ECONOMIC ISSUES RELATING TO PROPERTY RIGHTS IN TRADEMARKS: EXPORT BANS, DIFFERENTIAL PRICING, RESTRICTIONS ON RESALE AND REPACKAGING

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Economic Issues Relating to Property Rights in Trademarks: Export Bans, Differential Pricing, Restrictions on Resale and Repackaging

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Recently there have been a number of important legal rulings by the European Commission and Court concerning the rights of trademark owners. Some such as *Grundig* [1] and *Distillers* [2] have questioned the legality of the strategies of trademark holders which maintained different prices for the same brand item in different countries by means of export bans, restrictions on resale by customers and other means. Others, such as *Hoffman-La Roche* v. *Centrafarm* [3] and *Centrafarm* v. *American Home Products* [4] have curtailed the rights of trademark holders to prevent third parties repackaging and rebranding goods. All these rulings appear to stem from a desire by the authorities to maintain the unity of the common market and competition within that market.

This paper is directed at three groups of readers: law makers, lawyers and businessmen. It seeks to make three points. First, companies currently involved in selling or distributing branded goods may find their existing marketing strategies undermined because they are unable to stop subsequent distributors from unauthorised importing, exporting, relabelling and repacking. This may adversely affect current profitability and force radical changes in future marketing plans. Secondly, others may find that the law allows possibilities of profitable strategic or tactical advantage to be gained over customers, competitors or suppliers. Such gains can be made by those who realise that the law may make void contracts or property rights necessary for sustaining existing marketing situations. Finally, there is a very

* I am indebted for help and encouragement from Valentine Korah, Peter Cottis, Norman Kirke, Shiv Mathur, Nicholas Thompson. All errors remaining are unintentional and are the author's responsibility.

[1] Cases 56 & 58/64, *Consten S.A. and Grundig-Verkaufs GmbH* v. *Commission* [1966] E.C.R. 299, [1966] 5 C.M.L.R. 418.

[2] *Re the Distillers Co. Ltd.*: *Conditions of Sale and Price Terms*, O.J. 1978 L 50/16, [1978] 1 C.M.L.R. 400.

[3] Case 85/76, *Hoffman-La Roche & Co. A.G.* v. *Centrafarm Vertriebgesellschaft* [1978] E.C.R. 1141, [1978] 3 C.M.L.R. 217.

[4] Case 3/78, *Centrafarm Vertriebsgesellschaft* v. *American Home Products Corp.* [1978] E.C.R. 1823, [1978] 2 C.M.L.R. 63.

serious danger that the interpretation of the law as it currently stands may produce large, unforeseen, adverse consequences on competition, efficiency and the unification of the common market.

Whilst I criticise the Commission and the Court for inadequate rulings, in my opinion they have been badly advised not only by lawyers but also by economists. Economists have paid little attention to the subject of trademarks. Even in specialist works on the economics of industry by eminent writers such as Scherer,[5] the discussion of trademarks is brief in relation to advertising and other forms of product differentiation.

Because of the deficiency of the literature, I shall start from first principles outlining briefly the origins of modern trademarks and reviewing their economic functions. In section two, I shall argue in some detail that trademarks are unlikely to be a source of monopoly power. However, where a firm possesses a dominant position in the supply or distribution of a product, trademark property rights may be used to facilitate abusive exploitation. In section three, I discuss the roles of interbrand and intrabrand competition in the competitive process. I stress that restrictions on intrabrand competition may heighten interbrand competition, aiding the competitive process to the benefit of consumers. In section four, I discuss the merits of particular restrictions on intrabrand competition, namely those which forbid distributors from intertrading. I draw parallels between these formal restrictions and those granted by trademark law forbidding unauthorised relabelling and repackaging of branded goods. In section five, I discuss in a critical manner four landmark cases in Community law relating to trademark property rights. I show that these cases have important implications for lawmakers, lawyers and business men.

Brand names and the consumer

Historical origin of trademarks

It is not my purpose to give a full history of trademarks but to remind readers of the antecedents of modern trademarks. In a most readable history of the United Kingdom law relating to trademarks Frank Schecter [6] shows that they have been used in two quite different ways. In one way, medieval guilds required their members to attach a distinctive mark on their wares so that the original producer of a good might be identified. In maintaining the collective interest, such marks helped guild authorities trace and punish those who produced more than their quota or indulged in price-cutting or other anti-establishment practices. Whilst guilds may have been interested in maintaining quality standards the marks usually did not feature in advertisements or promotion activities. It would seem likely that guild marks indicated a liability and did not possess significant value in the form of goodwill.[7]

[5] F. M. Scherer, *Industrial Market Structure and Economic Performance* (2nd ed.) (1980), Chap. 14.

[6] F. I. Schechter, *The Historical Foundations of the Law Relating to Trademarks* (1925).

[7] *Ibid.* Chap. 3.

In a second way, trademarks were used as symbols of quality control. For instance beize produced in the City of Colchester in the early sixteenth century could not be sold as " Colchester Beize " unless it met the stringent quality standards set by the city authorities. Beize meeting this standard was packed in bales, specially sealed and promoted widely. It commanded fancy prices even on the continent. But sub-standard beize was either destroyed or sold under different marks (or unbranded) at lower prices. This use of trademarks as symbols of quality control, survived the guilds' demise.[8]

Brand names and economic value

Consumers value trademarks, or brand names as they are commonly called, as they can indicate a product's quality. For many products, particularly those which are packaged or durable, it may be hard to ascertain quality before purchase; quality being revealed through use or consumption. Because consumption or use changes the original characteristics of the product, and partly for other reasons, sellers are frequently unwilling to offer buyers effective financial guarantees against unsatisfactory purchase choices. Instead, the seller's reputation is invoked; buyers are encouraged to patronise those selling satisfactory wares.

Buyers value brand names for the same reasons that they value names of individuals or countries. Muhammed Ali commands a high fee for a boxing fight as viewers have expectations that his fights will be spectacular. *Ceteris-paribus* an article on economic issues written by the Nobel prizewinner, Paul Samuelson, is more likely to be read than one of similar merits by some unknown author. But Samuelson's reputation could not be maintained unless economists found that in general his articles were better than those of unknown authors. A product with the words " Made in U.S.A." is likely to command a price premium over one stating " Made in Hong Kong " even when the items are similar. But such a price premium for a brand is unlikely to be maintained in American shops if the United States made goods consistently fail to satisfy consumer needs better than those from Hong Kong. For similar reasons, the price premium of one brand line over another is unlikely to be maintained if the rival line performs consistently as well in all respects.

There are countless examples of brand names which have never been valuable, and notable examples of ones which have lost value. This loss of value is usually associated with their owners failing to maintain quality standards such that prices represent good value in comparison with competitors.

Brand names and monopoly power

Brand names as a source of dominance

It is unlikely that mere possession of a brand name can give rise to a dominant position. Dominance is defined as the power to curtail new and existing competition and it does not refer to transitory situations. Many

[8] *Ibid.* Chap. 4.

firms may have power to raise prices in the short term, few can exercise this power in the longer term.[9] For a firm to be dominant there must be barriers to entry retarding new competition.

Some firms are accused of cornering the market in brand names which have customer appeal. They are alleged to have done this by registering large numbers of names many of which may not be used commercially. (Such a strategy is inexpensive in countries where registration of a brand name is virtually costless.) Whilst it is probably true that some names have obvious affiliations with certain products (*e.g.* Realemon with artificial lemon juice), have these tactics meant that new brand owners are excluded or will have to bear substantial cost disadvantages in promoting their names? This is doubtful. Famous names such as Coca-Cola, I.B.M., Xerox, Kodak, Sears Roebuck, Marks & Spencer, and Cartier do not seem to possess singular characteristic combinations of letters which are exhaustible. Nor do these famous names have obvious linguistic associations with their products. As the law almost always allows a person to use his or her own name as a brand name—it seems most doubtful that the mere possession of a name alone, or even a large number of names, could give rise to a dominant position.

Marketing activities which may give brand owners dominance

A brand name owner may occupy any position in the chain of distribution as producer, wholesaler, retailer. Some, such as franchisors may not be in the chain. But regardless of the place so occupied, the successful brand owner is responsible for organising the marketing of the brand name.

The following marketing activities appear to be essential in maintaining a valuable brand name, though their importance may vary. The first is specification and design of the products' ingredients, monitoring quality and where appropriate the design of packaging. Producer brand owners undertake these activities ordinarily, others typically work closely with the producers, even sending specialist staff to the producers' factories to monitor quality. The second activity is promotion. To my knowledge, all successful brand owners engage in promotion which includes paying for advertising and sales staff. The third activity is after sales service, whose importance varies with the nature and durability of the product.

If there were barriers to entry into marketing in such a way that some existing brand owners had a cost advantage in marketing over new or existing rivals then ownership of a brand name could give rise to a dominant position. Such instances may exist, but they are rarer than many suppose, as I shall show.

On a theoretical plane, the marketing activities of a brand could give rise to a dominant position if there were very substantial economies of scale, or if the capital required from a new brand owner were large or if there were specialised knowledge about marketing available only to existing brand

[9] For more comprehensive discussion of dominance see C. Baden Fuller, " Article 86: Economic Analysis of the existence of a Dominant Position " (1979) 4 E.L.Rev. 423–441; and V. Korah, " Concept of a Dominant Position within the meaning of Article 86 " (1980) 17 C.M.L.Rev. 395–414.

name owners.[10] (Legal barriers to new competition could also give rise to dominance.[11]) Using these theories and citing evidence that larger advertising budgets can be more cost effective, that advertising expenditures are costly, and that brand managers are skilful, some have argued misguidedly that a successful brand owner is dominant.[12] In practice, brand owners face competition from many directions. First, there is the threat from existing brand owners already selling similar products to the same customer groups. Secondly, and more serious, there is the threat from existing brand owners selling the similar products in other markets. Last, and most serious is the threat from brand owners which are well established in selling other product lines.

With their well established names, they may extend their product range and perhaps compete easily on equal terms. Each of these three is a form of interbrand competition.

For example, in my study of the United Kingdom major domestic appliance trades, despite high concentration of market shares among the leading brands I found evidence of strong interbrand competition.[13] The minimum efficient volume of sales for efficient marketing of a brand name in any one of the lines appeared to be about 100,000 units a year, a figure which represents rather less than 10 per cent. of the United Kingdom market. Capital requirements in marketing were not high, at least not in comparison to those required for establishing a production line or even a chain store. Existing well established United Kingdom brand owners such as Hoover and Hotpoint in product lines such as washing machines had to contend with competition from smaller United Kingdom brands such as " Bendix " and foreign brand owners such as Indesit. More recently firms such as Electrolux are extending their product range from refrigerators to include washing machines and retailers such as Comet are selling their " own label " washing machines. Potential competition exists; producers of detergents such as Proctor & Gamble could enter the selling of washing machines as they have well established names in detergent.

In the clothing trade there is a plethora of brands, many of which are retail brands. A few brands have been very successful: notably " St. Michael " of Marks & Spencer with perhaps 30 per cent. of the United Kingdom men's shirt market and 50 per cent. of the United Kingdom women's underwear market.[14] Such high market shares do not come from benefits of scale in media advertising for Marks & Spencer spend insignificant amounts on media advertising. It is more probable that its success comes

[10] *Op.cit.*

[11] Many have argued that ethical drug brands have monopoly power because consumers cannot choose among the brands but have to buy those prescribed by the doctor.

[12] In Scherer, Chap. 14 (note 5, *supra*) there is a discussion of the benefits of scale in marketing and a comprehensive survey of the economics literature.

[13] C. Baden Fuller, *The Economics of Private Brands with Special Reference to the U.K. and U.S. Major Domestic Appliance Trade* (unpublished Ph.D. dissertation, University of London, 1980).

[14] Market research cited by *I.P.C. Marketing Manual*, also cited in note 13, *supra*.

from entrepreneurial skill evidenced by a very high standard of quality control. The " St. Michael " brand does not have a dominant position in the clothing market, but faces competition from many directions including the big grocery chains such as Tesco and Asda who are now selling clothing.

Market research data show that the two leading advertised (usually producer) brands of most grocery items in the United Kingdom and United States capture a large share (if not all) of the advertised brands sector of the market.[15] The fact that one or two advertised brands have a large share of a product line whilst suggestive cannot prove dominance.[16] For instance, retail brands can provide serious competition for the advertised brands. In the United States, a number of retail brands have together captured more than half the frozen produce market.[17] In the United Kingdom, retail brands have a large share of the instant coffee market,[18] and in general retail brands usually account for 20 per cent. to 30 per cent. of a grocery product's sales. Like retail brands, many non-retail brand names span several product lines, and the potential competition also curtails any monopoly power.

Brand names as a means of exploiting dominance

I have argued that neither ownership of a brand name nor its marketing activities are likely to give rise to a dominant position for a brand owner. However, a firm which possesses a dominant position in the supply of a product will usually wish to control the product's marketing and therefore its brand names. Through this control, the dominant firm may increase its profits. For the same reason, a firm possessing a monopoly in distribution of a product may wish to control its brands and the associated marketing expenditures. It is obvious that the marketing and brand name functions need not be controlled by ownership; suitably drawn up contracts may be all that is necessary. For example, patent holders may control the marketing through their licensing agreements. Because it does not have to contend with competition from rivals, a firm possessing a dominant position in the supply of a product realises that in many cases it can sustain a policy of charging different customers different mark ups provided the firm can prevent its customers from intertrading. In other words, its pricing policy is based not only on differences in costs of supply but also on differing abilities to pay.

Where the different customers of the dominant firm are *physically separated*, the dominant firm can partition the market in one of two ways. In the first way, it can offer a common brand in the two markets and charge higher mark ups in one rather than the other. To prevent customers from intertrading the firm may rely on the fact that its product is not easily transportable. Such has been the case in the United Kingdom cement industry where under the Agreement [19] customers close to a cement plant pay higher mark-ups on cost than those which are distant. Where the

[15] From Target Group Index Data; also cited in note 13, *supra*.

[16] See Case 27/76, *United Brands* v. *Commission* [1978] E.C.R. 207, [1978] 1 C.M.L.R. 429.

[17] From Sales Area Marketing Inc. data, also cited in note 13, *supra*.

[18] See notes 13 and 14, *supra*.

[19] *Re Cement Makers Federation Agreement* (1961) 2 R.P. 275.

product is easily transported, the firm may impose an export ban, dual pricing structure or some other condition of sale between the two markets. Electricity supply authorities supply residential customers at different mark ups from commercial customers. They impose a ban on the resale of electricity. In the second way, the dominant firm can offer two different brands, each geared to the different markets; each promoted only in its relevant market and each bearing different mark ups. A formal ban on trade may be unnecessary between the two markets even where transport costs are low, provided of course third parties are not allowed to ship the brands from one market to the other and relabel them. (Such relabelling is usually prohibited by trademark law: more on this later.)

Where the different customers of the dominant firm are *not physically separable* (as may be the case where they are consumers purchasing from the same retail outlets) the only way the dominant firm can partition customers is by offering different brands, each brand promoted differently and bearing differing mark ups. L.R. Industries, a firm found to have a dominant position in the sale of contraceptive sheaths by the United Kingdom Monopolies Commission, was shown to follow this strategy effectively.[20] It sold different brands of contraceptives at differing mark ups through differing outlets aimed at differing customer groups.

In general, whilst it is more common for the dominant firm to use a common brand in its markets and rely on formal restrictions in *intrabrand* competition it can often equally effectively partition the markets using separate brands and use trademark property rights to keep the customers apart. In either case, it is the dominant firm's control over the supply of the product and the implied control over *interbrand* competition which gives rise to exploitation.

Interbrand and intrabrand competition in competitive markets

Interbrand competition in competitive markets

In the previous section it was shown that where sources of supply (or distribution) are monopolised so that potential interbrand competition from *rivals* is limited then property rights relating to brand name owners can be used to extract greater profits. In this section, I shall explain that where production and distribution are not monopolised interbrand competition from existing or new rival firms ordinarily eliminates monopoly profits not just between brand owners but also between retailers and producers.

A firm not in possession of a dominant position, perceiving a new market, may enter that market either by promoting a new product or by promoting some existing product perhaps in a new way. Such an exploitation, even if profitable, is neither the creation of a dominant position nor the exploitation of one. Rival firms will perceive the first firm's actions. They may perceive the high prices the first firm charges or hear about its profits. These rivals may be *existing* producers of the same product, or *buyers* or *suppliers* to the firm, or other *new* firms. In time, these rivals will emulate the first firm's actions by promoting a similar version of the successful product or by

[20] L.R. Industries Ltd., *Monopolies & Mergers Commission Report* (1975).

promoting some newer competitive version. In either case, the new supplies will force prices to fall; erode the first firm's market, reduce its profits and increase consumers' welfare. This process of competition, a dynamic process of brand competing against brand, is one which favours consumers and is typical of competitive markets.

Intrabrand competition in competitive markets

In addition to interbrand competition there is intrabrand competition, that is the competition between distributors of a given brand line. Such competition can occur between two wholesalers stocking the same brand or between two retailers. (The dimensions of this competition, like all competition, include not just price but service too.)

Although brand owners are interested in minimising the power of their distributors, as higher mark ups in the distribution system usually mean lower sales and lower profits for the brand owner, there are occasions where restrictions on intrabrand competition act in the brand owner's interest. Where distributors promote a brand intensively offering free pre-sales services such as advice, display or advertising, they do not wish cut price stores to free ride on these costly activities. Wholesalers and retailers which provide such services therefore may demand from brand owners assurances that such free riding will be curtailed. To do this brand owners may grant exclusive terms, but such rights may not give the retailers undue profits. Typically contracts granting protection against this form of intrabrand competition have requirements such as a minimum sales volume to ensure that the brand owners' interests are maintained.

Whilst it is not my purpose to consider all restrictions on intrabrand competition, the reader should note that some restrictions on *intrabrand* competition *may* increase *interbrand* competition as maybe when each retailer only stocks one brand. In the sale of motor cars, motor cycles and certain other complex goods, such restrictions on intrabrand competition are common. They have been recognised as potentially beneficial to consumers.[21] In contrast, where restrictions on *intrabrand* competition *decrease* the potential for *interbrand* competition, these restrictions may not be in the public interest. Resale price maintenance may be just such a restriction for it may foster collusion and other anti-competitive practices between brand owners.[22]

In the next section, I shall consider in some detail a certain class of restrictions on intrabrand competition. These restrictions have received particular attention by the Commission and the European Court whose

[21] Economists such as Yamey and Telser have recognised this; see B. S. Yamey, *Economics of Resale Price Maintenance* (1974); L. Telser, "Why should Manufacturers want Fair Trade?" *Journal of Political Economy* (October 1960), Vol. III. The Commission has exempted agreements which restrict intrabrand competition in various industries on the grounds that they are necessary protection for retailers. See for instance: *SABA*, O.J. 1976 L 28/19, [1976] 1 C.M.L.R. D61; and V. Korah, "Comfort Letters—Reflections on the Perfumes Cases" (1981) 6 E.L.Rev. 14, esp. p. 19.

[22] See for instance B. S. Yamey, *Resale Price Maintenance* (1966) and *The Economics of Resale Price Maintenance* (1954).

decisions are of paramount importance to businessmen formulating corporate strategy.

The economics of restrictions on resale, export bans and differential pricing structures

Why brand prices and promotion expenditures may vary

It is common that the prices and promotions expenditures of different brands of a product vary between geographical markets or even in the same market at the same location. It is sufficient for our purposes to note three reasons for such differences.

First, when a wide range of consumers are potential users of a product, it often happens that these consumers can be categorised, and that their promotion needs differ in intensity. By this I mean that one group may place more value on promotion expenditure than another. For example, in the case of mineral water, British consumers as a group are unfamiliar with the taste and qualities of mineral water, and many distributors are loathe to stock the product.[23] In consequence to sell a given quantity of the product in the United Kingdom requires greater promotion (and hence higher prices) than to sell a similar quantity in France or Italy where mineral water is better known. Likewise, it has been noted that women who are employed (as opposed to those who work exclusively in the home) buy the advertised (more expensive) brands of grocery products more frequently than the unadvertised brands with similar physical characteristics. The first group of women appear to value promotion more highly.[24]

Secondly, where a firm faces differing amounts of competition in one market than another it may find that there are incentives to promote more intensively in one market as opposed to the other.[25] Finally, prices may vary between markets because of differences in costs of production or transport.

For convenience, I shall hence forth assume that the production and transportation costs of the firm are the same for all its customer groups and markets. (Such an assumption does *not* significantly alter the basic results.) I shall also assume that marketing costs differ between the markets and that greater promotion occurs in the higher priced market.

Firm strategies for physically separate markets

There is a choice of strategies for the firm which finds that its potential customers are physically separable. For instance if they were separable into two groups, A and B, so that people from A do not visit B and vice versa, and so that the media and promotion channels used to sell to those of A were distinct from B, the first can offer a single brand, but price and promote that brand differently. Alternatively it can offer two brands (X and Y); Brand X can be intensively promoted to people of A and brand Y less

[23] According to industry sources.

[24] See for instance J. G. Myers, "Determinants of Private Brand Attitudes" *Journal of Market Research* (February 1967), Vol. 4.

[25] Dorfman and Steiner have done research in this area. Quoted by Scherer, Chap. 14 (note 5, *supra*).

intensively promoted to those of B. By assumption, brand X bears the higher price. If the costs of making two brands were no different from the costs of making a single brand,[26] then to both the firm and its customers there is no difference between the single brand strategy and the dual brand strategy. If the costs of making two brands are greater, then the single brand strategy becomes more profitable for the firm.[27]

Under either strategy it will not be possible to maintain a higher price in A than in B unless there is a trading restriction between the two markets. For a product such as cement, which is costly to transport, the trading restriction may occur naturally. For a product such as whisky for which freight charges are low in comparison to the product's value the restriction may have to be imposed. Under the single brand strategy the restriction has to be one on *intrabrand* competition and may take the form of an export ban imposed as a condition of sale on those in B. (The legality of such a restriction will be discussed later.) Under the two brand option, the firm may need to place no formal restriction on trade but rely on the fact that trademark law (until recently) forbids merchants to buy Y in B, transport it to A and relabel it X. When following the two brand option, it is usual for the firm to incorporate some minor physical differences between the products of the two brand names.[28]

Where production, physical distribution and retailing are not subject to monopolistic control the existence of higher prices and greater promotion expenditures in A should not cause concern. Should the prices be higher than the costs of a normally efficient firm, new brand name owners will be attracted to enter that market. Because of the absence of entry barriers, these brand owners can offer a *new* brand of the *same* or similar product more attractively packaged in terms of price and promotion. But if the causes of the higher prices (and greater promotion expenditures) were that the people had greater promotional needs and if existing brand owners were not charging prices which exceeded the costs of a normally efficient firm then interbrand competition will *not* eliminate the price and promotional differences. In either case there is no need for intervention in the market mechanisms to ensure that competition prevails. (As will be explained later, intervention may make matters worse.)

In contrast, where the supplies of the product (or the channels of distribution) are monopolised, then the existence of higher prices and greater promotion expenditures should be of concern. Because of the monopoly, *interbrand* competition will be limited, and so the monopolist can exploit the two markets.[29] In such a case prices and promotion expenditures may be too

[26] Strictly speaking, assume that the costs of output depend only on the sum of outputs of all brands combined and not on the distribution of outputs between each brand.

[27] By this I mean that for any output of the two brands combined, a single brand of the same output would cost less. There could be other cost situations, but these seem unlikely and are ignored. Note, the prices to consumers will only change if the additional costs imply a change in marginal cost.

[28] The differences may be immaterial to many but not all buyers.

[29] The limiting of competition does not imply that there will be no rival firms offering brands—but just that they will have to compete on disadvantageous terms. See note 9, *supra*.

great and there may be a need for intervention in the market mechanism. Forbidding the firm to adopt a formal restriction on intrabrand competition such as an export ban will not solve the problem but may merely force the firm to adopt a multi-brand strategy utilising trademark law to create the restriction.

Firm strategies for inseparable markets

It is enlightening to examine the opposite extreme to separation of markets namely where the markets merge completely. Consider the case of a single geographical market whose inhabitants patronise similar stores. A firm may offer either a single brand or two brands. If it offers a *single* brand, although it may be possible to direct certain kinds of promotion differently to differing groups it is very difficult for the firm to charge different groups differing prices as both groups could patronise the same retail outlets. If it offers two brands (X and Y) it can promote these brands differently with the aim of making the products attractive to differing groups and it can price the brands differently. (Provided that it is illegal or infeasible for distributors to repackage the lower priced brand in the higher priced package.)

Where the supplies of the product (or the channels of distribution) are not subject to monopolistic control and where the brand name activity does not have monopolistic tendencies then the two brand strategy with the existence of a higher priced and more promoted brand X should not cause concern. *Interbrand* competition will tend to eliminate any unnecessary mark up of price over cost. Moreover, if the buyers of X place greater marginal valuations on the more intensive promotion activities than the buyers of Y, this would explain why price differentials between X and Y persist.

Where the supplies of the product (or the channels of distribution) are monopolised, if the first were to offer several brands it could charge the same price for all its brands or different prices. When the pricing strategy is tiered, the more promoted brand usually bears the higher price. Typically it would be directed to those who buy the product infrequently, are less expert in judging the products' characteristics or do not have confidence in their ability to assess quality. The less promoted brand may be bought by those who use the product regularly or buy in large quantities.[30] What should cause concern here to public policy makers is not the fact that the brands would be promoted with different intensities bearing different prices but the fact that prices might exceed the costs for an efficient firm and that expenditure on promotion would not be the same as would prevail under competition. Such distortions would occur because of the firm's dominance over the supply of the product (or its distribution).

In the single price strategy, the firm may offer one brand (or a group of similar brands) and promote it (them) heavily. In such a case the firm may make even greater profits, for there would be no lower priced brand which can take sales away from the promoted brands with a higher mark up. This strategy should cause concern for two reasons; prices will exceed the costs for an efficient firm and consumers may be denied the choice of buying a

[30] This is discussed in more detail in C. Baden Fuller, See note 13, *supra*.

lower priced brand. In both of the above cases, the dilemma is not caused by absence of intrabrand competition but rather by absence of *free* interbrand competition.

Firm strategies for new geographical markets

The optimal strategy for a firm wishing to tap new geographic markets where demand is uncertain may be different from that for existing markets where demand is more certain. With uncertainty, a firm cannot be sure whether the consumers of the new market will, in time, exhibit the same characteristics with regard to promotion needs as the current market. Should the markets become uniform the best strategy would not be the same as where the markets always differ.

A firm following the multibrand strategy faces the danger that when this unification occurs it may be at a disadvantage. Discarding brand names may be costly yet maintaining them may also be costly on account of factors such as the preparation of advertising copy. Moreover with multiple brand names, when the markets become more unified, people travelling between the markets may not find the brand of their choice as retailers and distributors usually wish to economise in stocking multiple brands of a product line so that they can carry a greater range of products. (However if the firm were initially to use significantly different ingredients or specifications for its brands in the differing markets—the situations become more complex; in such cases the use of different brands in the different markets would probably be advantageous otherwise consumers might be confused were the markets to become unified.)

Public policy implications

Public policy makers wishing to encourage new competition and promote unified markets, should consider allowing firms wishing to enter new markets with an existing brand to impose (at least for limited periods) trading restrictions between the new markets and existing markets. By this means not only would firms be able to take greater risks in the newer markets with less danger to their existing markets but also where new entry is successful, in time trading restrictions can be removed and the markets will become "unified." This way long run prospects for unification are better than when the firm promotes different brands in different markets. It will be shown that in at least one instance the EEC authorities have been reluctant to concede this point of view.

Likewise when uncertainty is present, a firm launching a new product may feel that the risks of failure in adopting a single price/promotion strategy are too high. Instead, it may wish to partition the market and adopt a wide variety of strategies tailored to local needs and spreading risks. A public policy that permits firms with new products to divide markets (at least for a limited period) will encourage more entry and so greater competition. I am glad to say that it appears that the authorities have adopted a more positive view towards new products.[31]

[31] Reg. 67/67, J.O. 1967, 894, O.J. 1967, 10.

Recent decisions by the Commission and Court

The European Community, to name but one, has an avowed policy of promoting unified and competitive markets. In the EEC Treaty Article 3*a* and 3*c* express the desire for unification:

> ". . . the elimination, as between Member States, of customs duties and of quantitative restrictions on the import and export of goods, and of all other measures having equivalent effect;
> "the abolition, as between Member States, of obstacles to freedom of movement of persons, services and capital;"

and Article 3*f* expresses the desire for competition

> "the institution of a system ensuring that competition in the common market is not distorted."

These objectives may conflict, as a competitive market need not be unified and a unified market certainly need not be competitive. In this section I shall show that the Court and the Commission in their zeal to promote one of the objectives hinders the achievement of the other objective and perhaps both of the objectives. I hope that through examining these cases, businessmen will be forwarned of the dangers of the law and lawyers will be able to argue more persuasively for a regime favouring not only businessmen but also consumers.

Export bans (territorial protection)

In the case of *Consten and Grundig-Verkaufs* v. *Commission* (July 1966),[32] the Court held that under Article 85 EEC export bans in relation to an exclusive distributorship may be illegal. The facts of the case [33] were that Grundig, a manufacturer of electronic goods appointed Consten as its exclusive distributor of radios, televisions and related equipment in France. Under the terms of the agreement, Consten undertook not to deliver its products directly or indirectly to anyone outside France, and Grundig undertook to supply directly or indirectly no one in France but Consten. Before entering into this contract, Grundig had imposed on all its concessionaires outside France and upon its German wholesalers similar obligations not to deliver outside their respective territories.

The Commission ruled the agreement contrary to Article 85 EEC. It objected to the export ban imposed on Consten and other distributors of Grundig and said that this ban need not have been an indispensable part of the distribution system. The Court although criticising the Commission upheld its findings. It said that under Article 85 (1), there is no need to take account of the concrete effects of an agreement once it has as its object the prevention, restriction or distortion of competition.

To gain exemption from the proscription through Article 85 (3) the parties must show that there is an improvement in the production or distribution of the goods in question. In this respect it appears, it is not enough to claim that there are competing firms offering other brands.

[32] See note 1, *supra*.

[33] According to the Court.

I would agree with the Court that to defend the export ban it is not enough to state the existence of competitors, but I would go on to argue that if the party could show that there was no monopolistic tendency in production, retailing or operating a brand (so that there was free unfettered *interbrand* competition) then the agreements should be exempt under Article 85 (3). In its Judgment, the Court did not consider such arguments, nor did it consider whether Grundig had a dominant position.

In the well publicised case concerning the sale of Scotch whisky brands owned by Distillers,[34] the Distillers company argued that certain restrictions on resale imposed upon their wholesalers and agents improved distribution. The facts of this case [35] were that Distillers marketed *inter alia* "Johnny Walker—Red Label," "White Horse" and "VAT 69" both on the European Continent and in the United Kingdom. In the United Kingdom whisky was well known and widely distributed through public houses, off-licences (liquor stores) and supermarkets. In consequence, it required little promotion by the producers. On the Continent whisky was less well known, bore adverse discriminatory tariffs [36] and required greater promotion. At the time of the Commission's decision, in June 1975, the wholesale price of whisky in the United Kingdom *before* taxes was £5·30 a case, but on the Continent the price was about £10·65.[37] The difference between the United Kingdom and the Continental prices was accounted for mainly by additional promotion costs, but it seems that Distillers gained a few pence a case more in profit on Continental sales. Because whisky in bond can be exported easily it was only possible to maintain the price differential between the United Kingdom and the Continent by forbidding United Kingdom wholesalers and retailers reselling in bond to the continent whisky bought at the "United Kingdom price." Whisky not in bond bore no formal restriction,[38] neither did Whisky bought at the higher Continental price. Bulloch, a wholesaler, objected to the European competition authorities that Distiller's terms of sale contravened Article 85. The Commission, disregarding arguments from the company that territorial exclusivity was necessary to ensure promotion on the Continent, held that Distiller's dual price structure was illegal and that there should be no restrictions on reselling between the United Kingdom and the Continent at the United Kingdom price. It has been said that the Commission expected a convergence of the United Kingdom and Continental prices of whisky. The Commission paid no formal attention to the fact that there were a large number of whisky producers, that whisky had substitutes, and that (unlike the United States), the retailing of whisky is widely spread through specialised outlets, grocery stores and bars. But, as

[34] See note 2, *supra*. In Case 30/78, *Distillers Co.* v. *Commission* [1980] 3 C.M.L.R. 121, the Court upheld the Commission on legal grounds and did not consider the economic merits of this case. This leaves open the question as to whether at some future date they would be swayed by economic argument.

[35] According to the Court and the Commission.

[36] *Ibid.*

[37] *Ibid.* See the Judgment.

[38] No formal restriction was needed as in the U.K. once duty is paid it cannot be rebated.

a consequence of the Whisky decision, Distillers raised the United Kingdom price of "Black and White" and "VAT 69" whisky to the Continental price and these brands' share of the United Kingdom market fell from a large one to almost zero. Distillers also reduced the Continental price of "White Horse" to the United Kingdom price. The fall in price forced a fall in margins whereupon the Continental distributors reduced promotion expenditures and Continental sales fell from an important share of the market to a very small share. This case history emphasises that different markets may have differing promotional needs and that the Commission's objective of promoting unified markets and encouraging *intrabrand* competition were incompatible. The European whisky market became less unified than before as well-known brands available on the Continent were no longer stocked in the United Kingdom. Despite the existence of substitutes, some consumers whose favourite brands had disappeared must have been disappointed. The Judgment has not produced a radical change in the prices charged in many local markets, suggesting that the supposed benefits of *intrabrand* competition have not materialised.

Repackaging

In the case of *Hoffmann-La Roche* v. *Centrafarm* [39] the European Court (June 1977) ruled that where a firm sells its product in more than one package, a distributor or third party *may* sometimes be permitted to buy the goods sold under that brand name and repack them *without* permission of the brand owner.

The facts of the above case [40] were that Hoffmann-La Roche, the Swiss based pharmaceutical firm made "Valium," a Diazepam tranquilliser. Its German subsidiary sold "Valium" in packets of 20 or 50 tablets which were further packaged, five small packets at a time, in quantities of 100 or 250 tablets for use in hospitals. A British subsidiary of the Roche organisation also made "Valium Roche" which it sold in the United Kingdom in packages containing 100 or 500 tablets at unit prices which were considerably lower than those charged in Germany. A German subsidiary of the Dutch pharmaceutical company Centrafarm B.V. bought "Valium Roche" in the United Kingdom, repacked it in the Netherlands, under the surveilance of a pharmacist, in batches of 1,000 tablets and sold them in Germany. On the new bottles and packages it put the names "Valium" and "Roche," together with the name "Centrafarm" and the words: "Marketed by Centrafarm Gmbh." (The fact that the brand name differed slightly does not seem to have been material to this case.) Each package came with an information leaflet in German signed by Hoffmann-La Roche. All this was done by Centrafarm *without* the permission of Hoffmann-La Roche. Hoffmann-La Roche alleged that the actions of Centrafarm infringed its trademark rights.

The plaintiffs claimed that Centrafarm was at liberty to buy "Valium Roche" in the United Kingdom in their original containers and resell

[39] See note 3, *supra*.
[40] According to the Court.

these in Germany. But it seems that the German consumers and hospitals were adverse to buying the British version of the product and that the provisions of the medical code of Germany made such purchase difficult. (Perhaps because the instructions were in English.)

The German Court, the Landgericht Freiburg asked the European Court to clarify the legal position. The Court in making its ruling under Article 177 EEC directed that under Community law it would be illegal for a firm to use trademark rights with the effect of artificially partitioning the market between Member States. The Court went on to say that where a firm does artifically partition the market then independent distributors may repackage its products provided: first, it could be shown that the repackaging does not impair the original condition of the product; secondly, that the owner of the trademark received "prior notice"; and thirdly, that on the new packaging it is written by whom the product had been repackaged.

The Judgment is not in itself revolutionary, but it set the stage for the one I shall now discuss.

Relabelling

In the landmark case of *Centrafarm* v. *American Home Products* [41] the European Court (October 1978) extended its Judgment and ruled that where a firm sells a product under several brand names a distributor or third party *may* sometimes be permitted to buy the goods sold under one brand name and relabel them with another name of the original firm *without* permission.

The facts of the case [42] were that American Home Products Corporation of New York (hereafter called AHPC) licensed a United Kingdom subsidiary to make the tranquiliser drug oxazepanum and sell it in the United Kingdom under the brand name "Serenid." AHPC also licenced its Dutch subsidiary to market a similar medicinal product with an oxazepanum base in the Benelux countries under the trademark "Seresta." Centrafarm imported "Serenid" from the United Kingdom into Belgium, relabelled it "Seresta" together with the words "Centrafarm B.V. Rotterdam" and resold it in the Benelux market without the permission of AHPC. AHPC applied to the Rotterdam court for an injunction to stop Centrafarm. The Dutch court asked the European Court to clarify the legal position. The Advocate General of the European Court stated that AHPC had not tried to prevent Centrafarm from importing "Serenid" from the United Kingdom to sell in Benelux under the "Serenid" brand name; apparently when Centrafarm did this it found that sales were insignificant perhaps because Benelux doctors were used to prescribing "Seresta" and were unfamiliar with "Serenid."

The Court in making its ruling under Article 177 directed that it is illegal for a firm which owns several marks to use such marks for the *purpose* of artificially partitioning the markets. Such a ruling applied to any product, not just drugs. It directed the Dutch court to establish the facts and find accordingly. This ruling is different from the previous case;

[41] See note 4, *supra*.
[42] According to the Court.

the former case stressed the illegality of effective partitioning of markets, the latter the illegality of attempting to partition markets.

It is notable that the European Court did not direct the German court to consider whether Hoffman-La Roche had a dominant position in the relevant market over the basic product, nor did it direct the Dutch court to consider if American Home Products had a dominant position over its basic product. These questions would seem to be very relevant.

I believe that these last two Judgments have potentially revolutionary consequences on the large number of firms which market within the EEC a basic product line under two or more brand names. Different brands of a basic product line are frequently offered with marginal physical differences of little importance to consumers but with substantial marketing differences aimed at filling the needs of different customer groups. The consequence of the differences in marketing is usually differences in prices. It seems to me that potentially the law makes legal the actions of an independent firm which buys a lower priced brand; repacks it; relabels it as a higher priced brand of the original firm and sells it.

I would argue that where the orginal firm was not dominant then such repackaging would act *against* the public interest. For some firms it would tend to reduce the incentive to match marketing to consumers needs and it would tend to retard the appearance of new brands—a key part of the process of competition. More seriously, some firms might find their potential market size more limited owing to the fact that marketing strategies were curtailed; this could lead to some failing to build plants big enough to achieve economies of scale, causing inefficiency and waste in the supplying industry. It could also reduce the incentive of those firms wishing to adopt innovative product strategies, retarding consumer progress. For some firms, there would be the incentive to introduce unnecessary substantial physical differences between the brands they offer to make repackaging by third parties more difficult. Such unnecessary differences may be costly forcing higher prices and a waste of society's resources. Finally, some firms might seek to get around the law by formally or informally licensing others to market their brands. If this were to happen, the law might be extended to include such activities, with far reaching effects. Currently many producer brand owners make similar versions of their own product lines available to retailers for sale under the retailers' brand names or to third parties for sale under third party names. Were the Court's rulings to extend to allow repackaging and relabelling between the producer's brands and the retailers' or third parties' brands, then these retailers and third parties would find that their sources of supply would disappear. Consumers would suffer serious damage in consequence from a loss of choice.

If the supplying firm were dominant and if the dominance were achieved illegally, then the best policy for the authorities would be to attack the dominance at the source of its power and not in curtailing the property right of trademarks. But, where the supplying firm were dominant and where the dominance had been obtained legally, as would be the case if the firm held a patent, the problem becomes most complex, and outside the scope of this article. The reader should note that in such cases artificial

partitioning of the market may increase the profits to the dominant firm—*and* it may raise consumer welfare.[43] Allowing third parties to repackage items may force the dominant firm to adopt a single brand policy. Such a policy whilst unifying the market in one respect may act *against* the consumer interest as it could restrict consumer choice (for instance, through the availability of a low priced little promoted brand) as well as causing higher average prices and less overall output. An analysis of the market would be necessary to determine the public interest.

The Court should clarify the rulings made in the last two cases regarding relabelling and repackaging to avoid long-term damage to *competition* and *unification*.

Conclusions

For too long economists have ignored the real problems faced by lawyers, and for too long lawyers have failed to recognise the extremely complex economic consequences of some of the issues they deal with. This paper has only started to bridge that gap. It has made reference to recent EEC decisions which have curtailed the ability of brand owners to partition markets by forbidding them to impose certain conditions of sale, and in some cases by permitting downstream buyers to repack without permission items under one brand name into another package bearing another brand name of the same upstream firm. These issues are all intimately related, and should not be separated.

It has been argued, with the use of case history, that such judgments where they are applied with little discrimination may have the opposite effect from that intended: they may cause prices to be higher than necessary. competition to be impeded, consumers to suffer and markets to become more divided.

From the point of view of *promoting competition*, it has been argued that in general it is unnecessary to object to dual pricing structures or similar practices where those which supply the product, or those which distribute the product do not have a dominant position. Interbrand rivalry from new and existing rival firms will ensure that competition is fostered. The argument is strengthened when one takes into account the stated objectives of *unifying markets*. Dual pricing structures, export bans and other restrictions on *intrabrand* competition may have to be endured so that in the long run the EEC may become unified. Without these restrictions unification may be impossible.

The current effect of the law appears to be to hinder the marketing activities of some firms and some of their distributors, an action which allows competitors and distributors to gain windfall profits. For this reason, it is vital that businessmen acquaint themselves with the law and realise its implications.

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[43] See B. S. Yamey, "Monopolistic Price Discrimination and Economic Welfare" (1974) 17 *Journal of Law and Economics* 377–380.