the goods. But that is not accurate. It is the trade mark of the plaintiff only in the United States and indicates in law, and, it is found, by public understanding, that the goods come from the plaintiff although not made by it. It was sold and could only be sold with the good will of the business that the plaintiff bought. It stakes the reputation of the plaintiff upon the character of the goods.<sup>194</sup>

### *Trademark Territoriality*

The Supreme Court in *Katzel* rejected the principle of universality, upon which a number of earlier circuit court opinions had been based,<sup>195</sup> and established the principle of the territoriality of trademarks. According to the principle of universality, a trademark placed on merchandise in one country by an authorized party could not infringe the trademark rights of another party in another country when the goods were transported from the first

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193. *Id.* at 692 (citation omitted).

194. *Id.* (citations omitted).

195. *See, e.g.*, *Apollinaris Co. v. Scherer*, 27 F. 18, 21 (C.C.S.D.N.Y. 1816) (rejecting right of patent owner to prevent sale or use of product outside of territorial limits of license); *Bourjois*, 275 F. at 539 (holding importation and sale in United States of article bearing trademark under which it is sold in the foreign country where it is made does not infringe American trademark on same imported article).

country to the second country.<sup>196</sup> The principle of territoriality, on the other hand, stands for two propositions: (1) that a trademark has a separate legal existence under each country's laws, and (2) that a trademark symbolizes the goodwill of the owner of the national mark.<sup>197</sup> The first proposition states the definition of territoriality; the second states its rationale.

The principle of universality is related to the principle of exhaustion, which allows a trademark owner to control only the first sale of a trademarked good.<sup>198</sup> Once the first sale is made, the trademark owner's rights are exhausted and subsequent sales can be made by owners of the merchandise, without infringing the trademark. As applied to the gray-market, the exhaustion doctrine implies that the trademark owner's rights are exhausted when the first sale abroad is made. Thus, there can be no infringement when the goods are imported and sold in the United States.

Once it is recognized that a trademark has a separate legal existence in the United States, the exhaustion doctrine is no longer relevant in the context of gray-market imports. The sale of the merchandise abroad exhausts the local trademark owner's interest, but not that of the U.S. trademark owner. The local trademark owner's interest remains until it sells the good. Consequently, when the gray-market good is imported into the United States, it is bearing a trademark that copies or simulates a U.S. trademark.<sup>199</sup>

A number of opinions have suggested that the gray-market import does not necessarily bear a mark that is a copy or simulation of the U.S. trademark. These opinions suggest that it must also be shown that the trademark owner has established local goodwill in order for the gray-market import to bear a mark that copies or simulates a U.S. trademark.<sup>200</sup> Evidence of such local goodwill would presumably include advertising expenditures, warranty service, or a public perception that the U.S. importer is

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196. See Derenberg, *Territorial Scope and the Situs of Trademarks and Good Will*, 47 VA. L. REV. 733, 734 (1961).

197. See *Osawa & Co. v. B & H Photo*, 589 F. Supp. 1163, 1171-72 (S.D.N.Y. 1984); Derenberg, *supra* note 196, at 734.

198. *Osawa*, 589 F. Supp. at 1172.

199. *Id.*

200. See, e.g., *Olympus Corp. v. United States*, 792 F.2d 315, 320 (2d Cir. 1986).

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the party behind the trademark.<sup>201</sup> This view is mistaken. U.S. law creates the separate legal existence, and the reason behind the law is to protect the local goodwill. In every case in which there is a valid U.S. trademark, there is local goodwill.<sup>202</sup> In order to establish local goodwill, there is nothing to prove other than the existence of a valid trademark. Therefore, relief would always be granted, which would undermine any attempt to distinguish among trademarks on the basis of whether they represent local goodwill.<sup>203</sup>

### *Rationale of Katzel*

One of the many questions in the debate on the gray market concerns the rationale of the Supreme Court in *Katzel*. Proponents of the gray market argue that the decision stands for the proposition that subsequent to the sale of a national business, the sale of goods manufactured by the sold business in the country of the purchaser by anyone else infringes the trademark.<sup>204</sup> Such an interpretation would imply that only independent U.S. trademark owners would be protected against gray-market goods. Proponents of this position point to the facts of *Katzel*—particularly to the sale of the U.S. business and to the passage about the sale of the business.<sup>205</sup> The difficulty with this interpretation is that the first passage cited is an argument by analogy, and not an explanation why the face powder imported by defendant infringed plaintiff's trademarks. An alternative interpretation of *Katzel* argues that the plaintiff's trademark was infringed because the U.S. trademark represented the local goodwill of the U.S. trademark owner.<sup>206</sup> The question still remains, however, whether the reg-

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201. *Osawa*, 589 F. Supp. at 1173.

202. If this were not true the trademark would have no value, it would not be distinctive of a class of goods, and it would therefore not be a trademark.

203. The Customs Service has argued that the regulations are justified on the grounds of administrative convenience by preventing Customs from determining whether the trademark owner has isolated domestic goodwill. *Olympus*, 792 F.2d at 320; 627 F. Supp. at 921. Such an interpretation, however, incorrectly assumes that there can be a meaningful inquiry into the question whether the trademark owner has developed independent goodwill in the U.S.

204. See, e.g., *Bell & Howell*, 548 F. Supp. 1063, 1066 (E.D.N.Y. 1982).

205. *Id.* at 1066; see *supra* notes 186-198 and accompanying text.

206. Proponents of this position point to the language cited in the passage quoted above. This passage leads to the conclusion that the trademarks were infringed.

istered trademarks protected the plaintiff's local goodwill because the public perceived the plaintiff as the source of the goods, although not their manufacturer, or whether the trademark protected the plaintiff's local goodwill irrespective of the public's perception.

Whatever the logic of the *Katzel* decision at the time it was written,<sup>207</sup> trademark law has evolved and expanded its protection to reduce (if not to eliminate entirely) the importance of the public's actual perception. Today, it is generally recognized that a trademark can represent an anonymous source, and need not represent a manufacturer.<sup>208</sup> Moreover, a line of trademark cases recognizes that trademark owners should not be placed in positions where their goodwill can be destroyed by the actions of other parties.<sup>209</sup> Thus, if the Court's holding in *Katzel* was that the gray-market face powder infringed the U.S. trademark because the public perceived the domestic trademark owner as the source, current trademark law holds that this public perception is irrelevant. Therefore, even if *Katzel* is not controlling, the logic of the Court's decision in *Katzel*, interpreted in light of modern trademark law, would provide U.S. trademark owners with relief against gray-market importers.

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207. In the cited passage, the phrase "it is found by public understanding" is contained in a parenthetical. This supports the view that the public perception was not the rationale for the holding. To hold, however, that this settled the matter would be placing too much emphasis on the placement of two commas more than 60 years ago. *Roger & Gallet v. Janmarie*, 245 F.2d 505, 511 (C.C.P.A. 1957).

208. 15 U.S.C. § 1127 (1982); see A. MILLER & M. DAVIS, *supra* note 49, at 149; see also *Premier Dental Products Co. v. Darby Dental Supply Co.*, 794 F.2d 850, 854-55 (3d Cir. 1986).

209. This line of cases, called reverse confusion or illusion of sponsorship cases, involves a large business (usually the defendant) that adopts a trademark similar to a trademark that is already being used by a smaller business (usually the plaintiff). Because of the defendant's advertising, the public mistakenly comes to believe that plaintiff's product comes from the defendant. *E.g.* *Big O Tire Dealers, Inc. v. Goodyear Tire & Rubber Co.*, 561 F.2d 1365 (10th Cir. 1977), *cert. dismissed*, 434 U.S. 1052 (1978). In such a case, there is no confusion as to the origin of the defendant's goods, which was the traditional requirement for trademark infringement. See *Westward Coach Manufacturing Co. v. Ford Motor Co.*, 388 F.2d 627 (7th Cir.), *cert. denied*, 392 U.S. 927 (1968). In 1962, the Lanham Act was amended and the requirement that the confusion relate to the origin of defendant's goods was deleted. This amendment, which made any form of confusion actionable, increased the protection granted to a firm's goodwill. See J. GILSON, *supra* note 49, § 5.01; A. MILLER & M. DAVIS, *supra* note 49, § 13.2.

the other remedies they provide, each provision would permit the exclusion of goods imported in violation of it.

*Section 526 of the Tariff Act of 1930*

1922-23 was a banner period for opponents of the gray market. In addition to the Supreme Court decisions in the two *Bourjois* cases, Congress passed the General Goods Exclusion Act of 1922, which was later reenacted as section 526 of the Tariff Act of 1930 (section 526).<sup>219</sup> The Genuine Goods Exclusion Act made it illegal for anyone to "import into the United States any merchandise of foreign manufacture if such merchandise . . . bears a trademark owned by a citizen of, or by a corporation . . . created or organized within the United States . . . unless the written consent of the owner is produced at the time of making entry."<sup>220</sup>

This statute, which was intended to overrule the decision of the Court of Appeals for the Second Circuit in *Katzel*,<sup>221</sup> has been at the center of the debate on gray markets.<sup>222</sup> The statute raises two important questions. The first question is whether the statute protects the goodwill of independent U.S. trademark owners only or of all U.S. trademark owners, irrespective of their relationship with their foreign manufacturers.<sup>223</sup> The second question is, assuming that the statute protects the goodwill of all U.S. trademark owners, whether Customs' regulations can be upheld as an exercise of its enforcement discretion.

Three circuit court cases have dealt directly with the scope of section 526 and the validity of Customs' regulations interpreting that section. The first case to put Customs' regulations under section 526 firmly at issue was *Vivitar Corp. v. U.S. and 47th St. Photo*.<sup>224</sup> Plaintiff, Vivitar, is a U.S. corporation and the owner of the VIVITAR trademark in the United States.<sup>225</sup> Vivitar author-

219. 19 U.S.C. § 1526 (1982).

220. 19 U.S.C. § 1526(a) (1982).

221. *Osawa*, 589 F. Supp. 1163, 1171 (S.D.N.Y. 1984).

222. *Compare COPIAT*, 790 F.2d 903, 910-912 (D.C. Cir. 1986) (section 526 intended to protect all U.S. companies), *with Vivitar Co. v. United States*, 593 F. Supp. 420, 426-428 (Ct. Int'l Trade 1984) (section 526 only intended to overturn *Katzel*).

223. *See Vivitar*, 593 F. Supp. at 1565-68; *Osawa*, 589 F. Supp. at 1163.

224. 593 F. Supp. 420 (1984), *aff'd*, 761 F.2d 1552 (D.C. Cir. 1985), *cert. denied*, 106 S. Ct. 791 (1986).

225. *Vivitar*, 593 F. Supp. 420, 422 (1984).

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### *Extending Katzel*

In 1923, the logic of *Katzel* was extended to section 27 of the Trademark Act of 1905 (1905 Act),<sup>210</sup> the predecessor of section 42 of the Lanham Act.<sup>211</sup> Section 27 of the 1905 Act excluded from entry into the United States marks that copy or simulate registered trademarks.<sup>212</sup> In *Bourjois & Co. v. Aldridge*,<sup>213</sup> the same plaintiff as in *Katzel* brought suit against Aldridge, the Collector of Customs, in order to exclude French face powder imported into the United States bearing the French registered trademark *POUDRE MANON LESCAUT*.<sup>214</sup> The plaintiff argued that the imported face powder bore a trademark that copied or simulated the identical U.S. registered trademark.<sup>215</sup> In response to questions certified by the U.S. Court of Appeals for the Second Circuit,<sup>216</sup> the U.S. Supreme Court ruled in favor of the plaintiff and directed the Collector of Customs to exclude the genuine, but infringing, French powder.<sup>217</sup>

The significance of the Supreme Court's decision in *Aldridge* is its holding that under section 27 of the 1905 Act, importation of genuine unauthorized trademarked goods produced abroad infringes the U.S. trademark. Thus, *Aldridge* extended the logic of *Katzel* to the 1905 Act and provided an independent statutory ground for excluding gray-market imports.<sup>218</sup>

### *Statutory Provisions*

Congress has enacted four statutory provisions by which the importation of gray-market goods may be fought. In addition to

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210. *Id.* (originally enacted as Act of Feb. 20, 1905, ch. 592, § 27, 33 Stat. 730).

211. 15 U.S.C. § 1124 (1982).

212. *See Osawa & Co. v. B & H Photo*, 589 F. Supp. 1163, 1171 (S.D.N.Y. 1984) (citing *A. Bourjois & Co. v. Aldridge*, 263 U.S. 675 (1923) (per curiam)).

213. 263 U.S. 675 (1923) (per curiam).

214. *See Osawa*, 589 F. Supp. at 1171.

215. *Id.*

216. The Second Circuit certified the following two questions:

- (1) Is the sale in the United States of Werthermer's Manon Lescaut powder an infringement of plaintiff's registered trade-mark?
- (2) Is the collector, by section 27 of the Trade-mark Law, required to exclude from entry genuine Manon Lescaut powder so as aforesaid made in France?

A. *Bourjois & Co. v. Aldridge*, 292 F. 1013, 1014 (2d Cir. 1922).

217. *Id.*

218. *See Osawa*, 589 F. Supp. at 1171.



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ized foreign firms to manufacture photographic equipment with the VIVITAR trademark.<sup>226</sup> The equipment was then marketed outside of the United States by a wholly-owned subsidiary of Vivitar.<sup>227</sup> Third parties bought the equipment abroad and imported it into the United States without Vivitar's authorization.<sup>228</sup> Plaintiff, contending that Customs' regulations were contrary to law, sought a declaratory judgment that Customs was required to exclude all imports bearing its trademarks that entered without its consent.<sup>229</sup> Thus, the central issue in *Vivitar* was the proper construction of section 526.<sup>230</sup> Both sides moved for summary judgment, and the U.S. Court of International Trade (CIT) found in favor of the defendant.<sup>231</sup> The CIT based its decision on two points: Congress had reviewed Customs' regulations enforcing section 526 without altering it, and Customs had maintained a consistent interpretation since 1936.<sup>232</sup> Thus, in view of the legislative and administrative history of section 526, the CIT held that Customs' interpretation was sufficiently reasonable.<sup>233</sup>

Vivitar appealed to the Court of Appeals for the Federal Circuit, which affirmed the CIT decision but on narrower grounds, specifically rejecting the grounds upon which the CIT's decision had been based.<sup>234</sup> The Federal Circuit found the legislative history too unfocused to permit a definitive interpretation of congressional intent.<sup>235</sup> It also found there to be no long-standing, consistent interpretation by Customs of section 526.<sup>236</sup> Instead, the Federal Circuit found a history of changing interpretations.<sup>237</sup> Finally, the court found Congress too unfamiliar with Customs' enforcement of section 526 to infer that Congress had ratified Customs' regulations.<sup>238</sup>

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226. *Id.*

227. *Id.*

228. *Id.* at 422-423.

229. *Id.* at 422.

230. *Id.* at 425.

231. *Id.* at 423, 436.

232. *Id.* at 425-26.

233. *Id.* at 433-34.

234. *Vivitar*, 761 F.2d 1552 (1985).

235. *Id.* at 1563-65.

236. *Id.* at 1565-68.

237. *Id.*

238. *Id.* at 1568.

The Federal Circuit did not hold Customs' regulations to be invalid; rather, it held the current regulations to be valid but not controlling with respect to the scope of protection of section 526(a).<sup>239</sup> The court held that Customs' regulations merely define Customs' role in initiating administrative enforcement.<sup>240</sup> Customs is not required to exclude all gray-market goods *sua sponte*.<sup>241</sup> Because section 526(c) provides U.S. trademark owners with a private right of action,<sup>242</sup> they can go to district court to have their rights under section 526 adjudicated on a case-by-case basis.<sup>243</sup>

The only case to strike down completely Customs' regulations was brought in the District Court for the District of Columbia by the Coalition to Preserve the Integrity of American Trademarks (COPIAT) against the United States. Two retailers that deal in gray-market merchandise, K-mart and 47th St. Photo, intervened. In *COPIAT v. United States*,<sup>244</sup> plaintiff brought an action alleging that Customs' regulations under section 526 are inconsistent with the 1930 Act and the Lanham Act.<sup>245</sup> Plaintiff sought a declaratory judgment that Customs' regulations are inconsistent with section 526, an injunction prohibiting enforcement of these regulations, and an order directing that the statute be enforced.<sup>246</sup> The district court found the regulations to be sufficiently reasonable.<sup>247</sup>

On appeal, the U.S. Court of Appeals for the D.C. Circuit, per Judge Silberman, held that the regulations were inconsistent with the statute they implemented.<sup>248</sup> The court found that the language of section 526 was clear, and thus, there was no room for a different interpretation by Customs;<sup>249</sup> hence, the court held that the regulations were invalid as an unreasonable interpretation of the statute.<sup>250</sup> The D.C. Circuit explicitly rejected the Federal

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239. *Id.* at 1570.

240. *Id.* at 1569.

241. *Id.*

242. 19 U.S.C. § 1526(c) (1982). See *supra* note 14 for statutory language of section 526(c).

243. *Vivitar*, 761 F.2d at 1570.

244. 598 F. Supp. 844 (D.D.C. 1984).

245. *Id.* at 845.

246. *Id.*

247. *Id.* at 852-53.

248. *COPIAT*, 790 F.2d 903.

249. *Id.* at 908-13.

250. *Id.* at 908-16.

guided by *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,<sup>260</sup> where the Supreme Court stated:

When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction of the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

'The power of an administrative agency to administer a congressionally created . . . program necessarily requires the formulation of policy and the making of rules to fill any gap left, implicitly or explicitly, by Congress.' *Morton v. Ruiz*, 415 U.S. 199, 231 (1974). If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute. Sometimes the legislative delegation to an agency on a particular question is implicit rather than explicit. In such a case, a court may not substitute its own construction of a statutory provision for a reasonable interpretation made by the administrator of an agency.<sup>261</sup>

Section 526 leaves no gap to be filled, and Customs' interpretation that the statute only applies when there is an independent

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260. 467 U.S. 837 (1984).

261. *Id.* at 842-44 (footnotes omitted).

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Circuit's conclusion that the regulations were a legitimate means of defining Customs' role in initiating enforcement because Customs has always viewed the regulations as its interpretation of the law, not as an expression of its discretion to prosecute less than to the full extent of the law.<sup>251</sup>

Most recently, the Court of Appeals for the Second Circuit, in *Olympus Corp. v. United States*, has followed the path of the Federal Circuit by upholding Customs' regulations while permitting U.S. trademark holders to pursue private remedies.<sup>252</sup> Olympus is the U.S. subsidiary of the Japanese corporation that manufactures OLYMPUS brand cameras and accessories.<sup>253</sup> Having failed to get Customs to change its administrative practice, Olympus brought suit seeking a declaration that the Customs' regulations are invalid.<sup>254</sup> The Second Circuit held that there had been congressional acquiescence in Customs' longstanding administrative interpretation.<sup>255</sup> The Second Circuit also held that Customs' interpretation of section 526 avoided the making of a decision at the time the goods are imported as to whether the trademark holder was engaging in price discrimination.<sup>256</sup> Judge Winter's dissent rejected the administrative convenience argument because that argument is premised on the idea that not all gray-market goods are excluded by section 526.<sup>257</sup>

What these cases suggest is that the validity of Customs' regulations is a question of administrative law as much as a question of tariff or trademark law.

There are several problems with the position that section 526 was enacted to protect independent U.S. trademark owners only.<sup>258</sup> First, the language of the statute is clear. All trademarked merchandise is to be excluded unless the U.S. trademark owner has given his consent. In deciding what deference to give Customs' interpretation of section 526, the D.C. Circuit in *COPIAT*<sup>259</sup> was

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251. *Id.* at 918.

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

253. *Id.* at 317.

254. *Id.* at 316.

255. *Id.* at 320.

256. *Id.*

257. *Id.* at 322 (Winter, J., dissenting).

258. The three circuit courts that have considered the issue have all held that section 526 was enacted to do more than just reverse the Second Circuit's decision in *Katzel Vivitar*, 761 F.2d at 1565; *COPIAT*, 790 F.2d at 912; *Olympus*, 792 F.2d at 319.

259. 790 F.2d at 908.

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U.S. trademark owner is in direct conflict with the statute.<sup>262</sup>

An examination of the legislative history of section 526 reveals no clear indication that Congress intended section 526 to be limited to the facts in *Katzel*. The Senate debate on section 526 was short but vigorous.<sup>263</sup> Certainly some of the opponents of the bill thought it would cover a wide range of imports. Senator Kellogg declared that it applied to everything,<sup>264</sup> and Senator Lenraut thought the amendment would apply to related as well as unrelated trademark owners.<sup>265</sup> The proponents of the bill stated on two occasions that the bill would only apply when the trademark had been sold to a U.S. citizen or business,<sup>266</sup> yet they did not say that any such U.S. business would have to be independent of the foreign trademark owner.<sup>267</sup> Moreover, the Senate was mistaken about the facts in *Katzel*. The Senate that passed the General Goods Exclusion Act of 1922 was of the opinion that the French trademark owner in *Katzel* sold the trademarked merchandise in the United States;<sup>268</sup> it did not know that independent

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262. In a recent case involving a Federal Reserve Board regulation defining banks, the Supreme Court held that the Board acted without authority in defining banks more broadly than their statutory definition. In striking down the regulation, which would have expanded the Board's authority beyond that granted by Congress, the Court made the following statement:

In determining whether the Board was empowered to make such a change, we begin, of course, with the language of the statute. If the statute is clear and unambiguous "that is the end of the matter, for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." The traditional deference courts pay to agency interpretation is not to be applied to alter the clearly expressed intent of Congress.

Board of Governors of the Federal Reserve System v. Dimension Financial Corp., 106 S. Ct. 681, 686 (1986) (footnote omitted).

263. It only runs four pages from 62 CONG. REC. S11,602 to S11,605.

264. 62 CONG. REC. S11,603 (daily ed. Aug. 19, 1922) (statements of Sen. Kellogg).

265. *Id.* at S11,605 (statement of Sen. Lenroot); see *COPIAT*, 790 F.2d 903, 911-912 (D.C. Cir. 1986).

266. 62 CONG. REC. S11,603, S11,605.

267. After declaring that the bill would only protect citizens who purchased the U.S. trademark, Senator Sutherland responded to a hypothetical posed by Senator Lenroot claiming that the bill would prevent an American from going to Toronto, buying, and then importing into the United States goods manufactured in the United States. 62 CONG. REC. S11,603 (daily ed. Aug. 19, 1922) (statements of Sen. Sutherland and Sen. Lenroot). This answer indicates a broader scope for the bill than the *Katzel* situation.

268. 62 CONG. REC. S11,603, S11,604 (daily ed. Aug. 19, 1922) (statements of Sen. Sutherland and Sen. McCumber).

importers purchased the powder in France and imported it into the United States. Because the Senate was mistaken about the *Katzel* facts, it would be difficult to limit section 526 to the actual facts in *Katzel*. Moreover, there are a number of references that suggest the provision is aimed at fraud.<sup>269</sup> A U.S. trademark owner is not defrauded by a foreign trademark owner just because he has purchased the U.S. rights; the foreign trademark owner commits fraud only when, after selling the exclusive U.S. rights to another, it tries to compete. Thus, it is difficult to reach any conclusions from the Senate debate on the scope of the legislation.<sup>270</sup>

In addition to the clear language of the statute,<sup>271</sup> the strongest argument against reading any implied limitations into the statute is that the Senate amended the bill so that it only covered merchandise of foreign manufacture, and the House amended the bill so that only U.S. entities, and not merely domiciliaries, were protected. If Congress really thought the bill applied only to independent U.S. firms that had purchased the exclusive U.S. rights from the foreign manufacturer, neither amendment would have been necessary.<sup>272</sup> Therefore, section 526 cannot properly be interpreted to exclude gray-market imports only when there is an independent U.S. trademark owner.

Proponents of the gray market have frequently argued that Customs' regulations reflect a consistent, long-standing interpretation of the statute and are entitled to substantial deference.<sup>273</sup> Putting aside the rule that an agency's interpretation of a statute cannot be upheld in the face of clear and contrary statutory language,<sup>274</sup> an examination of more than sixty years of administrative practice reveals a history of changing interpretations. The first set of regulations, issued in 1931, was quite broad and prohibited the entry of "imported merchandise bearing a genuine trademark when such trademark is recorded with the Treasury

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269. *Id.*

270. See *COPIAT*, 790 F.2d at 913-18; *Vivitar Co. v. United States*, 761 F.2d 1552, 1553 (Fed. Cir. 1985). But see *Vivitar*, 593 F. Supp. 420, 426-28 (Ct. Int'l Trade 1984).

271. Kenneth Dam, who argued that section 526 permits trademark owners to engage in monopolistic price discrimination, conceded that the plain meaning of the statute was probably controlling. Dam, *supra* note 6 and accompanying text.

272. See *COPIAT*, 790 F.2d at 912.

273. See, e.g., *id.* at 913-14; *Vivitar*, 761 F.2d at 1565.

274. See *supra* note 262.

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Department and registered under the trademark law of February 20, 1905 if compliance is had with all provisions of section 526 of the Tariff Act of 1930."<sup>275</sup> In 1936, Customs issued a new series of regulations that significantly limited the scope of section 526.<sup>276</sup> The new regulations still prevented foreign goods bearing an identical U.S. trademark from entering the United States without the U.S. trademark owner's consent. The new regulations, however, denied this protection against imports from a foreign entity if the foreign trademark and U.S. trademark were owned by the same entity.<sup>277</sup> In 1953, Customs further reduced the protection afforded by section 526 when it issued regulations that would not bar unauthorized imports when the foreign trademark was owned by a "related company" of the U.S. trademark owner; the definition of related company was broad enough to include licensees.<sup>278</sup> In practice, however, the regulation was not enforced and section 526 was enforced without exception.<sup>279</sup> In 1959, Customs changed its regulations again; the "related company" exception was out, replaced by a "same entity" exception. The 1959 regulations, however, did not require disclosure, so they could not be fully enforced.<sup>280</sup> In 1972, Customs adopted its present regulations, which contain exceptions for common ownership and license agreements, and which require disclosure of these relationships.<sup>281</sup>

That Customs has not maintained a consistent, long-standing interpretation of the statute<sup>282</sup> is also evident from the *Guerlain*

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275. *Vivitar*, 593 F. Supp. at 428-29 (quoting Customs' Regulations of 1931, art. 518(a)).

276. *Id.* at 429; Speech of David Elliot, Grey Market Goods—The Law and the Grey Market—Which Court Has The Current View? What Does the Future Hold?, Third Annual Judicial Conference of the Court of International Trade in New York City (Oct. 24, 1986).

277. *See Vivitar*, 593 F. Supp. at 428-32.

278. *See Vivitar*, 761 F.2d at 1566.

279. Speech of David Elliot, Grey Market Goods—The Law and the Grey Market—Which Court Has The Current View? What Does the Future Hold? Third Annual Judicial Conference of the Court of International Trade in New York City (Oct. 24, 1986); Note, *The Greying of American Trademarks; The Genuine Goods Exclusion Act and the Incongruity of Customs Regulation* 19 C.F.R. 133.21, 54 FORDHAM L. REV. 83, 98-101 (1985).

280. *See Vivitar*, 761 F.2d at 1566.

281. *Id.* at 1567.

282. Detailed discussions of the history of Customs' administrative practices are

and *Bell & Howell: Mamiya Co. v. Masel Supply Co.* cases. *Guerlain* involved three U.S. trademark owners that had used section 526 to exclude genuine goods.<sup>283</sup> The three U.S. firms were all related to the French manufacturers.<sup>284</sup> The district court found a violation of the Sherman Act.<sup>285</sup> On appeal, the Solicitor General indicated that the United States wanted to abandon the suit because, while the Justice Department considered section 526 unavailable to U.S. subsidiaries of foreign trademark owners, Customs considered itself bound to enforce section 526 literally.<sup>286</sup> Just three years ago, in *Bell & Howell: Mamiya*, the Chief Counsel of the Customs Service signed an amicus brief filed by the Department of Justice, arguing that the plain meaning of section 526 is controlling.<sup>287</sup> The brief argues that only the clearest showing of contrary congressional intent could justify a different interpretation, and that there is no clear evidence of such intent.<sup>288</sup> Thus, Customs'

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contained in *Vivitar*, 593 F. Supp. at 428-33, 776 F.2d at 1565-68; Note, *supra* note 279, at 98-101. The courts have reached opposite conclusions. The CIT concluded that Customs has been consistent, 593 F. Supp. at 432, and the CAFC concluded that it has not been consistent, 776 F.2d at 1568.

283. *United States v. Guerlain, Inc.*, 155 F. Supp. 77 (S.D.N.Y. 1957), *vacated and remanded*, 358 U.S. 915 (1958), *dismissed with prejudice*, 172 F. Supp. 107 (S.D.N.Y. 1959).

284. *Id.*

285. *Id.*

286. *See Vivitar Co. v. United States*, 761 F.2d 1552, 1566-1567 (Fed. Cir. 1985); *COPIAT*, 790 F.2d 903, 915 (D.C.Cir. 1986).

287. *See Vivitar*, 761 F.2d at 1568; *Duracell*, *supra* note 3, at 2-3 (additional views of Vice Chairman Liebler).

288. The amicus brief argues that U.S. trademark owners have the legal right to exclude gray-market imports:

[T]he plain meaning of the words Congress has selected is ordinarily conclusive of the scope of a statute, absent the clear expression of a contrary intent by Congress . . . . Here, nothing in the language of §§ 32 or 42 of the Lanham Act or in the language of § 526 of the 1930 Tariff Act, 19 U.S.C. 1526, which affords additional remedies to U.S. trademark holders, expressly limits the exclusionary rights conferred to U.S. firms that are independent of owners of identical foreign marks. Rather, the relevant language in all three statutory provisions purports to confer the exclusionary rights awarded to all owners of U.S. trademarks who satisfy the other requirements of the provisions. Since the statutory language contains no ambiguity on this point, only the clearest expression of a contrary intent in the legislative history would warrant departing from the normal meaning of the language employed by Congress . . . . But neither the legislative reports nor the congressional debate contain



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interpretation of section 526—that it does not cover trademarked imports when the U.S. and foreign trademark owners are related in certain ways—is at least fourteen years younger than the statute and has been inconsistent since then.<sup>289</sup>

Most of the litigation and debate involving section 526 now revolves around the validity of Customs' regulations promulgated under subsection d,<sup>290</sup> as seen in the division among the circuit courts on the question whether Customs' regulations are valid.<sup>291</sup> Two circuit courts have held that Customs' regulations are a legitimate exercise of Customs' discretion in enforcing section 526, but do not define the limits of section 526.<sup>292</sup> The statute, however, does not grant Customs the discretion not to exclude any trademarked merchandise covered by section 526(a). Thus, to permit Customs to refuse to exclude gray-market goods as an act of agency discretion is to allow it to engage in a pattern of nonenforcement of clear statutory language.<sup>293</sup> Moreover, the administrative convenience argument—that Customs can avoid determining whether the U.S. trademark owner is engaging in anticompetitive behavior—<sup>294</sup>presumes section 526 does not exclude all gray-market goods of foreign manufacture.<sup>295</sup> Therefore,

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any clear evidence of a legislative intent to deny trademark protection where the owner of the U.S. mark is owned or controlled by the foreign manufacturer of the trademarked goods.

Brief for the United States of America, *Amicus Curiae*, at 5, Bell & Howell: Mamiya Co. v. Masel Supply Co., 719 F.2d 42 (2d Cir. 1983) (footnotes omitted); see also *Duracell*, *supra* note 3, at 3 (additional views of Vice Chairman Liebler).

289. The inconsistency of Customs' interpretation of section 526 over the years weakens any argument that Congress has ratified or acquiesced in a particular interpretation. Moreover, although Congress was aware, albeit incorrectly, of Customs' interpretation in 1978 when it amended section 526 to exempt returning travelers, there is no evidence that Congress approved of Customs' practice. It does not follow that Congress acquiesced in Customs' interpretation of one part of the statute because it decided to change another. See *COPIAT*, 790 F.2d at 917; *Vivitar*, 761 F.2d at 1568. *But see Vivitar*, 593 F. Supp. at 432-33; see also Speech of David Elliot, *supra* note 276.

290. The regulations promulgated under 19 U.S.C. § 1526(d) (1982) are published at 19 C.F.R. § 133.21 (1985) and are reprinted in pertinent part in footnote 15, *supra*.

291. See *Vivitar*, 593 F. Supp. at 428-31 (quoting customs regulations promulgated pursuant to subsection (d) of the Tariff Act of 1930).

292. *Vivitar*, 761 F.2d at 1569-70; *Olympus*, 792 F.2d at 320. *But see COPIAT*, 790 F.2d at 918.

293. *Heckler v. Chaney*, 470 U.S. 821, 839 (1985) (Brennan, J., concurring).

294. *Olympus*, 792 F.2d at 320; *Vivitar*, 761 F.2d at 1569-70.

295. See *Olympus*, 792 F.2d at 320 (Winker, J., dissenting).

Customs' regulations under section 526(d) should not be upheld as an exercise of its enforcement discretion.

*Section 42 of the Lanham Act*

The second statutory provision that has been used to exclude gray-market goods from the United States is section 42 of the Lanham Act.<sup>296</sup> Section 42 of the Lanham Act reads in pertinent part:

*Except as provided in [Treasury regulations under section 526], no article or imported merchandise which shall copy or simulate the name of any domestic manufacturer, or trader, or of any manufacturer or trader located in any foreign country which, by treaty, convention, or law affords similar privileges to citizens of the United States, or which shall copy or simulate a trademark registered in accordance with the provisions of this chapter . . . shall be admitted to entry at any customhouse of the United States.*<sup>297</sup>

The ability of section 42 to provide relief against unauthorized imports is limited by Customs' regulations interpreting section 526 and the language "copy or simulate a [registered] trademark."<sup>298</sup> The issue is whether the unauthorized trademarks affixed to genuine merchandise imported into the United States copy or simulate a trademark, within the provisions of the statute. In most cases, the trademarks are similar, if not identical. Thus, the only questions would appear to be whether the foreign goods are insulated by virtue of their being genuine, and, if they are not, what must be proven to show that the mark is a copy or simulation of the registered trademark. *Katzel and Aldridge*, which held that genuine goods can infringe the identical U.S. trademark, clearly show that genuine goods are not exempt.<sup>299</sup>

Unlike section 32(1) of the Lanham Act, which defines trademark infringement,<sup>300</sup> section 42 does not require consumer con-

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296. 15 U.S.C. § 1124 (1982).

297. *Id.* (emphasis added).

298. See *supra* notes 219-287 and accompanying text.

299. See *supra* notes 185-194 and 204-218 and accompanying text.

300. Section 32(1) provides that the use of a copy of a registered trademark is only actionable if there is confusion. 15 U.S.C. § 1114 (1982). See *supra* notes 174-184 and accompanying text.

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fusion, only that there be a copy or simulation. Moreover, it is difficult to see how the relationship between the domestic and foreign trademark owner would be relevant under section 42.<sup>301</sup> *Aldridge* held that face powder produced by the French trademark owner in France for sale in France bears a trademark that is a copy or simulation of the U.S. trademark when the U.S. trademark is owned by a company that is independent of the French trademark owner.<sup>302</sup> If the U.S. trademark owner were related to the French trademark owner, the gray-market powder would still be genuine and would still enter the U.S. market outside of the control of the U.S. trademark owner. In both cases, the U.S. trademark owner would obtain his powder from the French manufacturer and would promote it in the United States. In both cases, the gray-market powder would be produced by the French manufacturer and it would be imported and sold by someone other than the U.S. trademark owner. From the perspective of the U.S. trademark owner, the situation would be the same.<sup>303</sup> Therefore, assuming the U.S. trademark is registered, then any gray-market import bearing that trademark bears a trademark that copies or simulates a U.S. registered trademark.

### *Section 43 of the Lanham Act*<sup>304</sup>

A third statutory provision that could serve as a basis for excluding gray-market imports is section 43 of the Lanham Act,<sup>305</sup> which is generally recognized as incorporating the common law of unfair competition into federal statutory law.<sup>306</sup> Section 43(b)

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301. See *Olympus*, 627 F.2d Supp. at 321. The court heard this argument but rejected it because it placed too much emphasis on a one-sentence, *per curiam* opinion that may have been influenced by the equities of the case. *Id.*

302. This holding was implicit. The circuit court asked if the powder infringed the U.S. trademark; a mark must be a copy or simulation in order for it to infringe a trademark.

303. When a U.S. trademark owner is related to a foreign trademark owner and gray-market imports do not copy the U.S. trademark, they cannot infringe the U.S. mark even if there is confusion; one of the statutory elements of infringement is that there be a copy of a registered mark. 15 U.S.C. § 1114(1)(a) (1982).

304. 15 U.S.C. § 1125 (1982).

305. The text of section 43(a) of the Lanham Act, 15 U.S.C. § 1125(a) (1982), can be found in footnote 155, *supra*; see also *supra* note 67 and accompanying text.

306. See J. GILSON, *supra* note 49, § 7.02; A. MILLER & M. DAVIS, *supra* note 49, at 250.

prohibits the importation of goods that are marked in violation of section 43(a).<sup>307</sup> Gray-market goods that are not adequately labeled as being imported and sold outside of the manufacturer's chain of distribution falsely represent the party that authorizes the goods. Thus, gray-market goods could violate the language of section 43(a) because they falsely suggest that they come from the U.S. trademark owner.<sup>308</sup> Although unlabeled gray-market goods would be covered by section 43(a), labeled gray-market goods that merely take a free ride on investments by domestic trademark owners would not be covered. For if the gray-market goods were properly labeled so that consumers knew precisely what they were receiving, there would be no false representation.<sup>309</sup>

*Section 337 of the Tariff Act of 1930*<sup>310</sup>

There is a fourth statute that can serve as a basis for excluding gray-market merchandise: section 337 of the Tariff Act of 1930, which is administered by the U.S. International Trade Commission (ITC).<sup>311</sup>

Section 337 proscribes unfair methods of competition (in the importation or sale of merchandise) that have the effect or tendency to destroy or injure substantially an industry efficiently and economically operated in the United States.<sup>312</sup> If the ITC finds a

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307. Section 43(b) reads in pertinent part: "[A]ny goods marked or labeled in contravention of the provisions of this section shall not be imported into the United States or admitted to entry at any customhouse of the United States." 15 U.S.C. § 1125(b) (1982).

308. See *infra* notes 310-336 and accompanying text.

309. This is not to say that properly labeled gray-market goods can prevent all confusion. A consumer who purchases a defective DURACELL battery that is clearly labeled as imported and sold outside the authorized chain of distribution may not know whether the battery is defective because of improper handling by the importer or poor quality control by Duracell. See *supra* note 184 and accompanying text. Although the purchaser of a properly labeled gray-market import can suffer trademark confusion, he would still have no claim under section 43(a) because there would be no false representation.

310. 19 U.S.C. § 1337 (1982).

311. *Id.* For a discussion of the Commission's proceedings under section 337, see Palmeto, *The U.S. International Trade Commission at Common Law*, 18 J. WORLD TRADE L. 497 (1984).

312. Section 337 of the Tariff Act reads in operative part as follows:

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violation of section 337, it must grant an order excluding the offending merchandise from entering the United States, unless considerations of public interest indicate that a different remedy or no remedy would be appropriate.<sup>313</sup> Once the ITC has made its determination, it must communicate this determination to the President, who may then disapprove the ITC's determination for policy reasons.<sup>314</sup> If the President disapproves the ITC's determination, the determination is without legal force or effect.<sup>315</sup>

*Certain Alkaline Batteries (Duracell)* is the first gray-market case to be brought under section 337.<sup>316</sup> The complainant, Duracell, is the owner of the U.S. registered trademark DURACELL, which it uses on alkaline batteries it manufactures in the United States.<sup>317</sup> The identical trademark, registered in Belgium, is owned by Duracell International, a subsidiary of Duracell.<sup>318</sup> Duracell authorized Duracell-Belgium, a subsidiary of Duracell International, to manufacture DURACELL batteries and affix the Belgian trademark.<sup>319</sup> Duracell-Belgium was not authorized to sell batteries in

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Unfair methods of competition and unfair acts in the importation of articles into the United States, or in their sale by the owner, importer, consignee, or agent of either, the effect or tendency of which is to destroy or substantially injure an industry, efficiently and economically operated in the United States, or to prevent the establishment of such an industry, or to restrain or monopolize trade and commerce in the United States, are declared unlawful, and when found by the Commission to exist shall be dealt with, in addition to any other provision of the law, as provided in this section.

19 U.S.C. § 1337(a) (1982).

313. Section 1337(d) reads in pertinent part as follows:

If the Commission determines, as a result of an investigation under this section, that there is a violation of this section, it shall direct that the articles concerned, imported by any person violating the provision of this section, be excluded from entry into the United States, unless, after considering the effect of such exclusion upon the public health and welfare, competitive conditions in the United States economy, the production of like or directly competitive articles in the United States, and United States consumers, it finds that such articles should not be excluded from entry.

19 U.S.C. § 1337(d) (1982).

314. 19 U.S.C. § 1337(g) (1982).

315. *Id.*

316. *Supra* note 3.

317. *Duracell*, *supra* note 3, at 4-5.

318. *Id.*

319. *Id.* at 5.

the United States.<sup>320</sup> Importers, such as the respondents, would purchase DURACELL batteries on the open market in Europe after they had left the control of Duracell-Belgium, import them into the United States, and sell them to retailers for sale in the U.S. market.<sup>321</sup>

The ITC unanimously held that gray-market DURACELL batteries violated section 337.<sup>322</sup> The ITC found a violation of section 337 on six grounds: (1) common law trademark infringement,<sup>323</sup> (2) trademark infringement under the Lanham Act,<sup>324</sup> (3) violation of section 42 of the Lanham Act,<sup>325</sup> (4) misappropriation of trade dress,<sup>326</sup> (5) false designation of origin,<sup>327</sup> and (6) violation of the Fair Packaging and Labeling Act.<sup>328</sup> The ITC determined that an order excluding the unauthorized batteries was the appropriate remedy because only an exclusion order could protect Duracell's goodwill in the United States.<sup>329</sup>

The efficacy of section 337 as an instrument to prevent gray-market imports is currently in doubt. On January 4, 1985, President Reagan informed the ITC of his decision to disapprove its determination in this case.<sup>330</sup> The President gave two reasons for his disapproval. First, the Commission's interpretation of section 42 of the Lanham Act was at odds with Treasury's interpretation.<sup>331</sup> Second, because the Cabinet Council on Commerce and Trade was studying the problem, a failure to disapprove the

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320. *Id.*

321. *Id.* at 5-6.

322. *Id.* at 1.

323. *Id.* at 6-20.

324. *Id.* at 23-33.

325. *Id.* at 20-23.

326. *Id.* at 33.

327. *Id.* at 33-34.

328. *Id.* at 34-35.

329. *Id.* at 39. The minority recommended a narrow exclusion order drawn against batteries that violated the Fair Packaging and Labeling Act, which requires labels in English. The minority also recommended labeling, arguing that it would prevent consumer confusion. *Id.* at 33-39 (views of Chairwoman Stern and Commissioner Rohr). The majority, however, thought that because of the strength of the mark and the low value of the product, consumers probably would not read the labels. *Id.* at 37-41.

330. Determination of the President Regarding Certain Alkaline Batteries, 50 Fed. Reg. 1655 (1985).

331. *Id.*

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determination could be viewed as a change in the current policy before the process was complete.<sup>332</sup> Although the President's disapproval of the ITC's decision in *Duracell* raises a practical question of whether section 337 will be used to prevent gray-market imports,<sup>333</sup> there is no question that section 337 is quite broad, since it refers to "unfair methods of competition and unfair acts in the importation of articles."<sup>334</sup> The Court of Customs and Patent Appeals (CCPA), which was the ITC's reviewing court,<sup>335</sup> has held that the language of section 337 cannot be limited to the technical definition of unfair methods of competition, and that the ITC has been given a wide grant of discretion in determining what practices are unfair.<sup>336</sup> Even at best, however, section 337 would be an imperfect solution to the gray-market problem. The virtue of section 337 is that the remedy is to exclude the offending merchandise. The weakness of section 337 is that the U.S. trademark owner may not be able to obtain that remedy until it has already been damaged, perhaps severely, by gray-market merchandise.

### CONCLUSION

Gray-market goods take a free ride on the investments made by U.S. trademark owners and reduce the returns to manufacturers and trademark owners from providing high-quality goods and promoting them. In the long run, this will lead to fewer brands, lower-quality merchandise, fewer services and less information. Prohibiting U.S. trademark owners from excluding gray-market goods will also inhibit the introduction of foreign products into the United States and the introduction of U.S. products

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332. *Id.*

333. Since the President's disapproval in *Duracell*, only one complaint involving gray-market imports has been filed with the Commission. This one case, involving "Cabbage Patch Kids" dolls, relied on a claim of copyright infringement and did not include any trademark claims. On November 7, 1986 the Commission voted to issue a general exclusion order; the period for presidential review expires 60 days later. Certain Soft Sculpture Dolls, Popularly Known as "Cabbage Patch Kids," Related Literature and Packaging Therefor, Inv. No. 337-TA-231, USITC Pub. 1923 (1986).

334. *See supra* note 300.

335. The Court of Appeals of the Federal Circuit (CAFC) is the successor to the CCPC following the 1982 reorganization, and is now the Commission's reviewing court. *See* 28 U.S.C.A. § 1295 (1982).

336. *In re Von Clem*, 229 F.2d 441, 444 (C.C.P.A. 1955).

abroad. Moreover, a government-enforced ban on gray-market imports is the only effective remedy against gray-market imports. Therefore, U.S. trademark owners should have the right to exclude gray-market imports from the United States.

In contrast, the current policy of the United States toward gray-market imports is illogical: gray-market goods can enter the United States without the U.S. trademark owner's permission only if the U.S. and foreign trademark owners are related. The folly of this approach is that the relationship between the U.S. and foreign trademark owners is independent of the cause of the gray-market goods.

Antitrust, trademark and administrative law principles also support granting U.S. trademark owners the right to exclude gray-market imports. Recognizing the right of U.S. trademark owners to exclude unauthorized imports would be consistent with modern antitrust principles because the U.S. trademark owner that excludes gray-market imports is essentially enforcing a nonprice, vertical restraint, which is almost always procompetitive, and which is only illegal if it is anticompetitive. Such a policy would also be consistent with modern trademark law principles, which recognize the rights of U.S. trademark owners to the returns generated by the goodwill they have created. Finally, such a policy would implement section 42 of the Lanham Act and section 526 of the Tariff Act of 1930, both of which by their language would exclude unauthorized imports.