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THE INTERNATIONAL GRAY MARKET: THE NEXUS OF VERTICAL RESTRAINTS, PRICE DISCRIMINATION AND FOREIGN LAW

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The research of this paper was completed, in part, while the author held a senior position with the Federal Trade Commission (FTC), Washington, D.C. The opinions in this paper are solely those of the author and do not necessarily express the views of the bureau, the Commission or any individual commissioner. This paper draws on a draft paper by David G. Tarr, "An Economic Analysis of Gray Market Imports" mimeo, FTC, 1985. Parts of his paper were revised and used in Part III A as well as a number of sources. In addition to David G. Tarr, I am indebted to Keith Anderson, Louis DeAlessi, Richard Higgins and John Peterman for helpful comments and criticisms.

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While gray market goods have been traditionally imported into the United States from Europe and Asian countries, there has been an influx in recent years of gray market imports from Latin America, particularly from Argentina and Brazil. For these gray market exporters, recent developments in U.S. law will greatly affect their future activities.

I. INTRODUCTION

On October 6, 1987, the United States Supreme Court heard oral argument in *K-Mart v. Cartier, Inc.*, a case that may determine the future of gray market trade.¹ Barring a decision based on jurisdictional grounds, the Supreme Court's decision should resolve the mounting tension among the circuits regarding the validity of the Customs Service's regulations on gray market goods and possibly restrict gray market goods from being sold in the United States.²

Customs Service regulations have essentially eliminated any restrictions that may have been imposed on the import of gray market goods by the Tariff Act of 1930. Specifically, the Customs Service has refused to enforce the language of the Act which specifically bars all gray market goods from entry into the United States.³ Until the recent *COPIAT* decision, challenges to the legality of the Customs Service's regulations had proven to be unsuccessful.⁴

1. Coalition to Preserve the Integrity of American Trademarks (COPIAT) v. United States, 598 F. Supp. 844 (D.D.C. 1984) *rev'd*, 790 F.2d 903 (D.C. Cir. 1986) *cert. granted sub nom. K-Mart v. Cartier*, 107 S.Ct. 642 (1986) (commonly referred to as *COPIAT*). See also *Oral Argument Held in Gray Market Case*, 34 Pat. Trademark & Copyright J. (BNA) 581 (Oct. 8, 1987).

2. The United States Customs Service has issued regulations (19 C.F.R. §133.21(c)(1)-(3) (1985)) refusing to literally enforce §26 of the Tariff Act of 1930 (19 U.S.C. §1526 (1982)).

3. 19 U.S.C. §1526 (1982).

4. See *Vivitar Corp. v. United States*, 593 F. Supp. 420 (Ct. Int'l Trade 1984) *aff'd on*

Gray market imports have also been challenged on the claim that they violate the Lanham Trademark Act.⁵ Section 42 of the Act provides that

. . .no article of imported merchandise which shall copy or simulate. . .a [registered] trademark. . .shall be admitted to entry at any customshouse of the United States. . .⁶

While section 42 is effective in enjoining counterfeit goods, gray market goods, because they are genuine, do not fall within the Act's provisions. Nevertheless, some uncertainty exists as to whether the plain language of the statute fails to bar importation if the goods are genuine.⁷

Finally, those who are attempting to halt gray market imports have claimed that the imports are a violation of section 337 of the Tariff Act of 1930, which focuses on unfair import practices.⁸ Relying on this section, the International Trade Commission recommended a halt to all gray market imports.⁹ President Reagan, however, disapproved of the Commission's recommendations as being at odds with the Treasury Department's interpretations of the section, at the same time noting that the Cabinet Council on Commerce and Trade was in the process of studying the issue.¹⁰

The legal debate concerning the desirability of a ban on gray market imports should not be separated from an economic analysis of the issue. Unfortunately, many of the decisions on the validity of the gray market have suffered from weak economic analysis. The purpose of the article is to examine some of the premises that

other grounds, 761 F.2d 1552 (Fed. Cir. 1985) *cert. denied*, 106 S.Ct. 791 (1986); *Olympus Corp. v. United States*, 627 F. Supp. 911 (E.D.N.Y. 1985), *aff'd*, 792 F.2d 315 (2d Cir. 1986). *But see COPIAT*, 790 F.2d at 918; Ross, *Court Deal's Setback to Gray Market*, Wash. Post, May 7, 1986, Bus. Sec.

5. Lanham Trademark Act, 15 U.S.C. §1124 (1982).

6. *Id.*

7. *Monte Carlo Shirts, Inc. v. Daewoo Int'l*, 767 F.2d 1054 (9th Cir. 1983); *DEP Corp. v. Interstate Cigar Co., Inc.*, 622 F.2d 621 (2d Cir. 1980); *A. Bourjois & Co. v. Katzel*, 275 F.2d 539, 543 (2d Cir. 1921), *rev'd*, 260 U.S. 689 (1923); *El Greco Leather Products Co., Inc. v. Shoe World, Inc.*, 599 F. Supp. 1380 (E.D.N.Y. 1984); *Parfums Stern, Inc. v. United States Customs Service*, 575 F. Supp. 416 (S.D. Fla. 1983); *United States v. Guerlain*, 155 F. Supp. 77 (S.D.N.Y. 1957), *vacated and remanded*, 358 U.S. 915 (1958), *action dismissed*, 172 F. Supp. 107 (S.D.N.Y. 1959).

8. Tariff Act of 1930, 19 U.S.C. §1337 (1982 & Supp. 1985).

9. *In re Certain Alkaline Batteries (Duracell)*, 6 I.T.R.D. (BNA) 1849 (1984), *disapproved by President Reagan pursuant to 19 U.S.C. § 1337(g) (1982)*, 50 Fed. Reg. 1655, *reprinted in* 225 U.S.P.Q. (BNA) 862, *appeal dismissed sub nom. Duracell, Inc. v. United States Int'l Trade Comm'n*, 778 F.2d 1578 (Fed. Cir. 1985).

10. See note 9, 50 Fed. Reg. at 1655.

support the gray market jurisprudence and to present an alternative economic framework with which one can analyze the social utility of an active gray market.

Sales of trademarked articles through "unauthorized" channels have been called gray market sales. "Unauthorized" means that the sale is made through a seller who is not authorized by the manufacturer, distributor or trademark registrant. "Authorized" means that the manufacturer establishes through a contractual agreement an exclusive territory or conditions of resale. As part of the agreement, the manufacturer, distributor or trademark registrant will generally agree to sell only to particular entities and not other entities that may compete with the authorized channel. The distribution of goods through the gray market has also been called parallel distribution. Gray market and parallel distribution are used synonymously in this paper. Gray market sales are to be distinguished from counterfeit sales in that the item sold is "genuine" in terms of its manufacturer, but its distribution is unauthorized.¹¹

Gray markets exist in both a domestic and international context. In the domestic case, the domestic seller is an unauthorized seller of a domestic manufactured product. In an international context, the domestic seller is an unauthorized seller of an imported product from a foreign manufacturer, distributor or retailer. The sale is unauthorized because some United States entity is registered as the owner or licensee of the trademark. The owner or licensee can either be an independent U.S. firm or a subsidiary of the foreign manufacturer or distributor. The protection of trademarks by means, such as suits for infringement by counterfeit sales, has evolved from common law principles and have been supplemented by various state and federal registration laws.

This paper deals with the international gray market. There are no reliable estimates of the dollar volume of gray market imports. Several sources have estimated that the gray market may have imported as many as sixty thousand (60,000) luxury automobiles in

11. An *authorized* seller may also deal in the gray market. For example, an authorized dealer may purchase the trademark product outside its authorized supplier, such as through another dealer or another distributor who is not its authorized distributor or a third party outside the authorized distribution network. See Part II C and D, *infra*. Most agreements have terms in addition to the rights pertaining to an exclusive territory, such as the dealer is only permitted to buy from a certain supplier. Thus, unauthorized generally refers to private contractual agreements and not necessarily to a violation of statutes or regulations. An exception to this may be the U.S. Custom's regulations and legislation, most particularly 19 C.F.R. §133.21.

1985.¹² Assuming an average import price of thirty thousand dollars (\$30,000) per vehicle, the value of gray market imports for luxury automobiles alone would amount to 1.8 billion dollars. Another source has reported a figure of 6 billion dollars for all types of gray market imports in 1984.¹³ Gray market imports generally consist of high quality, brand name goods. The Department of Commerce lists the following types of goods that have been imported through the gray market.¹⁴

12. Holusha, *Unauthorized Sales Up for Cars from Europe*, N.Y. Times, Mar. 4, 1985, at D1, col. 1.

13. Boyer, *The Assault on the Right to Buy Cheap Imports*, *FORTUNE*, Jan. 7, 1985, at 89.

14. Apparel and fashions

Appliances, small

Auto parts (Toyota)

Automobiles (Mercedes Benz, BMW, Porsche and Jaguar)

Baby care products (Johnson & Johnson)

Batteries (Duracell)

Boats

Business equipment (including computers, calculators, and typewriters)

Champagne (Dom Perignon & other luxury champagnes)

Ceramics

Chinaware

Construction equipment (Komatsu)

Cosmetics and fragrances (Revlon, Elizabeth Arden, Warner/Lauren, Yves Saint Laurent, Jacqueline Cochran, Alfin, Halston, Redken, Paco Rabanne, Warner)

Crystal and glassware (Waterford)

Electronics, including (televisions, radios, audio equipment, video games, electronic musical equipment, tape and video recorders and supplies)

Feminine protection products

Floor care items

Food

Forklift trucks

Home and garden equipment

Housewares

Leather goods (including luggage and shoes)

Optics

Organs

Outboard motors (Evinrude, Johnson)

Pharmaceuticals

Photocopiers

Photographic equipment and supplies (Canon, Kodak, Nikon, Fuji, Minolta, Pentax, Hasselblad, Tokina, Vivitar, Olympus, Ricoh)

Recordings (including phonorecords and tapes)

Semiconductors

Silverware

Ski equipment (Lange, Nordica, Rossignol)

Sporting goods

Tires

Toiletries

Toys

The Department of Commerce also lists twenty-three countries as the source of gray market goods.¹⁵ The source of gray market imports can be from a country other than its origin of manufacture. Gray market imports of luxury automobiles are almost exclusively manufactured in Europe, while cameras are generally produced in Japan.

The Department of Commerce classifies the different types of organizations as either favoring or opposing gray market imports.¹⁶ For example, K-Mart, Montgomery Ward, W. Bell & Co. and 47th Street Photo favor gray market imports. The Coalition to Preserve the Integrity of American Trademarks (COPIAT) is an organization comprised of members who oppose gray market imports.

Watches and clocks (Seiko, Rolex, Cartier)

THE PATENT AND TRADEMARK OFFICE, U.S. DEP. OF COMMERCE, ECONOMIC EFFECTS OF PARALLEL IMPORTS: A PRELIMINARY ANALYSIS, A1 (1985) [hereinafter D.O.C.].

Bruce Yandle has argued that the reason foreign manufactured goods have increased in reputational value in the United States compared to domestically produced goods may not be due to design or planning, but rather because of U.S. quotas and tariffs imposed on imports under the General Agreement on Tariffs and Trade (GATT) or other restrictions on international trade such as the voluntary accord between the United States and Japan dealing with automobiles. Yandle, *Quality Regulation in Developing Countries*, (Clemson University, March, 1987)(unpublished manuscript). For example, a per unit tariff added to foreign automobiles will narrow the relative U.S. price compared to the underlying relative foreign prices of high quality (price) goods compared to low quality (price) goods, thereby favoring the importation of high quality goods. A quota that restricts the number of imported goods will also favor high quality imports. The addition of a fixed transportation cost, regardless of quality, will also reduce the relative U.S. price of high quality. It is interesting to note that almost all of the authorized sales in the gray market consist of the top-of-the-line products. Some have also argued that unauthorized sales have been of lower quality. For an analysis of the importance of quality assurance, see Part II.

15. D.O.C., *supra* note 14, at 5.

Australia	Japan
Belgium	Korea
Brazil	Mexico
Bulgaria	Netherlands
Canada	Philippines
China	Portugal
Federal Republic of Germany	Singapore
France	Spain
Hong Kong	Sweden
Indonesia	Switzerland
Italy	United Kingdom
	Uruguay

16. *Id.* at 2.

	<u># of Firms Favoring Gray Market</u>	<u># of Firms Opposing Gray Market</u>
-Trade Associations	7	4
-Retailers	8	41
-Wholesalers/Distributors/ Importers	12	2
-Employees of discount catalog showroom chain	178	
-U.S. wholly-owned subsidiaries of foreign corporations		11
-U.S. corporations with foreign distributors/ licenses		3
-U.S. authorized distributors		4
-U.S. Corporations, no relationship to foreign corporation given		3

As a general rule gray market distributors or retailers pay lower prices than U.S. authorized distributors or retailers, thereby creating price differences. In many cases, but not all, the price of gray market goods is lower to the U.S. consumer.¹⁷ A price difference at some level in the distribution chain accounts for the existence of a gray market. This paper examines three alternative hypotheses to explain the existence of a gray market: (1) free-riding off the trademark; (2) price discrimination and (3) Robinson-Patman constraints. The gray market in the United States is primarily a phenomena of the 1980s. Accordingly, the hypotheses are tested (screened) in a very crude sense by requiring consistency with other changes that occurred in the 1980s. One such major change was the rapid appreciation of the dollar during the period of 1980 through 1985. Another change that does not have an exact time correlation, but may operate with a lag, is the evolution of foreign law, especially since the Treaty of Rome (1958) that governs the European Economic Community (a major source of some parallel

17. See, e.g., Certain Alkaline Batteries, U.S.I.T.C. Pub. 1616 (Nov. 1984) [hereinafter Certain Alkaline Batteries] (parallel imports of certain alkaline batteries apparently sold for the same retail price as authorized retailers). For a list of parallel imports selling at lower prices, see D.O.C., *supra* note 14.

imports). Other largely qualitative evidence is used when appropriate.

II. FREE-RIDER ARGUMENTS

A. Introduction

Gray market imports by definition involve a trademark. A trademark is an asset that embodies the accumulated goodwill of consumers. While a trademark is an intangible asset, there are certain property rights that a trademark has in common with tangible assets, such as the right of exclusion and the right to transfer. Without the right of exclusion, a trademark, similar to an automobile or house, will have little or no market value unless the owner can exclude others from its use. For example, if a trademark owner did not have the right to exclude others, then any manufacturer could simply use the trademark of another (e.g., counterfeit goods). If someone other than the trademark owner can receive the benefits of trademark investments without having to pay, then fewer resources will be invested in trademarks. Exclusive rights granted to trademark owners can be defended on grounds, similar to patents, as a means to create investment incentives. Opponents of gray markets have argued that parallel importers free-ride off U.S. investments in trademarks.¹⁸

In order to more fully understand the free-rider argument it is useful to understand (a) why some goods are associated with trademarks and others are not; (b) how trademarks benefit consumers; (c) what kinds of investments are made to create reputational value or goodwill; and (d) what pricing and institutional arrangements are necessary to create incentives to invest in and preserve the value of trademarks (i.e., prevent free-riding). Recent economic literature on quality assurance discussed in Section B addresses

18. See LEXECON, INC., *THE ECONOMICS OF GRAY-MARKET IMPORTS* (1985)[hereinafter LEXECON]. The above report was prepared for the Coalition to Preserve the Integrity of American Trademarks (COPIAT). COPIAT is an association of U.S. corporations and trade associations. Many COPIAT members are U.S. subsidiaries of foreign manufacturers, others are U.S. manufacturers who also manufacture and distribute their products abroad through foreign subsidiaries or licensees; still others are U.S. retailers, publishing firms and advertising agencies. See also *Certain Alkaline Batteries*, *supra* note 17 (protection of the trademark by preventing free-riding was the basis of the majority opinion and in the separate opinion of Vice Chairman Liebel); Knoll, *Gray Market Imports: Causes, Consequences, and Responses* (1985 unpublished manuscript)(presents a strong argument in defense of restricting parallel imports such as a ban based on the free-rider argument).

these questions.¹⁹ Sections C and D examine how the gray market may be a market response to exchange rate movements without free-riding off the *reputational* value of trademarks. In contrast, Section E examines free-riding by gray market sellers who may offer lower quality products or services compared to the claims made by trademark owners. The parallel market will lower U.S. trademark values (expressed in dollars) regardless of whether it is the result of exchange rate adjustments or free-riding. However, the gray market in the former case is beneficial to consumers, whereas in the latter case it is harmful to consumers. The analysis in Part II assumes a competitive market in trademark goods in order to distinguish free-riding from price discrimination that requires, *inter alia*, market power.

B. Quality Assurance

A trademark would have zero value in a world of perfect information because consumers could costlessly determine variations in quality and performance among products.²⁰ Certain products have the characteristic of not being able to costlessly determine quality before purchase (e.g., the list of products listed in Part I).²¹ Moreover, for many goods, the sellers' statements (or advertisements) about quality or warranties require enforcement costs (e.g., time and legal costs) that can exceed the value of performance if such statements are deceptive. Under these circumstances, a firm may have an incentive to deceptively sell a lower quality product. If a consumer receives a product of a quality at least as high as explic-

19. There are a number of free-riding arguments that have been developed in the literature. Quality assurance is an inherent attribute of trademarks and will be the focus of analysis. As shall be discussed, other free-rider arguments are related to quality assurance. For a detailed review of the various free-rider arguments see Overstreet, *Resale Price Maintenance and the FTC: An Analysis of the Corning Glass Works Case*, at 76-95 (FTC, 1985) (mimeo).

20. Klein & Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981) [hereinafter Klein & Leffler]. See also Klein, Crawford, Ampers & Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. L. & ECON. 297 (1978); Knoeber, *An Alternative Mechanism to Assure Contractual Reliability*, 12 J. LEGAL STUD. 333 (1983); Shapiro, *Consumer Information Product Quality and Seller Reputation*, 13 BELL J. ECON. 20 (1982); Shapiro, *Premiums for High Quality Products as Returns to Reputations*, 98 Q. J. ECON. 659 (1983); and Smith & Dox, *The Pricing of Legal Services: A Contractual Solution to the Problem of Bilateral Opportunism*, 14 J. LEGAL STUD. 167 (1985).

21. For other products, generally not associated with a trademark, consumers can determine quality prior to purchase at a low cost (e.g., fresh fruits or vegetables, lumber, grains, etc.).

itly or implicitly promised, then the consumer will continue to purchase from the seller. On the other hand, if quality is deceptive, consumers will cease to purchase from the deceptive firm. But, if there is a return on deception (i.e., receipt of a high quality price for a low quality/low cost product), each firm may have an incentive to be deceptive. In equilibrium, the only producers that will survive are those who produce low quality products whose quality can be determined prior to purchase (i.e., are not deceptive). Consumer information and enforcement costs limit the range of quality products available.

However, a price premium over and above the *costs of production*, including a normal profit, can create incentives for firms to produce high quality products. These price premia represent the return to brandname (trademark) capital investments. Trademark investments take the form of specific capital investments. Specific capital is defined as having a very low or zero *salvage* value (e.g., opportunity cost) in alternative uses. Thus, the returns (price premia) to investments in brandname capital (trademarks) depend on *repeat* sales. If future sales are not realized because the trademark loses its reputational value (e.g., the firm is deceptive), then the salvage value of the trademark capital will become very low or zero.

Specific capital investments also signal information to consumers on what firms have at stake if quality is deceptive. The capital at risk can be interpreted as a "performance bond" that is forfeited if future (repeat) sales are not realized.²² Specific capital investments simultaneously serve to insure "market" performance of quality assurance claims that would not be necessary in a world of costless enforcement of quality claims. Besides brandname advertising, other forms of specific investments may be made, such as luxurious storefronts, thick carpeting, and ornate displays and signs, even if yielding little or no direct service flows to consumers.²³

22. Note that the signal to consumers is the amount of specific trademark capital and *not* the return (quality assurance premium) which would require the consumer to have much more information, such as information on the costs of production. In a competitive equilibrium, specific capital investments in the trademark equal the expected present value of the price premia stream charged for quality products.

23. For example, the frequent use of noted personalities or entertainers in commercials may be attributed to consumer perception of the high cost of these endorsements rather than their being more effective in presenting advertisements. Pepsi Cola made no secret of the fees paid for Michael Jackson commercials. Or alternatively, noted personalities have

The price premium or specific quality assuring capital investments for any goods depends on a number of factors.²⁴ The more frequently a product is purchased, the less quality assurance capital required, because consumers can discipline a deceptive seller more quickly. Durable goods will require higher quality assurance investments. Because the quality assurance argument is premised on a market enforcement mechanism (rather than legal enforcement through the courts) of implicit and explicit claims, the cost of legal enforcement relative to the cost of nonperformance is important. For example, the consequential damages that may be realized by a defective drug may explain why low priced "generic" drugs, despite legislation intended to promote them, have not been all that successful against higher priced "brand" name drugs.²⁵ The decision to invest in trademark capital, similar to other investments, is a function of market conditions such as the interest rate. Once investment decisions are made, trademark capital is subject to the risk of changing market conditions. Finally, prices of trademark goods and, therefore, the quality assurance premia, are limited by competition. If a price premium is charged in excess of the premium necessary to deter (insure) deception (quality) by the manufacturer, then competing trademarks will enter the market and bid the price and premia down.

C. *Free-Riding Off Manufacturers' Trademark Capital*

Consider manufacturers or their wholly-owned subsidiaries (e.g., TM registrant) who incur *all* specific investments in the trademark and distribute directly to retailers on a competitive basis without restrictions. For example, brandname liquor manufacturers require retailers to make few, if any, specific investments. Specific investments, in the form of brandname advertising, are generally made by the liquor manufacturer or its trademark registrant.²⁶ The price premia for quality assurance, as defined above, are assumed net of other price premia used to cover other distribu-

their own reputational value at stake if the product is deceptive and therefore more credible to consumers. Finally, local advertisements often refer to other expensive advertisements such as "as advertised on the Tonight Show" to indicate the "stock" of capital at risk. Klein & Leffler, *supra* note 20, at 625.

24. *Id.*

25. *Id.* at 632, n. 18.

26. Retailer advertisements generally take the form of "price" or intrabrand competition advertising. See Part III B *infra*.

tion costs. The total price premium or mark-up is often expressed as a percentage of the manufacturer's suggested retail price. Part of the mark-up will be used to cover the cost of such functions as supplying shelf space or maintaining an inventory. The price premia for these other functions are assumed to be competitively determined in the market and not specific to the trademark. That is, there are a large number of buyers (e.g., distributors) and sellers (e.g., retailers) of shelf space. If the margin offered is not competitive (e.g., does not cover the cost of shelf space), then a retailer will turn to competitive buyers. The capital used in providing shelf space has alternative uses; therefore, its value is not specific to the reputational value of a trademark.²⁷ Mark-ups may also be used to compensate retailers for post-sale services such as the costs of handling refunds or warranty repairs. The capital used in providing such services may also be of a general nature (i.e., has alternative uses) and not trademark specific.²⁸ In order to distinguish between different types of potential free-riding, retailers are assumed to not be in a position to free-ride off the manufacturer, distributor or other retailers, or to not have incentives to be deceptive. For example, assume the consumer has knowledge that if a product is defective, then he/she has the responsibility to return it to the manufacturer for refund or warranty repair.²⁹ Free-riding, under these assumptions, can only take the form of parallel sellers free-riding off of manufacturers' specific investments in trademarks.

One free-rider argument advanced is that parallel import competition reduces U.S. retail prices, thereby reducing price premia.³⁰ The manufacturers' prices, compared to retailers', must fall in order to compete with the gray market because the price premium or margin available for retailers is assumed to be competitively determined (e.g., shelf space). This, in turn, reduces the price premium available for the manufacturer to cover specific investments in

27. This is not to say that the price of shelf space or the cost of inventory will be the same for all retailers. For example, the cost of land is likely to be much higher in the central business district than in out-lying areas. Thus, some retailers will have higher costs of capital and therefore a higher price premium. See Part III *infra* for a discussion of how Robinson-Patman may constrain the ability of a distributor to account for such differences.

28. For example, a major cost of refunds is the cost (interest rate) of capital. However, warranty repairs may require specific human capital investments (specialized training associated with a particular good) that cannot be transferred to other goods.

29. The costs of such services, of course, would be reflected in the price of goods to retailers.

30. See LEXECON, *supra* note 18.

trademark capital.³¹ Accordingly, it is argued that parallel importers receive the benefit of trademark capital without paying the costs.

However, if gray market retailers sell at a lower retail price, then they must either be more efficient compared to authorized retailers or be able to purchase goods at a lower price than authorized retailers. Retail services are assumed to be competitively supplied so that gray market retailers cannot be more efficient. If gray market retailers were more efficient, they would be authorized retailers.³² Therefore, parallel retailers must be able to purchase trademark goods abroad at a lower price than the U.S. trademark registrant charges authorized retailers in the United States. It is argued that the lower price abroad is the result, *inter alia*, of the rapid appreciation of the dollar in the 1980s.³³

Support for this argument rests with the fact that parallel imports and the dollar increased during the same period.³⁴ Tables 1 and 2 are used to illustrate the effects of a dollar appreciation. Assume a Japanese manufacturer charges \$120/unit to a U.S. distributor and 120F (francs) to a French distributor, when the exchange rates are \$1=1F=1Y (yen). Further assume there is a forty percent mark-up (\$48 or 48F premium) required in each country to provide a return to quality assurance investments.³⁵ Both distributors (i.e., trademark registrants) are assumed to be subsidiaries of the manufacturer.³⁶ The distributors' price to retailers is then \$168 and 168F respectively. Retailers' costs (e.g., shelf space, etc.) are

31. Because trademark capital is specific, the manufacturer will not exit the market or abandon the trademark unless the premia falls to zero. But, the manufacturer may have an incentive to be deceptive if the premium falls.

32. *But see* Part III *infra* (discussion of Robinson-Patman constraints that can lead to distributional inefficiencies in authorized distribution).

33. *See* LEXECON, *supra* note 18.

34. The parallel market in most cases began in the 1980s with the exception of cameras which started in the 1970s. *See* D.O.C. *supra* note 14, at 3. The multilateral trade-weighted real value of the U.S. dollar increased by about forty percent between 1980 and the fourth quarter of 1984. ECONOMIC REPORT OF THE PRESIDENT 351 (1985).

35. The analysis abstracts from other distributor costs (e.g., inventory) which are assumed to be competitively determined such that parallel importers must also incur these costs.

36. If distributors are not subsidiaries, then it is assumed that the manufacturer would charge each distributor \$168 and 168F respectively with a distributor rebate of \$48 or 48F upon proof of quality assurance investments. In the United States, if the trademark registrant is an independent entity, not controlled by the foreign manufacturer, then it is able to prevent parallel imports under current U.S. Custom's regulations. 19 C.F.R. §133.21(3)(1)(1985).

assumed to be competitively determined at \$24/unit and 24F/unit respectively. It is assumed that a parallel seller must also spend \$24/unit to cover its costs. Parallel shipping costs from France to the United States are assumed to be 11F.³⁷ Table 1 illustrates that parallel imports are not feasible under these assumptions. A French retailer will not sell to a parallel importer for less than 168F. If the parallel importer purchases the goods for 168F and adds \$24 for distribution costs and 11F for shipping costs, then total per unit costs equal \$203, which exceeds the authorized U.S. retail price (\$192).

TABLE 1
Per Unit Prices and Costs
Prior to Dollar Appreciation

	U.S. DISTRIBUTOR	FRENCH DISTRIBUTOR	U.S. PARALLEL MKT.
	<u>U.S.</u>	<u>FRANCE</u>	<u>PARALLEL MKT.</u>
Manufacturers' Price	\$120	120F	120F
Quality Assurance Premium	\$ 48	48F	48F
Cost to Retailers	\$168	168F	168F
Retailers' Premium to Cover Cost	\$ 24	24F	\$24
Shipping Costs	—	—	11F
Retail Price	\$192	192F	203F

Now consider the effect of a dollar appreciation. Table 2 is identical to Table 1 except that it is now assumed that $\$1 = 2F = 2Y$. Competing foreign trademark goods will decrease the manufacturer's price from \$120 to \$60 in the United States. It has been argued, however, that as trademark investments are incurred in the United States they are unaffected by a change in the exchange rate. Table 2 initially assumes that the U.S. quality assurance premium remains constant at \$48. Note, though, that the quality assuring premium in France (expressed in dollars) is \$24. The net effect of the dollar appreciation is to increase *relative* retailers' cost in the United States (\$108) compared to France (\$84).

37. It is assumed that the manufacturer's shipping costs from Japan to either market are equal and included in the manufacturer's price to distributors.

The U.S. premium as a percent of the manufacturer's price increases from 40%, prior to the dollar appreciation, to 80%, after the dollar appreciation. Retailers' premium of \$24 for other functions is assumed to remain unchanged, whether sold in the U.S. authorized market or U.S. parallel market.

Table 2 illustrates that French retailers now have an incentive to sell in the U.S. parallel market. The U.S. authorized retail price (absent competition from parallel distribution) is \$132. But a parallel importer could purchase goods at \$84 from French retailers and add its distribution cost of \$24 plus shipping cost of \$5.50 for a total marginal cost of \$113.50. A per unit profit of \$18.50 is possible at a U.S. retail price of \$132.³⁸ However, competition from parallel importers will eventually decrease the U.S. retail price from \$132 to \$113.50 (i.e., by \$18.50), which is the marginal cost of parallel importers.

Because it is assumed that the U.S. retailers' premiums are competitively determined, the manufacturer or the U.S. trademark registrant will be required to decrease its price to U.S. retailers from \$108 to \$89.50 (\$108 - \$18.50) in order to remain competitive.³⁹

TABLE 2
Per Unit Prices and Costs
After Dollar Appreciation

	U.S. DISTRIBUTOR	FRENCH DISTRIBUTOR	U.S. PARALLEL MKT.
	<u>U.S.</u>	<u>FRANCE</u>	<u>PARALLEL MKT.</u>
Manufacturers' Price	\$60	120F(\$60)	120F(\$60)
Quality Assurance Premium	\$48	48F(\$24)	48F(\$24)
Cost to Retailers	\$108	168F(\$84)	168F(\$84)
Retailers' Premium to Cover Cost	\$24	24F(\$12)	(\$24)
Shipping Costs	—	—	11F(\$5.50)
Retail Price	\$132	192F(\$96)	\$113.50

38. The French retailer will obviously want some return for supplying the parallel market; therefore, the price will be higher. The analysis abstracts from how the gains from parallel imports are distributed (e.g., the French retailer and parallel importer could be a joint venture).

39. That is, parallel importers have a competitive cost advantage of \$18.50 so that the U.S. distributor's price to U.S. retailers must be reduced by \$18.50 (\$108 - \$89.50) to permit its retailers to sell for a retail price of \$113.50.

The Japanese manufacturer will not adjust its price because it is able to profitably sell to the French distributor and other distributors for 120F (\$60).⁴⁰ Therefore, the U.S. quality assurance premium must fall from \$48 to \$29.50. The equilibrium result under these assumptions is that quality assurance premia across countries (expressed in dollars) will differ only by shipping costs. The net effect of the parallel market is that the value of the U.S. trademark (capitalized quality assurance premium) expressed in dollars will fall.⁴¹ In summary, parallel importers receive the benefits of U.S. trademark capital without paying the full costs because they are not charged the full U.S. quality assurance premium (i.e., quality assurance premium in France is \$24 versus \$48 in the United States).

This free-rider result is conditioned on the assumption that the U.S. quality assurance premium is invariant to a change in the exchange rate because trademark capital investments are incurred in the United States. This assumption requires further examination. Recall from Section B that specific trademark capital provides a signal to consumers of what manufacturers have at stake, if quality is deceptive. The value of trademarks under these assumptions represent the capitalized (present value) value of future quality assurance premia. A lower premium, and therefore lower future quality assurance investments due to parallel competition, may be argued to be perceived by consumers as a lower quality product or an increased likelihood of deceptive quality. Thus, consumer perceptions may lead to decreases in the demand for foreign trademark goods.

There are, however, several factors that suggest the quality assurance premium *should* adjust to a change in the exchange rate. First, a dollar appreciation will lower the price of foreign trademark goods. For example, in Table 2, the U.S. retail price will fall from \$192 to \$132 even without parallel competition. The increased quantity sold at a lower price will generate increased qual-

40. It is assumed that manufacturers have constant costs. This assumption is not critical. If manufacturer costs increase, then both U.S. and French retailers will pay a higher price, which in turn will mean a higher price to parallel importers. Therefore, there should be no comparative advantage to parallel importers, regardless of whether manufacturer costs increase or decrease with an expansion in output.

41. If the dollar appreciation or parallel imports is expected to be permanent, then the fall in the trademark capital value will be significant. On the other hand, if the dollar appreciation is expected to be temporary, there will be a short run capital loss with the value in the long run returning to a pre-dollar appreciation level as the dollar depreciates.

ity assurance premium revenues. The quality assurance premium/unit multiplied by the quantity sold represents a return on trademark capital. Thus, for any given stock of U.S. trademark capital, the return to capital will increase with a dollar appreciation and a constant quality assurance premium/unit. In a competitive market, the quality assurance premium can be expected to be reduced (i.e., by way of a decrease in price) to a normal return on trademark capital.

Second, the accumulated trademark capital is still at risk even though the return to the capital may be reduced by parallel competition. Thus, unless the accumulated trademark capital depreciates at a very rapid rate, consumer perceptions are not likely to be affected in the short run. Only future investments in trademark capital are affected. Moreover, at the lower prices brought by the dollar appreciation, if quality is deceptive consumers have less at risk. Thus, as the price of a good falls, all other things equal, less specific capital should be required as an indirect performance bond. For example, the quality assurance premiums or revenues were assumed to be forty percent of the manufacturer's price (or revenues) in Table 1 and increased to eighty percent of the manufacturer's price in Table 2, if the premium does not fall even with quantity demanded constant. Thus, if consumer demand for specific investments falls with a decrease in the retail price, competitive pressures will reduce the quality assurance premiums.

Third, related to the above, a dollar appreciation results in a comparative price advantage of foreign goods compared to domestic goods. Fewer *interbrand* advertising expenditures are necessary by foreign manufacturers to compete against U.S. domestic manufacturers with a price advantage.⁴² Moreover, domestic manufacturers subjected to increased price competition by foreign manufacturers will also experience a decrease in the price premiums available for quality assurance. Thus, the overall level of interbrand advertising may fall because of a change in the exchange rate.

In summary, there is no *a priori* reason to expect quality assurance premiums. Therefore, the value of accumulated specific capital and future investments may be unaffected by exchange rate

42. Part III B *infra* examines interbrand versus intrabrand competition in more detail. For the purposes of this discussion assume quality assurance is a proxy for interbrand competition.

movements even though these expenditures are incurred in the United States. Whether the quality assurance premiums falls, in proportion to a change in the exchange rate, or in a lesser or greater proportion to the exchange rate, is an empirical question.⁴³ However, it is reasonable to assume that there would be decreased premia in a competitive market. If the competitive premiums falls in proportion to the exchange rate, then parallel importers can have no cost advantage. For example, if the U.S. premium decreases to \$24 or more in Table 2, then the price to U.S. retailers would be the same or less than the price parallel importers must pay. On the other hand, if the competitive premiums decrease is less than proportionate to the exchange rate, then parallel importers can have a cost advantage. In this case, parallel importers free-ride off U.S. accumulated trademark capital by not being charged the full U.S. competitive premium.⁴⁴ The lower premium will also result in fewer future trademark investments that can affect future demand for foreign trademark goods.

Now consider the quality assurance premiums as a deterrent to prevent manufacturers from being deceptive. It is assumed that the dollar appreciates against the manufacturer's currency (yen) in the same proportion to the franc, such that $2Y = 2F = \$1$. If the U.S. premium of \$48 were maintained by restricting parallel imports, then the yen value would be 96Y in the United States and 48Y in France.⁴⁵ In this case, the value of the U.S. trademark, expressed in the manufacturer's currency, doubles and represents a windfall gain.⁴⁶ Therefore, as long as the percentage decrease in

43. Presumably, the level of specific investments is determined empirically through trial and error. See *infra* Part III C for a more detailed discussion of marketing and inter-brand competition.

44. More precisely, the competitive U.S. premium may be less than proportionate to the exchange rate by the amount of shipping costs incurred by parallel importers. For example, in Table 2, the U.S. premium could be \$29, instead of a proportionate \$24, without giving the parallel importer a cost advantage.

45. If there were no shipping costs in the above example, the quality assurance premium expressed in francs would be constant between countries. The shipping cost margin prevents a fall that equalizes the premium across countries such that there is a gain in the trademark value in the United States relative to France (expressed in francs). The above analysis also abstracts from the increased quantity sold in the United States as a result of a dollar appreciation. The return to trademark capital is the per unit premium times the quantity sold.

46. The analysis abstracts from underlying changes between countries that may have precipitated the change in the exchange rate. For example, increased inflation in France may cause the dollar to appreciate. In this case, the purchasing power of the franc changes, thereby lowering the real value of the U.S. trademark expressed in francs. Consideration of these factors is beyond the scope of this paper.

the U.S. quality assurance revenue is less than or equal to the percentage increase in the dollar appreciation, the *foreign* manufacturer will continue to have an incentive to manufacture quality goods. The foreign manufacturer has at least the same specific capital (expressed in yen) at risk if quality is deceptive under the new equilibrium. Therefore, parallel competition that comes into existence because U.S. premiums are fixed can be interpreted as an efficient market adjustment to the amount the foreign manufacturer has at stake if quality is deceptive.⁴⁷

The overall effect of parallel competition may simply be a movement down the demand curve as opposed to a shift in the demand curve. Parallel competition, as a result of a dollar appreciation that forces market adjustments in price premia revenues, is not necessarily free-riding off the U.S. trademark. As a general rule, under these assumptions, free-riding by the parallel importer can only occur when U.S. authorized distribution expenditures are *independent* of the exchange rate *and* the parallel importer is able to avoid some of these dollar expenditures.⁴⁸ The above analysis has focused on quality assurance premiums that under reasonable assumptions should decrease with dollar appreciation. The U.S. distributor incurs other costs in distribution related to a number of functions, such as maintaining an inventory and other transactions costs.⁴⁹ But, parallel importers may also incur these costs.

The adjustment factors enumerated above are premised on an assumption that in a competitive market the quality assurance premiums in the United States would adjust with a change in the exchange rate, such that the competitive price will be lower.⁵⁰ For

47. Similarly, if the dollar should depreciate against the yen (e.g., $\$2=1Y$), then a higher quality assurance premium expressed in dollars would be required to maintain the same specific capital at risk expressed in yen.

48. Foreign distributors receive a premium on units sold in the U.S. parallel market without incurring the expense for quality assurance. For example, in Table 2 *infra* the French distributor receives 48F (\$24/unit) on the additional sales to the parallel market without the necessity of making quality assurance investments in France. Therefore, the foreign distributor receives a higher return on its trademark capital. Assuming both distributors are subsidiaries of the foreign manufacturer, the lower return on U.S. trademark capital (expressed in dollars) is partially offset by the increased return on trademark capital in France. Therefore, the U.S. distributor should receive a credit on gray market sales. The net effect on revenues will depend on demand elasticities in both countries and manufacturing costs.

49. The same analysis can be applied to the provision of services by the manufacturer or distributor. For example, less capital in dollars is required for inventory, refunds and replacements if the cost of goods fall due to a dollar appreciation.

50. If the quality assurance premium is a fixed proportion of manufacturer's price, the

example, consider the Japanese manufacturer who after the dollar appreciation receives 96Y/unit return from its U.S. trademark capital and only 48Y/unit return from its trademark capital in France. Japan will increase its shipments to the United States, thereby reducing the U.S. retail price because the returns (expressed in yen) to its trademark capital are higher in the United States relative to France. Competition among foreign manufacturers will eventually force the U.S. price down to where the returns to trademark capital in various countries are equal.⁵¹ Therefore, manufacturers who do not adjust U.S. prices, and therefore quality assurance premiums, will be subject to competition from other manufacturers who do adjust. Parallel importers, of course, are competitors. But U.S. trademark registrants could simply decrease their price to U.S. retailers in the first instance, thereby eliminating the price differences between countries and the parallel market. There are several possible explanations that may explain price rigidity. First, the competitive market assumption is not valid such that inflexible price premiums represent a form of price discrimination. It should be noted that price discrimination requires market power and the ability to restrict resale. These points are discussed in Part III A. Second, there is an economic justification for inflexible price premiums or premiums that do not adjust in proportion to the change in the exchange rate.⁵² If price premiums are required to be rigid

competitive retail price would be \$108, which is equal to the price in France except for the higher U.S. premium to cover U.S. retailer costs as illustrated in Table 2 *supra*. A parallel market would not develop. On the other hand, if the quality assurance premium is not proportional to the manufacturer's price, then the competitive retail price may be lower or higher than \$108. If the competitive premium falls to \$29, which is more than proportionate to the percentage change in the exchange rate, then there is still no opportunity for a parallel market because of shipping costs of \$5.50.

51. Equal returns do not necessarily imply equal specific capital investments. Whether the U.S. per unit quality assurance premium is greater than, equal to, or less than foreign premiums will depend on *inter alia* the productivity of specific capital, demand elasticities and the extent of the market in various countries.

52. It can be argued that there are certain promotional expenses that do not adjust with the exchange rate. For example, wages or salaries in the form of salesmen or point of sales demonstrations in the United States are not likely to adjust with an exchange rate change. Offsetting these costs are the increased premium revenues from increased sales and the likelihood of less interbrand competition and more price competition due to the dollar appreciation. Finally, it is important to distinguish the portion of the quality assurance premium attributed as a return to accumulated trademark capital (stock) versus a return for future investments in the trademark (flow). Accumulated investments (the stock) in specific capital are a sunk cost. As discussed above, the quality assurance premium can be reduced in U.S. dollars and still provide a market return in yen. If the quality assurance premium is mostly a return on accumulated investments, then parallel competition will have little effect on demand. It is only that portion of the premium devoted to future investments that is

in the United States, then parallel importers do free-ride off the required higher premium in the United States since their price incorporates a lower premium charged in the foreign country.⁵³ Third, price rigidity may exist at the retail level when vertical restraints are introduced. In this case, manufacturers may supply the parallel market to avoid losing sales to other competitors or new entrants. The following section drops the assumption of competition at the retail level and introduces vertical restraints.

D. Vertical Restraints and Free-Riding

The preceding discussion assumed that the manufacturer or its subsidiary provided quality assurance and other services subject to free-rider concerns. Retailers simply sold the product with selling costs being competitively determined. Under these assumptions, it is not possible to free-ride off of U.S. retailers. However, marketing and the provision of services may be more effective when performed by firms closer to consumers. Some optimal mix of expenditures on marketing and services incurred by retailers, jobbers, wholesalers and distributors is likely to result. A gray market could not exist if distribution is totally integrated from the manufacturing level down to the retail level.⁵⁴ There are reasons discussed in the literature, however, as to why vertical integration may be

critical. For reasons discussed, future investments are likely to be reduced even in the absence of a gray market, as long as the dollar remains strong.

53. The above analysis assumes that the quality assurance premium is equal across countries. There is no inherent reason why quality assurance premiums or specific capital investments should be equal in different countries. For example, quality assurance investments are likely to have differential returns across countries because the determinants of quality assurance differ (e.g., laws, enforcement, interest rates, etc.). Parallel competition in this case would represent free-riding. That is, the parallel importer receives the benefit of larger U.S. quality assurance investments because of the lower premium charged in foreign countries. But presumably these differences existed prior to the 1980s. Shipping costs incurred by parallel importers could provide a separation of markets to permit differential margins as long as the margins are less than or equal to shipping costs. But shipping costs appear to represent a small percentage (e.g., 1%) of the retail price. See LEXECON *supra* note 18. The dollar appreciation, given the above assumptions, should not effect the differential if U.S. margins adjust. Thus, differential investments can not explain the emergence of the gray market in the 1980s unless whatever separated the market prior to the 1980s is also affected by a change in the exchange rate.

54. It is possible that a gray market importer's source of goods could come from purchases by foreign consumers who in turn sell to the gray market. However, the transaction costs of such a source would seem to be greater than any price premium differential. Moreover, absent price discrimination, the foreign price premium would be reflected in the consumer's price which in turn would be incorporated in the gray market importer's price.

inefficient.⁵⁵

There is no evidence on the ownership forms of authorized retailers who are subject to gray market competition. Common observation indicates that for many of the products listed in Part I (e.g., perfumes, watches, cameras) the authorized retailers are independently owned entities. The U.S. trademark registrant may enter into variety of agreements with retailers, jobbers, wholesalers and regional distributors ranging from terms that provide exclusive territories, location clauses, purchase requirements, required inventories to no restrictions, such as assumed above.⁵⁶ Some type of vertical restraint is necessary if independent firms are expected to invest in quality assurance or provide services.

The purpose of vertical restraints is to restrict intrabrand competition in order to maintain price margins, thereby creating incentives for retailers to invest in quality assurance or the provision of services. The most common vertical restraints are exclusive territories (ET) and resale price maintenance (RPM) agreements.⁵⁷ Explicit RPM agreements are now *per se* illegal under antitrust laws.⁵⁸ ETs have been examined under a rule of reason since *Continental T.V., Inc. v. GTE Sylvania, Inc.*⁵⁹

55. See Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937); Rubin, *The Expansion of Firms*, 81 *J. POL. ECON.* 936 (1973); Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 *J.L. & ECON.* 223 (1978). See also Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 *AM. ECON. REV.* 777 (1972).

56. The analysis in Section C assumed there were no agreements between manufacturers and retailers other than that of a sale of the goods to retailers in a competitive market without restrictions (i.e., intrabrand competition at the retail level). For sake of simplicity, the following analysis assumes all transactions are between the United States trademark registrant and retailers with no middlemen. This assumption does not effect the analysis. Part III B introduces different levels of distribution.

57. See OVERSTREET, *RESALE PRICE MAINTENANCE: ECONOMIC THEORIES AND EMPIRICAL EVIDENCE*, (1983 photo. reprint); Overstreet, *Resale Price Maintenance and the FTC: An Analysis of the Corning Glass Works Case*, FTC (1985)(mimeo). See also Easterbrook, *Restricted Dealing Is a Way to Compete*, REG., (Jan./Feb. 1984). The Supreme Court in *Dr. Miles Medical Co. v. John D. Park & Sons Co.*, 220 U.S. 373 (1911) held RPM agreements to be *per se* illegal.

58. RPM agreements were permitted under the Miller-Tydings Act (1937) and extended to nonsigners under the McGuire Act (1952). Both Acts were judicially repealed in 1975. In the *Matter of Corning Glass Works*, 85 F.T.C. 1061 (1975).

59. 433 U.S. 36 (1977). Technically, courts are to balance the increase in interbrand competition against the decrease in intrabrand competition. Vertical restraints, however, have been attacked on grounds other than antitrust, such as unconscionability, unfair bargaining and penalty clauses. State franchise relation/disclosure statutes and regulations also impose constraints on vertical restraint agreements. Thus the prevention of free-riding off the services of others is not just a matter of contract. The terms of these agreements and their enforcement are subject to constraints imposed by antitrust law, common law princi-

Retailers will agree to invest in specific trademark capital only if some assurance is provided that they will receive a return on their investments. The manufacturer will want to set a retail price that maximizes its profit given its costs, including a return on specific investments. While RPM agreements are illegal, most trademark goods have manufacturer suggested retail prices. Thus, the manufacturer, through a suggested retail price and the price it charges retailers, can control the margin available for retailers. In conjunction with setting the price margin, the manufacturer may grant exclusive territories to prevent an erosion of retailer price margins by intrabrand competition. However, the manufacturer is in a position to act opportunistically by reducing the manufacturers' suggested retail prices or increasing the price to retailers once retailers have made specific investments in the trademark. Given the potential for opportunistic behavior, retailers will want assurances that their margins will be maintained. Margins are likely to be contractually determined with very little flexibility.

Retailers may also engage in opportunistic behavior. Exclusive territories, created by restricting intrabrand competition, are one means to prevent one retailer from free-riding off the quality assurance investments or services of other retailers. Suggested manufacturer retail prices and therefore price premia are maintained by restricting intrabrand competition. Moreover, retailers' price premia and their specific capital investments serve an additional function beyond providing quality assurance to consumers. Retailer investments also serve as a means by which the distributor can enforce its vertical restraint agreements. For example, a retailer will weigh the benefits of free-riding (e.g., failure to advertise, failure to provide services or failure to maintain suggested retail price as explicitly or implicitly agreed) against the cost of termination resulting in a forfeiture of future premia required to

pled and state statutes and regulations. Despite these constraints, the amount of unauthorized selling (i.e., domestic gray markets) when transactions are confined within the U.S. is relatively small compared to gray market imports. See Klein, *Transaction Cost Determinants of 'Unfair' Contractual Arrangements*, 70 AM. ECON. REV. 356 (1980); Klein & Saft, *The Law and Economics of Franchise Tying Contracts*, 28 J. L. & ECON. 345 (1985). Eighteen states have general disclosure laws. Fourteen states require registration. In some states (e.g., California) the registration is modeled after Blue Sky Laws (e.g., merit regulation). Twenty-two states have business opportunity disclosure statutes. Bus. Franchise Guide, (CCH) ¶ 2001 (1985). Twenty states regulate terms such as termination clauses, purchasing requirements, discrimination, kickbacks, conduct standards, good faith dealing, repurchase/compensation, misuse of franchise fees and exclusive territory. Bus. Franchise Guide, (CCH) ¶ 2003 (1983). IBM has apparently had problems with gray market sales domestically.

cover specific investments.

Parallel distribution will occur if vertical restraints in the United States *and* foreign countries are too costly to monitor or enforce. For example, assume the \$24 retailer's premium in Table 1 is now a return to retailers' specific capital investments, rather than a premium to cover competitively determined costs, such as shelf space as previously assumed. The following analysis abstracts from other costs incurred at the retail level assumed to be competitively determined. If the French retailer sells in the parallel market (breaches its vertical restraint agreement), then it is subject to termination and forfeiture of the \$24/unit premium stream. The maximum per unit profit possible from the parallel market is \$13 (\$192-\$168-\$11). The parallel market is able to free-ride off of U.S. retailer investment in trademark capital by having a cost advantage. However, foreign retailer losses from termination (\$24) exceed the gains (\$13) from supplying the parallel market. Moreover, even if it were costly for the distributor to detect a breach of contract, a relatively small probability of being detected will result in a significant expected loss to a retailer.⁶⁰ In addition, the initial gains from selling in the parallel market decrease with increased parallel competition and therefore a lower U.S. price.

The parallel market can then be explained as either the U.S. distributor failing to adjust to a change in the exchange rate, as discussed in Section C, or the unenforceability of vertical restraints. As noted, vertical restraints in the United States are generally enforceable. However, certain aspects of foreign laws are in effect *pre-Sylvania*. Export restrictions are generally *per se* illegal in the European Economic Community and other countries. Second, a recent case decided by the Court of Justice of the European Communities held that a manufacturer cannot deny a guarantee on parallel sales if guarantees are supplied on authorized sales.⁶¹ Third, another recent case restricts exclusive territories in franchise agreements.⁶² Fourth, some countries have compulsory licensing laws that may restrict the terms of a vertical restraint.

60. The loss from termination is the specific capital invested, which is assumed to represent the present value of future price premia. On the other hand, the gains from selling in the parallel market will last only as long as the dollar is strong.

61. *Swiss Watch Maker May Not Discriminate Among Distributors in Offering Guarantee*, 50 Antitrust & Trade Reg. Rep. (BNA), at 263 (1986).

62. The Court of Justice has recently ruled on a franchise agreement that divides the market. *Pronuptia de Paris GmbH. Frankfurt v. Pronuptia de Paris Irmgard Schillgals Hamburg*, 1986 E. Comm. Ct. J. Rep. 161/84.

Table 1 can now be reinterpreted to consider the effect of the unenforceability of export restrictions in foreign countries. Assume the foreign manufacturer has subsidiaries in all Member States of the European Community and each of these distributors faces prices and margins identical to those illustrated in Table 1. Assume initially that both the United States and Member States of the European Community enforce vertical restraints. Retailers in all countries received a \$24 premium for specific trademark investments.⁶³ If export restrictions now become illegal (i.e., vertical restraints unenforceable), then parallel markets will develop in each of the Member States. For example, German or Italian retailers will sell in the French parallel market. If French retailers maintain their retail price of 192F, that includes the 24F quality assurance premium, then German or Italian retailers can free-ride off of French retailers' investments by selling at a price below 192F in the French parallel market. That is, German or Italian retailers can now sell outside of their exclusive territories and increase their sales by charging a lower price that does not include a premium for specific investments.

With parallel competition in France, the new equilibrium price will be 168F (192F - 24F) which is equal to the parallel seller's marginal cost. A similar argument can be made for French retailers selling in the German and Italian parallel market. The European retail price will fall to 168F or the equivalent exchange price in each country and the value of retailers' trademark capital in all European countries trademark will fall to zero since there is no return (price premium) that can be charged to recover investment costs with parallel distribution in all Member States.

Retailers in Member States, also, have an incentive to sell in the U.S. parallel market. A maximum profit of \$13/unit (\$192-\$168-\$11) can be realized by parallel importers if the U.S. price remains at \$192. However, the price will fall to \$179 which is the marginal cost to parallel importers (\$168 + \$11 shipping costs) with parallel competition in the United States. The \$13 U.S. price decline must come at the expense of either a reduced U.S. trade-

63. The analysis abstracts from other retailer costs such as shelf space. Because these costs are competitively determined and free-riding is not possible, ignoring these costs does not effect the analysis since the parallel importer can have no cost advantage over the authorized retailers in the United States. The retailers' premiums can also be interpreted as simply a margin that is forfeited if the retailer fails to perform services. The margin is assumed to be less than the costs required by the distributor to monitor performance, and thus represents an efficient performance bond and not a competitive return.

mark registrant's premium or a reduced U.S. retailer's premium or both. The inability to enforce foreign vertical restraints, coupled with the ability of parallel importers to free-ride off of U.S. retailers' quality assurance premiums, may explain the gray market even in the absence of a dollar appreciation. In this case, either the foreign manufacturer, U.S. trademark registrant, or U.S. retailers will experience a loss in trademark value. In the long run, consumers in the United States lose if foreign trademark goods are no longer able to command a premium. The losses are a result of the parallel market free-riding off of U.S. investments which will ultimately effect U.S. supply and demand of foreign trademark goods.

The foregoing analysis ignores any adjustment made by the manufacturer to the change in foreign law. The optimal level of quality assurance premiums prior to the change in foreign law was assumed to be \$48 at the distributor's level and \$24 at the retail level (Table 1). However, this level is based on an assumption that vertical restraints are enforceable. If free-riding occurs at the retail level, then manufacturers will have incentives to shift quality assurance investments to a level where free-riding is not possible. For example, if foreign retailers are charged a price of 182F instead of 168F, there will be no return to foreign retailers from selling in the U.S. parallel market.⁶⁴ The additional 14F price increase to foreign retailers serves to eliminate parallel distribution. The increase in foreign distributors' quality assurance premium permits increased trademark investments at the distributor level to compensate for the loss of investments or services at the retail level.⁶⁵

Now consider the effects of a dollar appreciation. If U.S. retailers are required to make specific investments in the trademark, they will then require assurances from the manufacturer or trademark registrant that the absolute premium will not change as noted earlier. In addition, the duration of these agreements are likely to extend over a long period in order to recoup specific capital investment costs. Therefore, retailer margins (returns) are

64. If parallel importer shipping costs to Member States were also \$11, there would be no parallel market in the European Community at a \$182 cost to retailers. That is, \$182 + \$11 shipping cost equals \$193, which is greater than the authorized price of \$192.

65. The level at which quality assurance and service expenditures are made will effect the optimal level of trademark capital investments. Quality assurance investments in foreign countries are likely to be less than the United States because of the loss of effectiveness due to the absence of vertical restraints. However, as long as the differential does not exceed parallel shipping costs, there will be no incentive for a gray market to develop.

likely to be inflexible.⁶⁶ Implicit or explicit agreements between the U.S. trademark registrant and U.S. retailers would imply that either the manufacturer or its subsidiary (i.e., U.S. trademark registrant) will bear the full impact of the fall in the U.S. price brought about by parallel imports.

Consider Table 2. Assume that the U.S. distributors' premium of \$48 and the retailer premium of \$24 should adjust to \$24 and \$12 respectively in a competitive equilibrium after a dollar appreciation (i.e., a proportional adjustment). The price in the United States should be equal to the price in France (\$96) as illustrated in Table 2. Also assume, as discussed above, that because vertical restraints are unenforceable in foreign countries, the \$12 retailers' premium, illustrated in Table 2, is now incorporated in the distributor price making the cost of \$96 for foreign retailers. The total cost to the parallel distributor is \$96, plus shipping costs of \$5.50 or \$101.50. The total U.S. retailers' cost is \$132 if both price margins in the United States do not adjust with the dollar appreciation. Assuming that other selling costs are competitively determined and equal for both the U.S. parallel importer and U.S. retailers, the parallel market has a cost advantage of \$31.50 (\$132-\$101.50) after a dollar appreciation with fixed U.S. margins. With parallel distribution, the competitive price in the United States must fall by \$31.50, which means that retailers' marginal cost in the United States must equal parallel importers' marginal cost of \$101.50.

However, if U.S. retailers' premiums of \$24 are contractually determined, the manufacturer or U.S. trademark registrant must absorb the \$31.50 cost difference, thus allowing U.S. retailers to remain competitive with parallel importers. Unlike the previous analysis in Section C, the manufacturer and/or U.S. trademark registrant now suffers a loss on trademark capital even when measured in yen. The dollar appreciation under a competitive equilibrium should lead to a \$24 reduction in the distributor's premium (\$48 - \$24), and the value of the trademark as measured in yen would remain unchanged. But, a \$31.50 reduction in the U.S. trademark registrant's premium results in a net premium of only \$16.50 or a net loss of \$7.50 over the competitive premium of \$24. The risk of loss and who bears the loss are normally incorporated into agreements which, in turn, are incorporated in prices. How-

66. This would likely be true in foreign countries if export restrictions were enforceable.

ever, the magnitude and duration of the strong dollar in the 1980s may not have been fully anticipated at the time vertical restraint agreements were negotiated in the United States. If the assumption that margins should adjust to exchange rates is correct, an unanticipated dollar appreciation results in overinvestment in U.S. trademark capital *ex post* by retailers.⁶⁷

The manufacturer or U.S. trademark registrant has three options. First, the parallel market can be avoided if the manufacturer or U.S. trademark registrant maintains U.S. retailer margins and absorbs the loss on its margin; this will result in an immediate loss in value of the trademark as measured in yen but avoids any loss by U.S. retailers. Second, the manufacturer or U.S. trademark registrant may maintain its margin at \$24 and U.S. retailer margins at \$24 by setting a manufacturer's suggested retail price of \$108. Even if parallel imports could be prohibited, the manufacturer who establishes a suggested retail price is likely to lose sales to other competitors who may have more flexible margins. Maintaining the distributors' or retailers' margin, and therefore the retail price, above the competitive level will result in losses of sales that are likely to reduce returns to both the foreign manufacturer and U.S. authorized retailers.

Finally, the manufacturer or its subsidiary may implicitly or explicitly sanction the parallel market. Parallel sales represent revenues to the manufacturer. Parallel competition will indirectly reduce authorized retailer margins even though it will appear that the manufacturer or U.S. trademark registrant is not breaching its contract with retailers.⁶⁸ For example, if foreign retailer premiums

67. Note the effect of the exchange rate. The manufacturer will perceive a fixed distributor premium as a higher return (in yen) on U.S. trademark capital and will accordingly increase shipment to the U.S., thereby lowering the price. However, U.S. retailers measure their return in dollars and not in yen. Thus, unlike foreign manufacturers, U.S. retailers are exposed to the risk of exchange rate changes that cannot be internalized by a foreign currency.

68. The policy implication of this argument is that manufacturers would not want to "ban" the parallel market. Assume, however, that trademarks cannot be instantly produced such that there is a natural restriction on entry in the short run. It can be argued in this case that a ban may be favored as a means for foreign manufacturers to implicitly collude so that contractual margins are maintained in the United States. A squeeze on U.S. retailer margins from parallel imports affects the reputation of manufacturers not only with their current retailers but with future retailers as well. Thus, competition among foreign manufacturers could still occur, but a ban may prevent competition from eroding contractually determined retailer margins. In this light, the unanticipated event may not only have been the exchange rate, but also the change in foreign law that enables parallel importers to receive goods. This result, however, is still inefficient in the sense that there has been an

are shifted to the distributor level, parallel importers' cost would be \$96 plus \$5.50 in freight for a total cost of \$101.50 (Table 2). Even if the U.S. distributors adjust their margin to \$24, then the cost to U.S. retailers is \$84. The U.S. authorized retailer will only receive a \$17.50 (\$101.50 - \$84) premium at a competitive price of \$101.50 set by the parallel importers' marginal cost. Thus, there is an indirect adjustment from \$24 to \$17.50 or a loss of \$6.50/unit to U.S. retailers.

Each of these options has a cost to the manufacturer. The first option results in a lower return on its specific investment, causing a loss of trademark wealth but not a loss of sales. The second option represents a loss of sales revenues to the manufacturer and U.S. authorized retailers in favor of competitors with more flexible margins. The third option can be interpreted as a means of shifting the unanticipated loss of a dollar appreciation from manufacturers or U.S. trademark registrants to U.S. retailers.

The reduced premium to U.S. retailers will not cause them to exit the market provided some return is earned on their investments. A zero return is realized if they exist.⁶⁹ There is a cost to the manufacturer, however, of sanctioning the parallel market. Even if U.S. retailers fail to recognize the indirect adjustment, they will have less trust in continuous dealings with foreign trademarks. The risk of loss will also effect the ability of the U.S. trademark registrant to attract new retailers. The manufacturer will weigh this cost against the immediate cost of absorbing the loss. Under these assumptions, the long run consequences are likely to be more flexible vertical restraint agreements and/or risk premiums to compensate for exchange rate changes.

In summary, the parallel market, under these assumptions, may be a market adjustment to an over-investment by U.S. retailers in trademark capital due to an unanticipated dollar appreciation.⁷⁰ United States retailers receive a lower return (premium) on their capital as long as the dollar remains strong. Unlike the analysis in Section C, U.S. retailers suffer real losses that are not inter-

overinvestment in trademark capital in light of the new exchange rate and that prices would be artificially high under a ban. See Part III B (discussion of a manufacturer sanctioned gray market).

69. It is interesting to note that the 1985 Department of Commerce study made no mention of U.S. trademark registrants losing retailers. See D.O.C., *supra* note 14.

70. Of course, if U.S. retailers anticipated the effect of the dollar appreciation at the time vertical restraints were negotiated, then the analysis is not applicable.

nalized by a conversion of the premium to a foreign currency.⁷¹ However, the parallel market may be indirectly sanctioned by manufacturers as a means to minimize their losses and achieve lower retailer margins in the U.S. in order to remain competitive in the market. Parallel importers, under these assumptions, are not free-riding off U.S. sellers as they pay prices that include all free-ridable expenditures. United States consumers benefit from lower prices.⁷²

E. Lower Quality Products and Service

The analysis in Sections C and D require a number of restrictive assumptions. Under certain assumptions, the parallel market enhances economic welfare if U.S. prices and U.S. price margins are reduced, even though the dollar value of the U.S. trademarks is reduced. A key assumption for this result is that quality assurance premiums should adjust to the dollar appreciation in a competitive equilibrium. On the other hand, if these premiums are assumed not to adjust in a competitive equilibrium, then the parallel market is not welfare enhancing. In this case, parallel competition causes a shift in U.S. demand for foreign trademark goods by constraining U.S. quality assurance investments to lower levels determined in other countries (markets).

Another critical assumption has been that U.S. consumers receive the same goods and services in the gray market that they receive from authorized sellers. This assumption means there is no consumer deception and therefore the "reputational" value, as dis-

71. Note that if the U.S. trademark registrant is not a wholly owned subsidiary of the foreign manufacturer, then U.S. shareholders in the U.S. trademark will realize a real loss in the same manner as U.S. retailers. Thus, it may be U.S. shareholders that favor a ban on parallel imports. While there is evidence that most U.S. trademark registrants are subsidiaries of the foreign manufacturer, this is no evidence of the stock ownership in terms of nationalities. Or alternatively, the foreign manufacturer may be owned by U.S. shareholders whereby the reduced premium is not internalized by a foreign currency since dividends must be paid in dollars. Thus, the composition of shareholders in multinational firms may effect the pricing decisions of these firms. For example, wholly owned subsidiaries are likely to force premiums (prices) down for those firms partially owned by U.S. citizens. Of course, if the dollar appreciation is anticipated *ex ante*, the risk of loss through exchange rate movements will be reflected in the price U.S. citizens will be willing to pay for stock.

72. There is no inherent reason why consumers should bear the cost of an overinvestment in trademark capital. Of course, if there are economic reasons for inflexible margins, then the parallel market owes its existence to free-riding, and therefore is not welfare enhancing.

tinct from the "market" value, of the trademark is unaffected.⁷³ The effects of the parallel market were assumed to act only on price premiums and therefore "market values" of past investments and incentives for future investments in trademarks.⁷⁴ The effects are of a temporary nature unless the dollar appreciation, and therefore the parallel market, are permanent phenomena.⁷⁵ In contrast, this section focuses on the "reputational" value of the trademark that can be "permanent" even if parallel competition is eliminated.

Assume gray market importers sell lower quality products. Gray market goods that are inferior to authorized goods will disappoint consumer expectations and possibly increase the costs of consumer information.⁷⁶ For example, a gray market good may be last year's model or it may not have been properly stored or shipped or may not be suitable for use in this country (e.g., different electric currents). Specifically, Duracell (and perfume manufacturers) alleges that gray market imports of batteries (perfumes) lose their freshness and therefore are not as durable as those in the authorized chain. Camera dealers claim that gray market cameras are damaged by improper shipment and storage and that components such as a carrying bag and strap are not included.

Lower quality products diminish the reputational value of the trademark. Consumers who receive lower quality products will perceive them as being of deceptive quality. If authorized products cannot be distinguished from gray market products, consumers will either stop purchasing the trademark good regardless of its source or will not pay a price premium for the trademark good as discussed in Section B. The net effect of deception is a decrease (shift) in demand, and therefore lower prices and price premia for trademark products. The market value of the trademark will fall and the lower premiums will mean fewer quality assurance invest-

73. Consumer deception can have a legal meaning that is not necessarily implied in this analysis. For the purpose of this discussion, consumer deception is an unanticipated lower quality product or service from parallel importers where consumer anticipation is based on either trademark claims or prior purchases and services received from authorized sellers.

74. That is, if price premiums should adjust in competitive equilibrium for the reasons enumerated above, the firm's reputation or what is at stake should also adjust. On the other hand, if price premiums are assumed not to adjust, then the reputational value will also be affected in the long run.

75. See Ross, *Dollar's Drop Drubs Gray Marketeers: Fewer Back-Door Imports Can Be Sold at Bargain Prices as a Result*, Wash. Post, May 4, 1986, at F3 ("[T]here is widespread agreement that the [gray market] problem has receded.").

76. See LEXICON, *supra* note 18, at 43-50.

ments in the future.

Gray market sellers may also fail to provide post-sale services, such as warranties, that consumers expect because of the claims of the trademark owner. If consumers are unable, or find it costly, to distinguish authorized sales from gray market sales, then a consumer who purchases a gray market good may take the good to authorized sellers for post-sales services (e.g., warranty, refund, adjustment). That is, the consumer may find it more convenient to have the product serviced at an authorized seller. If parallel sellers or authorized sellers refuse to provide post-sale services, then consumers may perceive the quality as being deceptive. Authorized sellers may provide post-sale services for gray market goods to avoid diminishing the reputational value of the trademark. Thus, the gray market may also free-ride off authorized sellers if they provide a lesser amount of post-sale services than authorized sellers. The gray market seller is at a competitive advantage by having lower costs, that in turn are reflected in lower prices compared to higher cost-authorized sellers.

If vertical restraints are enforced world-wide, a retailer will weigh the benefits (i.e., cost savings) of free-riding by providing lower quality products or services against the cost of forfeiting the \$24 premium if terminated (e.g., Table 1). In addition, a similar calculus will be performed if the retailer breaches its agreement by selling in the parallel market. If vertical restraints are not enforceable, thereby permitting free-riding or sales in the parallel market, then it can be assumed that expenditures subject to free-riding behavior will be taken at the manufacturing or distribution level and incorporated in the retailer's price. Accordingly, there can be no cost advantage by the parallel importer over authorized U.S. importers. Parallel importers must have a cost advantage in order to free-ride.

However, if the dollar appreciates, an incentive for foreign retailers to sell in the U.S. parallel market may result. But, this incentive exists only if U.S. premiums do not fall when the dollar rises. The premium for services, similar to the premium for quality assurance, should fall to some extent with a fall in the manufacturers' price. For example, the cost of capital tied up in refunds and inventory will decrease with a decrease in the cost of goods.

On the other hand, U.S. expenditures for labor, equipment or building costs that may be necessary to provide services in the United States are not related to the exchange rate. Therefore, it

would seem more likely that U.S. service costs, relative to quality assurance, will not fall proportionately with the rise in the dollar, permitting a price difference between the United States and foreign countries. This price difference, due to cost rigidity coupled with consumer deception, can lead to a gray market, despite the incorporation of a margin for foreign free-ridable expenditures in the parallel importer's cost.

Consumer expectations need not be disappointed even with the presence of lower quality goods or services. A lower price (lower premium) in the gray market may signal lower quality, including the loss of services. For example, some purchasers will make a tradeoff between an authorized product with all the services and a gray market product without services, such as the absence of a warranty for a lower price.⁷⁷ In these cases, a low quality product is simply "de-bundling" the good from the services without deception or free-riding. For example, in the case of Bell & Howell, the gray market importer offered to display and include in its advertising that it was responsible for warranty work on cameras it sold. However, this kind of product differentiation may increase consumer information costs, a cost the manufacturer attempts to minimize by having a trademark.

Several other facts dilute these consumer deception assumptions. First, some gray market sellers have their own refund or return policies and provide warranties independent of those offered by the manufacturer.⁷⁸ Consumer complaints about gray market goods do not appear to be a significant problem.⁷⁹ Finally, gray market sellers such as Montgomery Ward and K-Mart have trade-

77. See Katten, *Memorandum to Gray Market Task Force on Consumer Protection Issues Related to Gray Markets*, 1985 F.T.C. 7 (detailed discussion of differences in gray market versus authorized goods as well as an analysis of labeling requirements, deception and warranties). A survey conducted by Market Probe International, Inc. showed that 32% of consumers surveyed stated that they would prefer to pay \$100 for an item with a warranty from the trademark holder rather than pay \$75 for the same item and receive a warranty from the domestic distributor or retailer. *Id.* at 25. In a different context, one study of the purchasers of Rolex watch replicas found that no one buying the replica thought they were buying genuine Rolexes. The same survey found that 13% would have purchased the genuine Rolex if the price of the replica had risen sufficiently. Higgins & Rubin, *Counterfeit Goods* 29 J.L. & ECON. 211 (1986).

78. A number of gray market retailers are providing warranties independent of the manufacturer. See McCosh, *GM Warranty on Gray Market Cars*, AUTOMOTIVE NEWS, Apr. 15, 1985, at 3; *Are Those Cheap Camera Prices for Real?*, CONSUMER REPORTS, May, 1985, at 300; Gilman, *No Guarantees for Guarantees in Gray Market*, Wall St. J., Feb. 5, 1985, at 33 (K-Mart Sale of Seiko watches with independent guarantee).

79. See Katten, *supra* note 77.

marks that are specialized to distribution services rather than the manufacture of goods. These stores are unlikely to be deceptive in selling inferior goods or services because their trademark also depends on repeat sales. For example, Montgomery Ward switched to the gray market for some items after ten years as an authorized dealer because of better service and value from the parallel importers.⁸⁰ Thus, quality assurance expenditures of some retailers may be a substitute, in part, for quality assurance expenditures of the trademark owner. Department stores such as Neiman-Marcus, for example, have considerable specific investments in the form of luxurious furnishings, storefronts and rugs, that serve as quality assurance in providing distributional services. Neiman-Marcus customers are likely to accept quality assurances from the fact that Neiman-Marcus handles the product rather than because the good is from a particular manufacturer.⁸¹

Thus, the extent of any damage to the trademark reputation will be a function, in part, of the types of stores that sell gray market goods. There is no hard evidence of the relative sales volume of gray market sellers such as Montgomery Ward or K-Mart versus sellers such as 47th Street Photo.⁸² If Montgomery Ward and K-Mart are deceptive in selling inferior goods or fail to provide consumers with anticipated post-sale services such as warranties, they will lose repeat sales and incur a loss on their specific trademark capital. On the other hand, a gray market seller with little or no specific capital can make a return on being deceptive by getting in and out of the market or by catering to a market that does not depend on repeat sales. Consumer deception may permanently affect the reputation of trademarks. Unlike the analysis in sections C and D, parallel competition in this case can have a lasting effect, even if the dollar depreciates or parallel importers are eliminated.

80. *The Assault on the Right to Buy Cheap Imports*, FORTUNE, Jan. 7, 1985, at 89. Such companies provide independent post-sale services such as refunds and replacements.

81. There is no evidence that Neiman-Marcus sells gray market goods. However, given the amount it spends on quality assurance, it would seem to be in their interest to purchase in the gray market, especially in light of Robinson-Patman constraints discussed in Part III.

82. One could hypothesize that gray market sellers are likely to be large volume purchasers because the transactions costs of gray market importers in establishing their own distributional network is likely to be very high. K-Mart launched an extensive consumer write-in campaign as a lobbying measure to voice reaction to government proposals to ban parallel distribution.

F. Summary

Section B presented an overview of the quality assurance literature that was used as a framework to analyze the free-rider argument. Because trademarks are used as a means of assuring quality, it is particularly necessary to understand: (1) why some goods have trademarks, whereas others do not; (2) what types of investments are made in the trademark; (3) how the market provides a return to these investments; and (4) what institutional arrangements are necessary to maintain the value of these investments. A comparative static approach was used by comparing pre-dollar appreciation conditions with post-dollar appreciation conditions because the rapid dollar appreciation in the 1980s coincided with the emergence of the gray market in the 1980s. Section C analyzed trademark investments confined to the manufacturer or distributor level. This section concludes that the parallel market can be explained either by manufacturer price discrimination or price premia that do not adjust with a dollar appreciation. Price discrimination will be analyzed in Part III. Under reasonable assumptions, it is argued that price premia should adjust to a dollar appreciation in a competitive equilibrium.

Section D analyzed vertical restraints. The parallel market may be a means by which manufacturers can indirectly adjust independent retail margins, thereby avoiding losses on their own trademark capital. Sections C and D present arguments that the parallel market may be an efficient market adjustment process that benefits U.S. consumers. Section E examined parallel importers who may sell inferior goods or provide inferior services to that of authorized retailers. In each case, it can be expected that the dollar value of U.S. trademarks will fall as a result of parallel imports. The only unambiguous case of free-riding occurs when parallel importers deceptively sell lower quality products or provide less services than anticipated by consumers. There is some evidence that consumer deception is not a widespread problem. Unfortunately, there is insufficient data to be able to conclude or test which is the more plausible explanation.

III. PRICE DISCRIMINATION ARGUMENTS

Proponents of gray markets argue that manufacturers' prices discriminate between countries, thereby creating arbitrage oppor-

tunities.⁸³ Parallel imports have the result of lowering prices to U.S. consumers. Section A will discuss price discrimination based on different demand elasticities. Some parallel importers also argue they are more efficient in distribution than authorized high margin sellers. Section B considers the constraints on price and marketing under the Robinson-Patman Act and its implication on the gray market. In summary, proponents argue that price discrimination or distributional inefficiencies in authorized distribution artificially restrict *intra-brand* competition to the disadvantage of U.S. consumers.

A. Price Discrimination and Demand Elasticities

There are three elements necessary for price discrimination. First, demand elasticities must differ between markets.⁸⁴ Second, a firm must be able to prevent, or make costly, independent resales of the product between markets. Third, a firm must possess market power. Parallel markets are defined as the unauthorized resale of products from one market (country) to another market (country). If parallel importers arbitrage price differences set by discriminating monopolists, then why have these arbitrage opportunities suddenly appeared in the 1980s?

First, it is possible that price discrimination existed prior to the 1980s. However, parallel imports will not exist in the United States unless there is a source of supply abroad. The existence of a gray market has recently been observed. As discussed in Part II, enforceable vertical restraints coupled with the forfeiture of specific capital investments can deter or eliminate incentives of sellers to deal in the gray market even though arbitrage opportunities may exist. Hence, the gray market may be explained by developments in foreign law during the 1970s and 1980s that restricted the ability of foreign manufacturers to impose sanctions on foreign retailers who resold to parallel importers.

Second, as discussed in Part II, a rapid dollar appreciation oc-

83. Presumably this is what motivated William Niskanen, then a member of the Council of Economic Advisors, to state "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." Boyer, *The Assault on the Right to Buy Cheap Imports*, *FORTUNE*, Jan. 7, 1985, at 89.

84. See Schmalensee, *Output and Welfare Implications of Monopolistic Third Degree Price Discrimination*, 71 *AM. ECON. REV.* 242 (1981) (full analysis of the welfare consequences of domestic price discrimination).

curred in the 1980s. All other factors being equal, a dollar appreciation can lead to even greater price differences if the United States demand curve exhibits decreasing elasticity (in absolute value) with a quantity increase.⁸⁵ Consider Table 1 in Part II. Prior to the dollar appreciation, the assumption was that the manufacturer charged one hundred twenty dollars to U.S. distributors and one hundred twenty francs to French distributors. When the dollar appreciated such that $\$1 = 2F$, the manufacturer received 240F (\$120) for units sold in the United States, and only 120F for units sold in France. Accordingly, manufacturers would ship more units to the United States to receive the higher marginal revenue (in francs or yen). The U.S. price, hence, falls as more units are sold. The manufacturer would continue to ship to the United States until the marginal revenue in the United States (measured in yen) equals marginal revenue in France (measured in yen).⁸⁶ However, a discriminating monopolist would not decrease the U.S. price (measured in dollars) to sixty dollars (\$60) (120F), which is the competitive price with constant costs. The U.S. price charged would be higher than sixty dollars (\$60) but less than one hundred twenty dollars (\$120).

As a general rule, the greater the dollar appreciation and the less elastic U.S. demand becomes with an increase in quantity, the greater the price differences between countries. On the other hand, if the U.S. demand curve exhibits constant elasticity or increased elasticity (in absolute value) with a quantity increase, then price differences will get smaller or not increase at all. While a dollar appreciation *may* lead to larger price differences, thereby enhancing arbitrage opportunities, it does not necessarily follow that it must lead to greater price differences.⁸⁷ Whether U.S. demand

85. This will be true for any product provided that its demand curve exhibits decreasing elasticity (in absolute value) as the quantity increases. A linear demand curve is one such curve. More generally, any convex or slightly concave demand curve will possess decreasing elasticity as the quantity increases. A demand curve will have to exhibit strong concavity for the elasticity not to decline as the quantity increases. For a constant elasticity demand curve, price discrimination is unaffected by the exchange rate.

86. If the manufacturer has constant costs, the price and quantity sold in France will be unaffected by the dollar appreciation. This also assumes the dollar appreciated against the manufacturer's currency (e.g., yen) in the same degree as against the franc.

87. While parallel imports are generally assumed not to be in the manufacturer's interest because they arbitrage price differences, it is possible that manufacturers may sanction and encourage parallel imports to eliminate price differences. For example, assume United States demand elasticity increases or remains constant with a quantity increase. As discussed above, price differences will get smaller or not increase at all even though the firm has market power. But consider the contractual price rigidity discussed in Part II D as a result of an

elasticizes, becomes less elastic, more elastic, or remains constant as quantity increases, is an empirical issue, not a theoretical issue. Data is not available to estimate demand elasticities.

The principal difficulty with the price discrimination explanation is that foreign manufacturers must have some degree of market power. While it can be argued that vertical restraints can be used to facilitate collusion and thereby price discrimination among manufacturers or retailers, there is a general consensus among economists that vertical restraints are likely to be pro-competitive (i.e., prevent free-riding) in the absence of certain factors.⁸⁸ The transaction costs of obtaining a consensus for a collusive agreement are high if there are a large number of participants. The industries subject to the gray market do not appear to be concentrated at the manufacturer level.⁸⁹

ex post over-investment in trademark capital by U.S. retailers. The effect of such rigidity will be price differences that may not be in the manufacturer's interest. By lowering the United States price through supplying the parallel market, the manufacturer's total revenues may increase more than proportionately to total costs, thereby increasing profits. Thus, parallel competition can have a desired effect to both consumers and manufacturers by eliminating price differences.

88. See generally R. POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE* (1976) [hereinafter POSNER]; POSNER, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6 (1981). Posner states:

An agreement to divide markets is a classic method of cartelization. Its advantages compared to price fixing are that the parties do not have to negotiate a common price and do not to worry about dissipating cartel profits in non-price competition. If consumers are highly mobile, however, market division may not be an effective method of cartelization; adherence to the agreement will be difficult to police, and supplementary price-fixing agreement may be necessary to maintain an "equitable" division of the cartel's profits among its members. Price fixing and market division are thus alternative methods for achieving the same thing—monopoly pricing and profits—with the choice governed by the circumstances facing the cartel.

POSNER at 159.

89. It is, of course, possible although unlikely that U.S. authorized retailers can collude to create market power. See Easterbrook, *Restricted Dealing is a Way to Compete*, REG. JAN./FEB. 1984, at 23-27 (1984). Even if the transaction costs of an agreement are overcome, there are incentives for any particular member to cheat on the cartel price(s) and thereby erode the cartel price(s). Without the assistance of government enforcement, both monitoring and enforcement of a cartel agreement are not likely to be effective. There does not appear to be any government restrictions on entry in the industries subject to the gray market that would foster market power. Thus interbrand competition would seem to preclude the ability of foreign manufacturers to price discriminate among countries. But as discussed in the following section, trade restrictions can create market power.

B. Trade Restrictions and International Price Discrimination

In 1776, Adam Smith, in *The Wealth of Nations*, presented his arguments against restrictions on trade. His arguments were premised on the principal of comparative advantage. In essence, his argument was that there were mutual gains with international trade, just as there are mutual gains from domestic trade. Free trade results in each country specializing production in its areas of comparative advantage and exchanging these goods in return for goods for which it does not have a comparative advantage. Thus, the wealth of nations rests with specialization and trade.

It is beyond the scope of this paper to examine the current debate over free trade versus fair trade. What is clear is the fact that there are a number of agreements that restrict international trade. Protectionist legislation or agreements exist in the United States as well as other countries.⁹⁰ For example, in April 1981, Japan agreed to a voluntary export restraint (VER) limiting Japanese auto sales in the United States to 1.68 million annually.⁹¹ The effects of the VER have been to increase the U.S. price of Japanese automobiles, increase the price of domestically-produced automobiles, and increase the quality of cars imported.⁹² Similarly, the General Agreement on Tariffs and Trade (GATT) affects thousands of goods imported to the United States.⁹³

90. See Milton Friedman, *Outdoing Smoot-Hawley*, Wall St. J., Apr. 20, 1987, at 22 ("Malcolm Baldrige, . . . ; William Brock . . . ; and . . . Clayton Yeutter, the current trade negotiators, have been making Smoot-Hawley look positively benign. Despite the harm it did, Smoot-Hawley had at least one virtue—the tariffs it imposed did yield revenue to the Treasury.").

91. See generally Lochmann, *The Japanese Voluntary Restraint on Automobile Exports: An Abandonment of the Free Trade Principles of the GATT and the Free Market Principles of United States Antitrust Laws*, 27 HARV. INT'L L. J. 99 (1986).

92. See Feenstra, *Automobile Prices and Protection: The U.S.-Japan Trade Restraint*, in *THE NEW PROTECTIONIST THREAT TO WORLD WELFARE*, (D. Salvatore ed. 1987).

93. See General Agreement on Tariffs and Trade, *opened for signature*, Oct. 30, 1947, 61 Stat. A3, T.I.A.S. No. 1700, SS U.N.T.S. 187, See also Blackhurst, Marian & Tumlr, *Trade Liberalization, Protectionism, and Interdependence, Studies in International Trade*, Geneva, November (1977). This study lists several of the goods subject to the gray market. "New trade restrictions have been imposed in the last few years on many new products. Most of them, however, are concentrated in a few manufactured product groups: textiles, clothing and shoes; steel; transport equipment, mainly ships; and such diverse light engineering products as TV apparatus, ball-bearings, thermionic valves, dry-cell batteries and so forth." *Id.* at 44.

The report describes the difficulties in measuring the extent or degree of trade restrictions. Quantitative estimates of the magnitude of the trade flows under restraint are unsat-

International price discrimination can exist because of trade restrictions even though the firms or industries have no monopoly or market power. The effect of a quota or VER is to restrict imports, thereby permitting firms in the exporting countries to set prices similarly if they were to organize into a cartel. The principal difference with a quota or VER is that the cartel agreement is enforced by the United States, whereas a private cartel agreement is subject to enforcement and free-rider problems. Thus, a lower price can exist in the exporting country that has a comparative advantage compared to the importing country with a quota. Trade restrictions can create market power and effectively separate markets to permit price discrimination.

Consider the case of tariffs in conjunction with changes in the exchange rate. As discussed in Part III A above, it is necessary to assume inelastic demand if changes in the exchange rate are to explain increased price differences and therefore increased arbitrage (gray market) opportunities. Adjustments in quantity will result in a unitary or elastic demand because of a change in the exchange rate. Hence, a new equilibrium, where marginal revenue equals marginal cost, thereby leading to smaller or no changes in the relative prices of a discriminating monopolist, will be achieved.

This analysis changes, however, if quantity adjustments are constrained by a U.S. quota or VER. For example, initially assume \$1 = 1 yen and the price of imports was \$1 at the quantity set by the quota. Now assume that there is a change in the exchange rate such that \$1 = 2 yen. Without a change in the quota, the importer will now receive 2 yen for his exports instead of \$1. Regardless of the elasticity of demand in the United States, the importer will now receive twice the revenue. The price of \$1 may not be the profit-maximizing price and quantity, but the quantity (quota) is determined in the United States and not in Japan. Thus, trade restrictions permit a more general case of increased price discrimination as a result of changes in the exchange rate because it is not

isfactory for at least three reasons, all of which impart a downward bias to the estimate. First, the magnitude of the trade flow under restraint tells little about the degree of restraint; in the absence of protection, the flow would be larger, but it is impossible to say by how much. Second, one cannot count as protection anti-dumping or countervailing measures which are, in principal, legitimate actions to protect fair competition; yet it must be surmised that in a period of generally rising protectionist pressure, anti-dumping and countervailing procedures may also be abused for protectionist purposes. Finally, and most importantly, the uncertainty generated by restrictive measures actually taken, as well as by the pressure for additional ones, is in itself a highly effective deterrent to trade. *Id.*

necessary to assume market power or a particular elasticity. Arbitrage opportunities (gray market) will increase with a change in the exchange rate.

The above analysis is premised on the exporting firms capturing the rents or profits created by the quota. Of course, if the exporting firms were in a competitive industry, they would eventually bid the export price down to where domestic prices equaled export prices adjusted for differences in costs, such as transportation costs. At the other extreme, the government of the exporting country could capture all the rents of a U.S. quota by requiring an export license and charging fees. That is, a U.S. quota creates rents, thereby generating a situation of excess demand of foreign countries to export. The exporting government will then charge a license fee equal to the rents created by the quota.

A change in the exchange rate would not explain an increase in arbitrage opportunities (gray market) under either extreme. The U.S. price would be bid down to adjust for a change in the exchange rate, with a competitive market in exports and no licenses. With export licenses, arbitrage opportunities created by the price differences between countries brought about by a change in the exchange rate are captured by the exporting government. Gray market exporters would also have to bid for the licenses, thereby eliminating price advantage. However, a number of scenarios between these two extremes exist. Assume there are no export licenses and that, prior to the change in exchange rates, the U.S. quota was a non-binding constraint in that rents were not created. Foreign manufacturers with U.S. trademark registrants and trademark capital would have an advantage over their competitors, who do not have a U.S. presence or brand-name capital to take advantage of a change in the exchange rate. The quota will become a binding constraint creating rents with the change in the exchange rate. Without export licenses, the gray market will replace authorized exports by charging lower prices. In this case, the gray market is not necessarily free riding off the trademark. Rather, it is simply taking advantage of arbitrage opportunities created by the U.S. quota or VER.⁹⁴

Foreign governments would not likely remain passive in re-

94. Foreign manufacturers may engage in rent-seeking by lobbying for export licenses in their own country, even in the absence of quotas or tariffs in the United States. In this case, a ban on gray markets in the United States supports the cartel agreement of the foreign country.

sponse to a binding U.S. quota or VER. There are rents that can be captured by either foreign firms or foreign governments, or both, that are dissipated by competition from the gray market. Rent seeking by these firms or governments should lead to export licenses that would in turn eliminate the competitive gray market. However, there are difficulties faced by firms with a multinational market. Foreign countries or foreign manufacturers have no incentive to restrict exports to countries where they do not have a comparative advantage. Exports to these countries will have to compete with the importing country's firms.

In a multinational market, the price of imported goods will vary across countries (i.e., international price discrimination) depending on comparative advantage, exchange rates, and quota or VER considerations. The United States could have a quota restriction for certain imports from Japan, but these same Japanese goods could be imported to France without quotas. If France has a lower price for Japanese goods because they do not impose quotas on Japanese imports, then gray market entrepreneurs can arbitrage the price differential between Japan and the United States by trans-shipping through France.⁹⁵ An additional problem exists for the foreign manufacturer with a multinational market. While a Japanese manufacturer may engage in rent seeking with the Japanese government for export licenses, for example, it may not be in a position to do the same thing in France or other countries to curtail the gray market. Many foreign countries are pre-*Sylvania* in terms of vertical restraints.⁹⁶

There are several facts about the gray market that support the above argument. First, gray market goods are imported from numerous countries other than the country of manufacturing origin. Moreover, a quota that is effective will result in high quality imports.⁹⁷ A quota represents a valuable property right to the exporting country. Suppose there are two imports — product A is high quality and sells for \$100 and product B is low quality and sells for

95. Alternatively, if the United States has a tariff on Japanese imports and no tariffs on French imports, and there are no U.S. tariffs on imports from France, then an arbitrage opportunity also exists by trans-shipping through France.

96. *Continental T.V. Inc., v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977). One interpretation of the actions by foreign manufacturers and their United States trademark registrants in lobbying the U.S. government for a ban on unauthorized imports is to protect the rents created by U.S. quotas or VERs.

97. See *supra* note 14. It has been alleged that some gray markets represent the low end of the quality spectrum which are not sold by authorized dealers in the United States.

\$50, and both products fall under the quota. Suppose the quota creates a rent on each product of twenty percent. The firm that produces A will be able to pay a license fee equal to \$20 times the quota, whereas the firm that produces B is only able to pay \$10 times the quota. Firm A will outbid firm B.⁹⁸ The same argument would apply to a per-unit tariff imposed by the United States. For example, suppose the tariff were \$12 per unit. Firm A would still be able to earn a rent (\$20 - \$12), whereas firm B would be priced out of the market.⁹⁹ If U.S. quotas or tariffs were not binding constraints, and thus did not create rents, it would be expected that U.S. imports would represent a broad spectrum of quality. However, the gray market is clearly associated with high-quality goods. There may be other reasons for this as discussed in Part II, but the above factors are suggestive that trade restrictions may be the cause of the gray market.

C. Cost Justified Price Differences

There are a number of circumstances in which price differences may not be the result of price discrimination or lead to supra-competitive profits. For example, markets may be such that quality assurance investments have differential effectiveness as discussed in Part II. Price differences may also be necessary to accommodate short-run, unexpected market conditions in various regions or countries. Without price differences, short-run market fluctuations that vary by region would disrupt the dealer network and individual marketing investments in such regions.¹⁰⁰ If sup-

98. The same argument would apply if both products A and B were produced by the same manufacturer.

99. A per-unit tariff, similar to per unit transportation costs, also changes relative prices in the importing country that favors high quality (priced) goods over low quality goods. The change in relative prices explains why a proportionately greater quantity of high quality oranges and beef are shipped from California and Texas to New York and a proportionately greater quantity of low quality oranges and beef are sold in California and Texas.

100. Two camera companies reported to Customs that they must set prices for a reasonable period of time to avoid "yo-yoing" their distribution network. See D.O.C. *supra* note 14, at 12. A spokesman for Mercedes-Benz stated that they prefer to maintain stable prices and that Mercedes "did increase its prices in the mid-1970's when the dollar weakened against the West German mark . . . but has since stuck to a policy of holding prices firm regardless of currency fluctuations." See Holusha, *Unauthorized Sales Up for Cars From Europe*, N. Y. Times, Mar. 4, 1985, at D1.

Costs are also involved when a manufacturer changes its wholesale price. Retailers may have catalogues printed on an annual basis and may be obligated to honor the catalogue price if the product is offered. Contracts may have been made which cause losses to wholesalers if they have to absorb a price increase. For such reasons as these, manufacturers will

plies are fixed in the short run and an oxygenous change (e.g., dollar appreciates) occurs, such that market A has a higher demand than B, then shipments exclusively to market A will disrupt and lower the prior trademark investment in market B (i.e., exclusive dealers in B can no longer supply the product).¹⁰¹ Price differences of the fixed supplies perform an allocative function without destroying or diminishing the goodwill associated with a distribution network.

Up to this point it has been assumed that authorized sellers are as efficient in the functions they perform as gray market sellers. A distribution network can be complex with a variety of functions at various levels in the distribution chain. The functions, as discussed in Part II, range from the quality assurance of inventory to the provision of services. In order to achieve a broad market penetration, a national distributor may deal with diverse firms that have comparative advantages in performing various functions. For example, small retailers may not have the facilities to handle a large inventory to meet fluctuating demand. In such a case, the distributor will provide inventory services or utilize jobbers. On the other hand, large chain stores may be more efficient in maintaining inventories than distributors or jobbers. In a competitive market, the distributor's price to the chain store would be lower than that charged to the small retailer because of the cost savings.

The Robinson-Patman Act, however, prohibits price differences in Section 2(a).¹⁰² There is a cost justified defense to price

try to avoid frequent changes in their wholesale prices. During a period of dollar appreciation, lags in adjusting wholesale prices will normally open up arbitrage possibilities and increase gray market imports until the wholesale prices are adjusted. Gray market importers, due only to lags and not to monopoly power, will eventually be eliminated as wholesale prices adjust. If the dollar continues to strengthen over a sustained period of time, as in the 1980 - late 1984 period, then lags could explain price discrimination and gray market imports over a longer period. Vertical restraints are also likely to lead to "sticky" prices as discussed *supra* in part IID.

101. See Anderson, Comments on Gray Market, FTC (1985)(mimeo).

102. Throughout this section, references to Section 2 of the Robinson-Patman Act should technically be references to Section 2 of the Clayton Act as amended by provisions contained in the first section of the Robinson-Patman Act. 15 U.S.C. §13 (1982). The relevant portion of Section 2(a) that pertains to the defense is: "... That nothing herein contained shall prevent differentials which make only due allowance for differences in the cost of manufacture, sale, or delivery resulting from the differing methods or quantities in which such commodities are to such purchasers sold or delivered: *Provided, however,* that the Federal Trade Commission may, after due investigation and hearing to all interested parties, fix and establish quantity limits, and revise the same as it finds necessary, as to particular commodities or classes of commodities, where it finds that available purchasers in greater quantities are so few as to render differentials on account thereof unjustly discriminatory or

differences, but it entails evidentiary problems that make it extremely difficult or impossible to prove.¹⁰³ The Robinson-Patman Act has been strongly criticized by a number of commentators, such as Posner and the Department of Justice.¹⁰⁴ In general, it is argued that the Act restricts pro-competitive price and marketing flexibility. In addition to the difficulties associated with the cost justification defense under Section 2(a), certain practices are *per se* illegal without a showing of competitive harm;¹⁰⁵ buyers are exposed to liability for bargaining over price; competition is restricted for new markets and consumers; private brands and product differentiation is encouraged;¹⁰⁶ inefficiencies in the

promotive of monopoly in any line of commerce; and the foregoing shall then not be construed to permit differentials based on differences in quantities greater than those so fixed and established." Section 2(b) provides that the burden of proof is on the person so charged to affirmatively show justification. 15 U.S.C. §13(b) (1982). Section 2(b) also provides for a good faith "meeting of the competition" defense. 15 U.S.C. §13(b) (1982).

103. R. POSNER, *THE ROBINSON-PATMAN ACT: FEDERAL REGULATION OF PRICE DIFFERENCES*, 40-41 (1976) [hereinafter POSNER II] has argued that:

. . . The statutory structure is objectionable: cost justification would be an appropriate matter of defense were there some basis for thinking that most price differences were discriminatory - that is, not cost-justified - but in fact discriminatory prices in the economic sense are surely the exception rather than the rule. A better presumption would be that a price difference was cost-justified than that it was not The main objection to the cost-justification provision in Section 2(a) is not that the burden of proof is on the defendant but that the commission has been so niggardly in the scope it has allowed to the cost-justification defense Thus, the act has in practice undoubtedly operated to suppress price differences that were justified by differences in cost It is enough to note that the defense has been so interpreted are applied to make it virtually impossible for firms to justify price on the basis of cost differences. Items of genuine economic cost are excluded under arcane and unrealistic cost-accounting principles. *Id.* at 40-41.

See also U.S. Dep't of Justice, *Report on the Robinson-Patman Act*, Ch. IIA(2) (1977) (hereinafter Justice) (critical analysis of the cases brought by the FTC relating to defenses). The difficulties lie in the fact that price differences have to be justified in terms of full costs. Thus there are difficulties associated with allocating fixed and joint costs. Moreover, the difference must be fully justified (100%) and not just substantially justified. Only 11 attempts were made to use the defense in contested FTC cases during the period 1936-1954. Of these, only 2 were fully successful. 2 F.M. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* (2d ed. 1980), at 578.

104. POSNER II, *supra* note 103; Justice, *supra* note 103. But see Brooks, Report of Pilot Field Survey of Market Effects of Robinson-Patman Orders (commissioned by the FTC). The report is based on survey data of seven cases. The report has been criticized as being superficial and poorly controlled.

105. The defense is not available for alleged violations of Section 2(c) (brokerage payments). 15 U.S.C. §13(c) (1982). Disproportionate promotional allowances, Sections 2(d) and 2(e), are *per se* violations without a cost justified defense. 15 U.S.C. §13(d),(e) (1982).

106. One way to possibly avoid the Robinson-Patman Act prohibitions on price uniformity is to use private labels and/or unique product specifications. This type of circumvention not only increases direct costs (such as production and inventory costs), it increases

distribution network are preserved; more efficient forms of distribution are inhibited; and brokers are unduly protected and the proportionality test for marketing allowances leads to wasteful expenditures and inefficiencies.¹⁰⁷ If distributors charge equal prices to sellers when there are differences in cost, then equal prices encourage distributional inefficiencies.¹⁰⁸ A parallel market sanctioned by the manufacturer may thus achieve distributional efficiencies that its U.S. trademark registrant may find costly because of the Robinson-Patman Act.¹⁰⁹

the cost of marketing and information costs to consumers as well. If a Kenmore washing machine marketed by Sears is really of "like grade and quality" to that marketed under the "Whirlpool" name, then there is an atrophy of information to the consumer. Private labels may achieve other marketing objectives, but their use is likely to have been extended under the Act. Parallel distribution of goods that are not authorized are similar to private labels if the two distribution channels are distinguished in some manner.

107. See Justice, *supra* note 103 (case analyses of these points).

108. The analysis above focuses on a single commodity with different prices. However, the Robinson-Patman Act often fails to consider that there may be varieties of a commodity. For example, differences in space, time, quality and uncertainty of a so called commodity may in reality be several commodities. Thus, charging the same price for an orange in Florida and Alaska is discriminatory in an economic sense. In addition, these commodities may result from a "joint production process" such that it may be meaningless to ask whether prices are discriminatory just as it is meaningless to ask what should be the "appropriate prices" of wool and mutton when the sum of the prices equals the marginal cost of raising and slaughtering a lamb. The distinction is illustrated by the Taussig-Pigou controversy over whether multiple railroad rates could be explained by Marshallian joint supply (Taussig's position) or common costs and ability to discriminate between buyers (Pigou's position). Ekelund & Hulett, *Joint Supply, The Taussig-Pigou Controversy, and the Competitive Provision of Public Goods*, 16 J. L. & ECON. 369 (1973). The controversy is similar to the distinction here in that the above can be classified as the Pigou position and what follows as the Taussig position in explaining price differences. The principal criticism directed against Robinson-Patman is that it fails to distinguish different varieties of commodities (e.g., in a spatial, time, uncertainty and quality dimensions) such as to make equal prices discriminatory or it fails to adequately consider jointness in supply. See L. PHILIPS, *THE ECONOMICS OF PRICE DISCRIMINATION* (1983) (an excellent survey of pricing with respect to space, time, income differences, and quality differences). See also M. GREENHUT & H. OHTA, *THEORY OF SPATIAL PRICING AND MARKET AREAS* (1975).

109. Automobile parts are among the goods imported through the gray market. There have been a series of automotive parts cases brought under the Act. See, e.g., *Alhambra Motor Parts, Inc.*, 68 F.T.C. 1039 (1965). In this case a co-operative in its warehouse capacity bought large parts inventories on its own account, stored them at its own risk, and filled members' orders out of the co-operative's inventory. The FTC ruled that since the co-operative was owned by retailer members, discounts would be considered discount payments to the retailer members and because members were in competition with non-members, the discounts would have to be cost justified. The FTC, after analysis, rejected the justification offered and struck down the discounts.

The motor parts cases illustrate the difficulties associated with combining distributional functions within a parallel or multiple distribution system such as a combination of retailers, direct-ship retailers, distributors, wholesalers, and integrated wholesalers-retailers. The difficulties associated with justifying functional discounts to parallel distribution systems

A foreign manufacturer is subject to the Robinson-Patman Act, but there are problems of obtaining jurisdiction over a foreign firm other than through a U.S. subsidiary. Exports by U.S. manufacturers are not covered by the Act.¹¹⁰ Foreign countries that have statutes similar to Robinson-Patman are also likely to exempt exports.¹¹¹ Thus, a foreign manufacturer is not likely to be limited by its own laws in sanctioning parallel distribution to the United States and to the extent that parallel distribution is not "authorized" it may not be subject to Robinson-Patman. Even if data were available, it would be difficult to test whether parallel importers are more efficient in distribution than authorized sellers.¹¹²

Despite the limitations of data, there are several factors that support an inference that the gray market may be used to circumvent the Robinson-Patman Act. First, the Robinson-Patman Act has been interpreted as providing relief for small businesses and discriminating against large discount chain stores and mail order houses.¹¹³ If the specialization of certain functions is difficult to

are likely to lead to inefficiencies and higher retail prices. Functional discounts not only expose the seller to liability under Section 2(a), but may also expose the buyer to liability under Section 2(c) or 2(f). 15 U.S.C. §13(c),(f) (1982). However, out of the more than one thousand-one hundred (1,100) Robinson-Patman cease-and-desist orders issued by the FTC, only thirty (30) were brought under Section 2(f). F.M. SCHERER, *supra* note 103, at 574.

110. Under the Export Trading Company Act of 1982, the Secretary of Commerce may issue export trade certificates of review granting protection to the holder and its members from treble damage suits and criminal and injunctive suits under federal and state antitrust laws for export conduct specified in the certificate and carried out during its effective period in compliance with its terms and conditions. To receive a certificate of review an applicant must establish, *inter alia*, that the proposed conduct will not include any act that may reasonably be expected to result in the sale for consumption of a gray market or parallel distribution. Moreover, the clause seems to be directed at Robinson-Patman price differences where the export price is likely to be lower than the domestic price.

111. See Grant, *Recent Developments in the Control of Price Discrimination in Countries Outside North America*, 26 ANTITRUST BULL. 593 (1981). See also, Baumol & Ordover, *Use of Antitrust to Subvert Competition*, 28 J. L. & ECON. 247 (1985); Gerber, *The Gelman Approach to Price Discrimination and Other Forms of Business Discrimination*, 27 ANTITRUST BULL. 241 (1982).

112. Different allowances for quality assurance expenditures at various levels in the distribution chain, as discussed in Part II, are likely to be extremely difficult to cost justify and may also be considered disproportionate promotion allowances. That is, there are likely to be disputes over accounting for these types of expenditures. Such expenditures are much more complicated in an accounting sense relative to more simplified cases such as savings in inventory costs that have been disputed. Moreover, the best defense for these cases is to do a preliminary cost study prior to implementing the practice.

113. See R. POSNER, *ANTITRUST LAW: AN ECONOMIC PERSPECTIVE*, Part II (1976) [hereinafter POSNER III]; Ross, *Winners and Losers Under the Robinson-Patman Act*, 27 J. L. & ECON. 243 (1984) (Part IV); Justice, *supra* note 103, at Ch. III (discussion of the historical background leading up to the passage of the Act). Note that enforcement of the Act also has

justify in terms of cost, then certain otherwise efficient outlets will be precluded as authorized dealers.¹¹⁴ In part, purchasers of gray market imports are large direct purchaser chains such as Montgomery Ward and K-Mart.¹¹⁵ As discussed in Part II, gray market sellers such as Montgomery Wards and K-Mart that have a reputation at stake are not likely to free-ride.

Second, while firms subject to parallel import competition argue that the source of gray market goods is from independent third parties:

. . . Some parallel importer respondents don't agree, asserting that foreign manufacturers and authorized distributors are sources of parallel imports.¹¹⁶ . . . Parallel importers . . . [stated] . . . the foreign parent or subsidiary at least tolerates and sometimes encourages parallel imports.¹¹⁷

Thus, if the gray market is sanctioned by the manufacturer, the alternative explanations of price discrimination and free-riding can be ruled out because a gray market would not be in the manufacturer's interests.

Third, several cases exist in the domestic gray market where the source of gray markets are non-profit institutions. Non-profit institutions such as hospitals and universities are exempt under the Robinson-Patman Act, provided the purchases are for their own use.¹¹⁸ Non-profit groups such as hospitals, medical clinics and international-relief groups are among the sources of gray market

been against buyer co-operatives which perform certain functions that the manufacturer or distributor would otherwise have to perform.

114. See POSNER III, *supra* note 113, at 42; Justice, *supra* note 103, at Ch. IIB.

115. The National Association of Catalog Showroom Merchandisers, Inc. and 47th Street Photo are also listed as selling parallel imports in the Department of Commerce Study. Seven trade associations that might be interpreted as buyer cooperatives were listed as favoring parallel imports while only four trade associations opposed parallel imports. Twelve wholesalers / distributors / importers favor parallel imports and only two are in opposition. Opponents of the gray market appear to be small firms for which the Robinson-Patman Act was designed to protect. Forty-one retailers, presumably authorized dealers, oppose parallel imports while only eight favor them. D.O.C. *supra* note 14, at 2.

While the Act was passed to help small businesses, only 36, or 6.4% of the 564 companies named in FTC Robinson-Patman Act complaints between 1961 and 1974 had annual sales of \$100 million or more, more than 60% had sales below \$5 million. Moreover, between 84% and 85% of the respondents with sales of less than \$10 million, but only 37% of the \$100 million companies. F.M. Scherer, *supra* note 103, at 581.

116. D.O.C., *supra* note 14, at 6.

117. *Id.*, at 8.

118. Section 4 of the Act as amended, 15 U.S.C. 13(c), 52 Stat. 446 (1938).

pharmaceutical products.¹¹⁹ The source of gray market personal computers may come from, in part, non-profit institutions such as colleges and universities. These examples illustrate how the Robinson-Patman Act may be a binding constraint in the United States. Lower prices may also be given to volume purchasers (e.g., chains) similar to exempt institutions in the absence of the Robinson-Patman Act or if a cost-justified defense were easier to prove.

Fourth, as discussed in Part II, a ban would be the most effective public policy in preventing parallel importers from selling lower quality goods, offering lower quality services, or free-riding off quality assurance investments. However, COPIAT, an interest group comprised of foreign and U.S. manufacturers, distributors and retailers, have proposed a mixture of labeling and reasonable demarking of gray market imports. Thus, the COPIAT proposal on its face would seem to tolerate a gray market that distanced itself from the authorized channel by labeling and demarking.¹²⁰ A labeling and demarking proposal, instead of a ban, is consistent with avoidance of the Robinson-Patman Act.

The Robinson-Patman Act was enacted in 1936 and the gray market should have appeared prior to the 1980's as a means to circumvent the Act.¹²¹ As discussed in Part II, a change in foreign law will lead to a shift of quality assurance investments and service costs from the retail level to the distributor level. A shift in investment and service costs to the distributor level will mean that foreign retailers, all other circumstances being equal, will pay a higher manufacturer or distributor's price than the price charged to U.S. retailers who make quality assurance investments and incur service costs because vertical restraints are enforceable. Higher foreign retailer prices mean higher prices to parallel importers. The evidence available, however, suggests parallel importers pay a lower price

119. *Gray Market: Sale of Drugs Bought from Hospitals Raises Worries About Safety*, Wall St. J., Aug. 6, 1985, at 1.

120. LEXECON, *supra* note 18. There are other explanations for COPIAT proposing demarking rather than a ban. But reasonable demarking or labeling is a means for authorized sellers to be distinguished from parallel importers in order to provide some limited protection for authorized margins without totally eliminating parallel imports.

121. Foreign imports have increased as a percentage of U.S. Gross National Product since 1936. Moreover, the dollar appreciation of the 1980's increased imports dramatically as evidenced by the increased balance of trade deficit. There may be scale economies in establishing parallel markets whereby the import market may not have been of sufficient volume prior to 1980. However, it is beyond the scope of this paper to examine international trade trends.

than U.S. retailers.¹²² In order to understand how it may be possible that parallel importers pay a lower price than their authorized competitors, it is necessary to further examine the interrelationship between vertical restraints and Robinson-Patman.

D. *Vertical Restraints and Robinson-Patman*

In *Sylvania*,¹²³ the court held that territorial restrictions are to be considered under an antitrust rule of reason. Courts are required to balance the increase in interbrand competition against the decrease in intrabrand competition. The interbrand versus intrabrand competition argument may be summarized in the following terms. It is in the manufacturers' interest to minimize their costs of distribution, as their costs are minimized by having competition in the distribution process (i.e., intrabrand competition). Thus, in the absence of marketing considerations, restrictive distribution comes at a cost. But, competing distributors or retailers of the same brand will have little incentive to invest in marketing the brand in order to compete with other brands (i.e., interbrand competition). Assuming marketing is more effective at the local level, then *interbrand* competition is purchased at the cost of foregoing *intra*brand competition.

While, conceptually, intrabrand versus interbrand competition may be defined as a movement along the demand curve versus a shift in the demand curve, as a practical matter it is difficult to distinguish between the two.¹²⁴ The emphasis of this article has been on quality assurance that can be considered as a proxy for interbrand competition. A manufacturer's claims that attempt to distinguish one product from another must be assured unless it is assumed consumers have information prior to purchase to make quality distinctions and quality claims are relatively inexpensive to enforce.¹²⁵ Interbrand competition may include factors beyond

122. See D.O.C., *supra* note 14, at A51.

123. 433 U.S. 36 (1977).

124. Marketing, like other social sciences, is not an exact science.

125. Quality assurance is not necessarily confined to observable "objective" data but may include an assurance of "subjective" characteristics. For example, what is the quality assurance in the case of perfumes that do not carry warranties? It may simply be an assurance of its pre-marketing tests that indicates the sample group prefers the aroma of this product over other products. It should also be noted that the quality assurance literature is consistent with the economics of information literature such as "search", "experience" and "credence" goods. Quality assurance includes both experience and credence type goods. The advantage of the quality assurance framework is the insight it provides into the nature of

quality assurance. Given the current state of the marketing literature, however, the quality assurance hypothesis is amenable to empirical testing, whereas the term interbrand competition is subjective.

Intrabrand competition, on the other hand, is best described by activities of competing firms that have no brand or trademark. For example, firms that sell "generic" products such as fresh fruits or vegetables still perform a number of functions including advertising. The advertising is in the form of "price" advertisements. Price advertising is undertaken for the purpose of taking sales away from other firms and is not free-ridable.¹²⁶ Moreover, only the most efficient firms (with the lowest prices) will survive. Price advertising provides information to consumers other than price, such as the existence of the good and its availability at a specific location, even though there may be no claims of quality. Thus a manufacturer's decision calculus of whether to have vertical restraints or not is not a choice of advertising or not advertising, but only the form of advertising. Moreover, as discussed in Part II, interbrand competition may be carried out at the distributor level

trademark investments.

As a number of empirical studies have demonstrated, vertical restraints or high marketing costs will not necessarily lead to higher prices. Economies of scale and specialization may not be realized unless there is a sufficient market. Advertising to the extent that it increases demand may in fact lead to lower prices because of achieving economies of scale or specialization in manufacturing or distribution. See Benham, *The Effect of Advertising on the Price of Eyeglasses*, 15 J. L. & ECON. 337 (1972); Bond, et. al., *Effects of Restrictions on Advertising and Commercial Practices in the Professions: The Case of Optometry*, (FTC, 1980); Cady, *An Estimate of the Price Effect of Restrictions on Drug Price Advertising*, 14 ECON. INQUIRY 493 (1976); McChesney & Muris, *The Effects of Advertising on the Quality of Legal Services*, 65 AMER. B. A. J. 1503 (1979); Muris & McChesney, *Advertising and the Price and Quality of Legal Services: The Case for Legal Clinics*, 1979 AM. B. FOUND. RES. J. 179; Telser, *Advertising and Competition*, 72 J. POL. ECON. 537 (1964). All of these studies provide empirical support for the hypothesis that advertising lowers prices. Indeed the effect on consumer prices in the future is the cost that is expected to follow from reduced marketing expenditures as a result of free-riding. However, there are a number of distinctions between gray markets and these empirical studies. The studies were based on legal restrictions prohibiting advertising. The studies generally do not distinguish between brandname advertising and price advertising. That is, parallel distributors are likely to advertise but it will take the form of price advertising rather than brand advertising.

On the other hand, even if there were no advantages attributable to economies of scale or specialization such that prices remain constant or increase, advertising is still beneficial in the sense of a lower cost of information to consumers relative to consumer search cost in the absence of advertising. The existence of price differences in the gray market, absent price discrimination, suggests that marketing costs in the United States have not led to lower prices in comparison to foreign countries.

126. Price advertising can be interpreted as creating "pecuniary" externalities on other firms that are normally perceived as "competition" or welfare enhancing.

and intrabrand competition at the retail level.

What is meant by "intrabrand competition" in light of the enforcement of the Robinson-Patman Act? Retailers that have comparative advantages in performing certain functions, such as maintaining inventories, or have economies of scale in advertising or service, may not receive a compensating price adjustment because of the difficulties in proving a cost justified defense. The Robinson-Patman Act, as enforced, changes the trade-off between interbrand competition and intrabrand competition through restricting *intrabrand* competition and, thus, encouraging, at the margin, *interbrand* competition. In the absence of the Robinson-Patman Act, intrabrand competition, in the form of parallel distribution, would be more likely, distribution costs lower, retail prices lower and quantity sold higher for any given manufacturer's price.¹²⁷

The effect of the evolution of foreign law on distribution costs is likely to be more complicated than that discussed in Part II D. It was argued that because export restrictions in foreign countries are unenforceable, any quality assurance and free-ridable service expenditures at the retail level would be shifted to the distributor level, thereby increasing the price to foreign retailers. But an offsetting effect is also likely to occur. In the absence of vertical restraints, distribution at the retail level will be competitive. Intrabrand competition at the retail level is likely to create distributional efficiencies. The focus of the analysis in Part II was on quality assurance and free-ridable services. There are, however, other distribution costs, such as maintaining inventories, refund policies and other transaction costs, that may not be free-ridable. The required margins for the cost of these functions will decrease as intrabrand competition increases. The increased inefficiency in performing these other functions is likely to result in a shift of these functions from the distributor level to the retail level. Thus, the increased margin required at the distributor level for *interbrand* competition may be partially offset by a decrease in the distributor's margin for other functions now performed more effi-

127. Note that it is price *differences* that can be challenged. A uniform price even though it is discriminatory in an economic sense is not a violation of the Act. Thus, avoidance of Robinson-Patman Act can be accomplished by a single distribution chain or charging the *same* price. Thus, it can be argued that the Robinson-Patman Act encourages RPM agreements, thereby putting it at cross purposes with other antitrust law. In the absence of the Act, it is likely there would be fewer vertical restraint cases brought. The importance of this interrelationship is evidenced by the fact that of all private antitrust actions, approximately 30% are Robinson-Patman and 40% are vertical restraint cases.

ciently at the retail level.¹²⁸

It can be argued that if efficiency gains of sufficient magnitude can be realized, then the United States trademark registrant would emulate foreign distribution. But this assumes the Robinson-Patman Act is not a binding constraint on intrabrand competition in the United States. Both systems may be inefficient. Too much (little) intrabrand (interbrand) competition may exist in foreign countries because of restrictions on vertical restraints.¹²⁹ Too much (little) interbrand (intrabrand) competition may exist in the United States because of Robinson-Patman. Dollar appreciation will increase these differences unless margins adjust with the exchange rate. But, for reasons discussed in Part II, pricing in the United States is likely to be less flexible due to vertical restraints. The net effect of parallel imports can be the enhancement of efficiency by achieving lower distribution costs through intrabrand competition than through authorized distribution. Moreover, the price that parallel importers pay foreign retailers may include a quality assurance premium at least as great as the combined U.S. quality assurance premium. From the manufacturer's standpoint, parallel imports may not represent free-riding off U.S. quality assurance investments if adjustments are made that credit premiums on parallel sales to the U.S. distributor.

E. Conclusion

Price differences between countries may increase with a dollar appreciation provided that the required elasticity and market power conditions are satisfied. The greater the price difference, the greater the opportunity for arbitrage by parallel importers. Arbitrage, under these conditions, is welfare-enhancing to U.S. consumers. However, there is no data to support the required elasticity or market power conditions. United States demand elasticity could be

128. For example, consider the \$48 distributor premium and \$24 retailer premium in Table 1. Now assume one-half of the respective premiums is for quality assurance and the other one-half is for other functions (e.g., inventories). Assume that the \$12 premium for quality assurance at the retail level is absorbed by the distributor in foreign countries because of export restrictions. Further assume a forty percent efficiency gain in distribution because of intrabrand competition at the retail level. The \$12 added distributor premium could be more than offset by the lower distributor premium for other costs. That is, a forty percent efficiency gain in the combined costs for other functions would result in a \$14.40 ($40\% \times (\$24 + \$12)$) savings.

129. This assumes that quality assurance investments that are shifted to the distributor level are not as effective compared to investments at the retail level.

constant or become more elastic with a dollar appreciation.

Section B examined protectionist measures such as U.S. quotas, tariffs, and voluntary export restraints (VER) that create international price discrimination and therefore arbitrage opportunities for a gray market. Foreign manufacturers that have a multinational market would have difficulties in monitoring the arbitrage opportunities created by various multilateral and bilateral trade agreements. Trans-shipment of goods through different favored nations that are not subject to U.S. trade restrictions can create the lower prices that gray market suppliers receive.

Sections C and D examined the Robinson-Patman Act and its effect on authorized distributional arrangements. If cost-justified differences in price are difficult to prove under the Robinson-Patman Act, then intrabrand competition will be sacrificed, at the margin, for interbrand competition, thereby creating distributional inefficiencies. A controlled experiment to estimate the social cost of the Robinson-Patman Act similar to the studies conducted to examine the social costs of RPM legislation is not possible.¹³⁰ A recent study shows that firms subject to FTC complaints have incurred significant stock market losses.¹³¹ While FTC price

130. As one economist has stated: "The problem with the Robinson-Patman Act is that it applies all across the country. We simply don't have a country like the United States in every respect except that it does not have the Robinson-Patman Act. What we are left with, since we do not have the laboratory experiment that we had with Fair Trade, is a much more tentative basis of judgment and logic and inference." Hearings on the Robinson-Patman Act before the Domestic Council Review Group on Regulating Reform, Tr. 261-61 (1975) (testimony of Kenneth G. Elzinga).

131. Ross examined the stock prices of a portfolio of grocery chain stores. His results reveal that the chain portfolio began a series of negative abnormal returns from about June, 1935 (Robinson-Patman introduced in both houses at this time) and continued with a brief pause in late 1936, for about two and one-half years. The cumulative loss in the portfolio value over the period represents as much as 80 percent of its original value. Ross, *supra* note 113, at 250-60.

Ross also examined FTC consent orders under Robinson-Patman for the period August, 1962 through April, 1981. The results indicate a decline in the value of the stock portfolio of 10 percent within a period of 50 days before and 60 days after a consent order was entered. Ross also examined cases with cease and desist orders and cases that were dismissed. The decline in stock value is smaller in these cases relative to cases involving consent orders. The surprising result, however, is that firms also lose value even when cases are dismissed and the loss is about the same for firms which were ordered to cease and desist from the prohibitive actions. What is surprising about the percentage decline is that the alleged violation usually only consists of sales that represent only a small share of total sales by the corporation. *Id.* at 260-70. The results indicate that the market (as embodied in stock prices) responds in a dramatic way to FTC Robinson-Patman actions. The results of the Ross study do not permit a conclusion of whether the decline in stock values are attributable to not being able to price discriminate based on market power or a loss in price and marketing

discrimination actions have declined over the years, private actions remain at a high level with only a slight decline in recent years. According to a recent study, private price discrimination actions may represent as much as 17 percent of all private antitrust actions during the period 1973-1983.¹³² Thus, Robinson-Patman would appear to be a binding constraint on a firm's pricing and promotional background.

Foreign manufacturers, unlike their U.S. trademark registrants, are able to circumvent Robinson-Patman through sanctioning the parallel market. For reasons discussed in Part II, vertical restraint agreements may be too rigid if changes in the exchange rate and foreign law were not anticipated. The parallel market creates intrabrand competition at the expense of interbrand competition that may be desirable, *ex post*, for foreign manufacturers.

Finally, the lessons learned from the enforcement of the Robinson-Patman Act within the United States should create reservations about applying the Robinson-Patman Act internationally. Price differences between countries should not be presumed to be the result of price discrimination absent a showing of some indicia of market power or trade restrictions that create market power. There are other reasons for price differences not related to market power. Tables 1 and 2 in Part II used equal prices and margins for expository reasons. The analysis of the effect of the dollar appreciation does not change if differential prices and margins are assumed, provided that whatever separates the market is not effected by the exchange rate. That is, if U.S. margins should adjust in a competitive equilibrium, then price differentials between countries will be the same both before and after dollar appreciation. The dollar appreciation is therefore not an explanatory factor for the emergence of a gray market, even assuming differential margins.

A tremendous amount of data, including prices, costs, marketing expenditures, quantities, international trade agreements, and the degree of trans-shipment, would be required to explain why price differences exist. There are some inferences that can be drawn to suggest that foreign manufacturers may explicitly or implicitly sanction the parallel market. On the other hand, if the gray

flexibility that is cost justified.

132. Robinson-Patman Act FTC complaints averaged 74 cases per year during 1960-65 and declined to 5.6 per year during 1966-70. F.M. SCHERER, *supra* note 103, at 581. There are even fewer cases in the 1980s.

market is the result of trade restrictions, then foreign manufacturers would want these trade restrictions enforced to capture the rents. The most efficient way to enforce the trade restrictions, if they are circumvented by trans-shipment, is to have a ban or other restrictions on gray markets.

IV. POLICY CONCLUSIONS

Despite the fact that luxury automobiles have received the most publicity as an example of the gray market, they are not representative of the gray market in general because of extensive regulations. Factors other than free-riding or price discrimination can explain, in part, the price differences between the authorized and gray market sale of luxury automobiles. The gas guzzler tax and corporate average fuel economy (CAFE) tax may account for between \$2,800 to \$3,800 of the price difference between the gray market and authorized sales of automobiles. Costs of different product liability and product recall standards, as between the United States and foreign countries, may explain an additional margin. Differences in equipment and differences in compliance with emission and safety regulations also make comparisons difficult. The elimination of these factors may reduce the price differences sufficiently so that consumers would be unwilling to take the risk of purchasing a gray market automobile. Thus, a general policy directed at gray markets should exclude the consideration of luxury automobiles until such time that price differences can be attributable to factors other than automobile regulation.

Many of the products subject to the gray market incur service costs in the United States of only 20% of the sales price, yet price differentials between authorized and parallel distribution appear to be greater than twenty percent. This data, however, is not substantiated or presented in detail, and it is not clear how certain expenditures are defined, such as advertising or services, or whether prices are suggested prices or transaction prices. The only conclusion to be drawn is that the costs of obtaining data on worldwide transactions is not likely to permit one to accept or reject the arguments presented in Part II and III.

Until recently, trademark owners have been unsuccessful in restricting parallel imports either by legislation or in the courts.¹³³

133. Coalition to Preserve the Integrity of American Trademarks (COPIAT) v. United

There have been a number of legislative proposals to restrict or ban parallel imports.¹³⁴ The price discrimination arguments state that parallel competition decreases U.S. prices, and any restriction on parallel imports will result in increased prices and thus a decrease in U.S. consumer welfare. The free-rider argument, when confined to consumer deception by gray market importers selling lower quality goods or providing lower quality services than those provided by authorized sellers, is also straight-forward in terms of policy. Because deception effects the "reputational" value of the trademark, consumers incur losses in the form of fewer trademarks on higher quality goods being offered in the market. Restrictions on parallel imports are, therefore, welfare enhancing. A ban enforced by the Customs Department would appear to be an efficient means of eliminating parallel imports, thereby protecting consumers.

A policy of regulatory inaction protects consumers against price discrimination, but provides no protection against deception. A ban provides protection against deception and no protection against price discrimination. Absent protectionist measures, reliance on expert opinion would lead to the conclusion there is no market power and, therefore, no price discrimination. But protectionist measures are by design intended to create international price discrimination. Reliance on limited evidence such as lower gray market prices, independent warranties or refunds or replace-

States, 790 F.2d 903 (D.C. Cir. 1986) *cert. granted sub nom.* K-Mart v. Cartier, 107 S. Ct. 642 (1986). Copiat's attack on the Customs regulations failed in the lower court. The District Court held that the regulations were a sufficiently reasonable interpretation of the statute, supported by its legislative history, legislative acquiescence, judicial decisions, and long-standing practice of the agency charged with enforcement. The Court of Appeals reversed the District Court on the substantive issue, directing it to issue a judgment declaring the Customs regulations contrary to the statute they are meant to enforce. In its opinion, the appellate court concluded that none of the factors cited by the District Court overcame the literal language of the statute giving U.S. trademark owners an absolute right to exclude genuine trademarked foreign goods.

The *COPIAT* decision creates a split between the circuits on the issue of the validity of the Customs regulations. Earlier, in the *Vivitar* case, the Court of Appeals for the Federal Circuit affirmed a Court of International Trade decision upholding these regulations. *Vivitar v. United States*, 593 F.Supp. 420 (Ct. Int'l Trade 1984), *aff'd on other grounds*, 761 F.2d 1552 (Fed. Cir. 1985), *cert. denied*, 106 S. Ct. 791 (1986). Moreover, another case raising this issue has been decided in the Second Circuit. *Olympus Corp. v. United States*, 627 F.Supp. 911 (E.D.N.Y. 1985), *aff'd*, 792 F.2d 315 (2d Cir. 1985). See also Ross, *Court Deals Setback to Gray Market*, Wash. Post, May 7, 1986.

134. See, e.g., *New Bill Would Permit Ban on Gray Market Goods*, 34 Pat. Trademark & Copyright J. (BNA) 511 (Sept. 17, 1987); *Legislation to Protect Parallel Importation Introduced in the Senate*, 34 Pat. Trademark & Copyright J. (BNA) 10 (May 7, 1987).

ments, and limited consumer complaints suggest consumer deception is not a significant problem. A ban has conflicting consumer welfare implications depending on whether it would facilitate collusion and market power or increase welfare by eliminating free-riding.¹³⁵

A ban of parallel imports would *benefit* manufacturers by either facilitating price discrimination or eliminating free-riding. The possibility exists, however, that a ban may not be in some manufacturers' interests. In Part II D, which examined retailers' price margins that were contractually determined, it was concluded that if U.S. price margins should adjust to exchange rate changes in a competitive market, then U.S. vertical restraints that restrict adjustments at the retail level may create post-contractual opportunities for manufacturers to adjust these margins by explicitly or implicitly sanctioning a parallel market. Parts III C and D examined the Robinson-Patman Act as encouraging vertical restraints and distributional inefficiencies. The parallel market may be a means to avoid the Robinson-Patman Act constraints and to achieve distributional efficiency at the margin. In these cases, U.S. consumers *and* foreign manufacturers gain at the expense of U.S. retailers. The gain to consumers under standard welfare analysis would exceed retailers' losses. Thus, a ban is not warranted.

Similar to the price discrimination and the free-rider hypotheses, there is no conclusive evidence that parallel markets are sanctioned by foreign manufacturers. Allegations by parallel importers, and a labeling proposal (as opposed to a ban) advocated by a manufacturer's interest group, support an inference that manufacturers sanction parallel markets.¹³⁶ However, litigation by this same interest group attempting to have Customs regulations (that permit parallel imports) declared contrary to the Tariff Act of 1930, and therefore unlawful, does not support a manufacturer-sanctioned parallel market. If a recent U.S. Court of Appeals decision is upheld, parallel imports will be banned.¹³⁷

135. Included in the meaning of fostering collusion or market power is the creation of rents for the exporting countries because of either U.S. protectionist measures or restrictive export licensing agreements of foreign countries. These rents represent a loss in U.S. consumer welfare not only because of the higher prices of imports, but also higher prices of domestically produced goods because of the absence of lower priced competing imports. The gray market dissipates these rents to the benefit of U.S. consumers.

136. See LEXECON, *supra* note 18. The Lexecon proposal can be interpreted on other grounds.

137. Ross, *supra* note 113 (referring to the *COPIAT* case).

Of the hypotheses examined, the free-rider hypothesis is the only one that supports a ban. A ban, or import restriction, is in effect a vertical restraint that eliminates parallel imports. A private solution, it is argued, is not possible because vertical restraints are not enforced in foreign countries, and therefore, there is no way to prevent parallel imports without a ban. The principal difficulty with the free-rider argument is that multinational manufacturers should be expected to have made price adjustments in foreign countries to adjust to prohibitions on export restrictions, and foreign retailers can no longer be assured of a price margin to provide marketing and services. If the manufacturer is to maintain the value of the trademark in foreign countries, it must either vertically integrate or have the national distributor undertake those expenditures. In either case, free-riding would not be feasible. All other things being equal, the manufacturer's or distributor's price to retailers should be higher in foreign countries than it is in the United States; but, if parallel importers purchase from foreign retailers, how can parallel importers have a comparative cost advantage over U.S. authorized retailers? The data clearly indicate that parallel importers pay a lower price than U.S. authorized dealers.

A lower distributor price to foreign retailers is possible if the efficiency gains in distribution costs, other than quality assurance, offset the distributor's higher quality assurance premium. It has been argued in Part II that there may be too much intrabrand competition by authorized sellers in foreign countries because of restrictions on vertical restraints, and too much interbrand competition by authorized sellers in the United States because of the restrictions imposed by Robinson-Patman. Parallel distribution in the United States can be interpreted as a market adjustment that, at the margin, increases intrabrand competition. Authorized sellers who are not as efficient in their distribution as parallel importers will incur losses, which are offset by the gain to the consumer in the form of lower prices.

In summary, the free-rider argument is weakened by the evidence that parallel importers pay a lower price than U.S. authorized dealers in light of foreign law. While it is possible that parallel importers may still free-ride, the likelihood that their price includes a foreign premium for quality assurance and free-ridable services, in conjunction with evidence that parallel importers offer the same quality and services as authorized sellers while charging a lower retail price, raises doubts of free-riding. Protectionist mea-

tures in the United States are one explanation for parallel importers being able to purchase at a lower price. The fall in the dollar in the past year is consistent with a decline in gray market imports. However, if Congress passes sweeping trade legislation, then we may experience an upsurge in gray market imports.¹³⁸

The overall conclusion of this paper is perhaps best summarized by a poem from Robert Frost.

Before I built a wall I'd ask to know
What I was walling in or walling out,
And to whom I was like to give offense.¹³⁹

This paper has no definite conclusion as to whether a wall against gray market goods should be built or not. It does, however, provide alternative explanations of what would be walled in or walled out and to whom it is likely to give offense. There are several lessons to be learned from the gray market. The gray market, domestic or international, may be a market adjustment that circumvents the inter-relationship between vertical restraints and the enforcement of the Robinson-Patman Act. Finally, the gray market may also be a market adjustment to circumvent protectionist legislation.

138. As of the date of publication of this article, Congress was stalled on the passage of any comprehensive trade legislation. (Dec. 1987).

139. R. Frost, *Mending Wall*, in *Poetry of Robert Frost* 33, 34 (1969).