Impact of Gray Market on Licensing

Legal outlook for importation of genuine goods bearing authentic trademarks/copyrights

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Gray market goods or parallel imports are trademarked or copyrighted goods that are sold outside the United States, but which are resold in the United States by unauthorized importers and distributors. The significance of gray market goods has rapidly grown in recent years due to the strength of the dollar to an estimated $6 billion.[1] The Administration's Cabinet Council paper on "Gray Market" Import Options describes the reasons for the growth of the gray market in the following manner:

> In the past, gray market goods have only been a minor irritant to U.S. trademark owners, because of their relatively low volume. Large-scale parallel import competition has been fairly recent, starting for most products in 1980 or even more recently. The reasons for parallel import competition are varied. Relative exchange rates result in price differentials across national borders and are said to contribute greatly to parallel import competition. Other reasons include price disparities between parallel imports and authorized goods due to value-added taxes; cyclical demand; uneven supply; different wholesale prices depending on the market in different countries; and, in some cases, product dumping by foreign manufacturers. The recent acceleration of parallel imports has alarmed U.S. trademark owners and has made the review of the Customs Service policy a pressing issue.[2]

The gray market presents a difficult challenge for both lawyers and businessmen. The challenge is to develop a strategy which will permit the licensor and its licensees to obtain the value of the marketing investments made in the licensed products. A successful strategy will take into account the speed with which currency relationships change and the consequent impact upon which countries become the supplier of gray market goods (the weak currency countries), and which countries become the recipient of gray market goods (the strong currency countries). In addition, a successful strategy must consider the cost benefit analysis of actions taken to diminish the gray market.

To understand what approaches may retard the gray market, it is necessary to trace the state of the law in many forums in the United States in which the gray market issue has been contested. The debate over the gray market has taken place in several places, the courts, the International Trade Commission ("ITC"), and the Administration.

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The next several months may result in a definite determination on the gray market issue. The lower court's decision in *Copiat*[3] will be reviewed by the D.C. Court of Appeals. *Copiat* concerns a challenge to the Customs Service §526 regulations,[4] which prohibit the unauthorized importation of imported goods except where the U.S. and foreign trademark is owned or controlled by the same entity, or where the U.S. trademark owner allowed affixation of the U.S. trademark.

SECTION 526 OF THE CUSTOMS ACT AND SECTION 42 OF THE LANHAM ACT

Section 526 was enacted in 1922 for the purpose of reversing the Second Circuit decision in *A. Bourjois & Co. v. Katzel.*[5] In *Katzel*, plaintiff had purchased the U.S. trademark "Java" for face powder and the U.S. business of the French manufacturer of "Java" face powder. Later, the U.S. trademark owner found itself competing in the U.S. with Katzel, an importer who purchased the same face powder in France from the French manufacturer and resold the face powder in the latter's package that bore the French "Java" trademark. The Second Circuit found there was no trademark infringement because the goods sold were the "genuine" goods covered by the trademark.[6] That case was one of a line of Second Circuit cases which had relied upon the universality theory of trademarks — "if a trademark was lawfully affixed to merchandise in one country, the merchandise would carry that mark lawfully wherever it went and could not be deemed an infringer although transported to another country where the exclusive right to the mark was held by someone other than the owner of the merchandise."[6a]

The Supreme Court reversed the Second Circuit decision. Holmes, J., speaking for the unanimous Court, stated the trademark monopoly "deals with a delicate matter that may be of great value but that easily is destroyed, and therefore should be protected with corresponding care. It is said that the trademark here is that of the French house and truly indicates the origin of the goods. But that is not accurate. It is the trademark of the plaintiff only in the United States and indicates in law, and, it is found, by public understanding, that the goods come from the plaintiff although not made by it."[7] This, the Court adopted the territorial theory of trademarks, i.e. trademarks have a separate legal existence under the laws of each country.

The Court also found in a related case[8] that Section 27 of the Trademark Act of 1905, which prohibited the importation of goods copying or simulating a U.S. trademark, was violated by the importation of the face powder.

The controversial question is whether the territorial theory means that a trademark not only specifies the origin or manufacture of a good but also embodies the local goodwill of the U.S. trademark owner so that the public can rely on a trademark as symbolizing the reputation earned by the owner of the U.S. trademark. That is one of the issues involved in the controversy over the scope of the §526 regulations.

While originally the Customs Service's regulations tracked the language of the statue, since at least 1936 the regulations have precluded U.S. trademark owners from using §526 if the foreign and U.S. trademark are owned by the same person. Those regulations have also encompassed Section 27, which was reenacted as Section 42 of the Lanham Act, 15 U.S.C. §1124.

In 1957, in *United States v. Guerlain,*[9] a district court sustained a Department of Justice monopolization complaint against three sellers of French perfumes for utilizing §526 to prohibit importation of their perfumes. The court reasoned that the U.S. part of a single international enterprise was not entitled to use §526 to prevent the importation into the U.S. of authentic products sold by the foreign part of the enterprise. While the court admitted the unauthorized importations would permit the importers to receive the benefits of the trademark owners' advertising, it found the "exclusive right to sell in the American market on the part of an international concern exploiting world markets is not an element of good will except in so far as it may be made so artifically by import regulations."[10] The court also found that the particular perfumes involved constituted relevant product markets which had been unlawfully monopolized by defendants' use of §526.[11]

The Supreme Court granted review, but it vacated and remanded the case at the request of the Solicitor General who stated the government intended to introduce a bill in Congress to clarify the issue of unauthorized importation of trademarked goods.[12] A bill, H.R. 7234, was introduced which would have repealed §526 and amended §42 of the Lanham Act to deny its remedies to persons owned or controlled by a foreign manufacturer who uses the registered trademark. However, Congress did not enact the bill.

In 1972, the Customs Service revised its §526 and §42 regulations to make them inapplicable when (1) the foreign and U.S. trademarks or tradenames are owned by the same company; (2) the owners of the foreign and U.S. trademarks or tradenames are parent and subsidiary or otherwise under common ownership or control; or (3) the foreign trademarks or tradenames were applied under the authorization of the U.S. owner of the trademark or tradename.[13] That is the current form of the Customs Service regulations. It should, however, be noted that Customs has not always followed its stated policy.

A sharp increase in strength of the dollar led to the recent cases. The first case, *Bell & Howell: Mamiya Corp. v. Masel Supply Co.*,[14] the district court issued a preliminary injunction enjoining the importation of Mamiya Cameras. In its opinion, the court concluded *Guerlain's* analysis of §526 was incorrect. It found that Congress "wanted it absolutely clear that sharing a common foreign manufacturing origin with the American trademark owner's goods did not make other similarly or identically trademarked goods purchased abroad any less infringing."[15] The court was critical of the *Guerlain* court's rejection of defendants' argument that they owned the goodwill embodied in the trademarks. It stated the rejection was similar to the approach taken by the Second Circuit before *Katzel.* In addition, the *Guerlain* conclusion that the relevant markets were particular perfumes was said to be inconsistent with the Supreme Court's decision in *United States v. E.I. duPont de Nemours & Co.*,[16] where the Court stated trademarked products could not constitute a relevant product market.[17]

During the appeal to the Second Circuit, the Antitrust Division of the Department of Justice *and* the Customs Service filed a joint amicus brief supporting the district court decision. They argued that *Guerlain* was inconsistent with current legal precedent and sound economic analysis. They also argued that since the language of §526 unambiguously provides a remedy to all U.S. trademark owners, only the clearest expression of a contrary intent in the legislative history would warrant not following the dictate of §526. The Department of Justice and the Customs Service stated the legislative history did not show an intent to deny protection to U.S. trademarks owned or controlled by the foreign manufacturer of the trademarked goods. It concluded by arguing "the fact that legislation was enacted as a result of a contemporaneous judicial decision does not mean that the statutory language should be limited precisely to the facts of that decision, absent a clear expression of such a limited purpose on the part of Congress."[18]

The Brief also argued that the use of the trademark constituted another means of conferring an exclusive territory on a distributor, i.e. a vertical restraint which can be subjected to antitrust scrutiny under the rule of reason.[19] It stated trademark and antitrust policies are complementary not antagonistic; in fact, trademarks were said to generally enhance competition by improving consumer awareness.[20]

The Second Circuit reversed the lower court because the irreparable injury requirement for a preliminary injunction had not been satisfied. It held "[o]n the basis of the present record, irreparable injury may well not be present herein since there would appear to be little confusion, if any, as to the origin of the goods and no significant likelihood of damage to BHMC's [plaintiff's] reputation since thus far it has not been shown that Masel's [defendant's] goods, which have a common origin of manufacture with BHMC's goods, are inferior to those sold by BHMC and are injuring BHMC's reputation."[21] Furthermore, it suggested should plaintiff ultimately prevail instead of a preliminary injunction, a permanent injunction, an accounting, or an award remedy of damages, would remedy any injury to plaintiff. The case was remanded to the district court for further proceedings.[22]

In *Vivitar Corp. v. U.S., et al.*,[23] plaintiff sought a declaratory judgment in the Court of International Trade ("CIT") that the U.S. Customs Service must, pursuant to §526, exclude all imports of Vivitar's trademarked products that enter the U.S. without its written consent. The CIT granted defendant's motion for summary judgment. It found Congress enacted §526 to reverse the Second Circuit decision in *Katzel.* The CIT held Congress had intended to protect trademark owners in situations factually similar to *Katzel* and not in situations where the foreign source of imports was related to, or the agents of, the U.S. trademark owner. In other words, the CIT interpreted §526 as being limited to cases where the U.S. trademark owner was independent of the owner of the foreign trademarks.

In further support of its decision, the CIT relied upon the Customs Service's longstanding interpretation of §526 because it found this was a reasonable interpretation in light of the legislative history of §526. Finally, it believed Congress had acquiesced in Customs' interpretation in 1976 and 1978 when it enacted legislation closely related to §526, but failed to amend §526.[24]

Vivitar argued that gray marketers got a free ride on its reputation because Vivitar incurred substantial advertising, marketing and warranty expenses. In response, the CIT stated that "free riding can be a form of unfair competition affecting any trademark owner" which might be actionable under the unfair competition provision of the Lanham Act, 15 U.S.C. §1114.[25]

Vivitar was affirmed by the Court of Appeals for the Federal Circuit ("CAFC").[26] However, in its affirmance the majority disagreed with the reasoning of the lower court in a way that one might have expected would have led to a reversal. The CAFC found no limitations, based on Congressional intent at the time of enactment of §526, could be read into the statute. Rather, it found that, contrary to the lower court, reversal of *Katzel* was not the sole purpose of the enactment of the statute.[27]

In addition, the CAFC disagreed with the lower court's holding that the Customs Regulations had been consistent. Instead, the CAFC found the Customs Regulations had been neither consistent nor had they consistently applied.[28] Finally, the CAFC disagreed that the amendment to §526 amounted to implied ratification of Customs' interpretation of the statute.[29]

Having thoroughly disagreed with the lower court reasoning, the CAFC did not reverse. The CAFC held:

> we conclude that the regulations do no more than define Customs' role in initiating administrative enforcement of the statute.

The CAFC concluded that Congress could not have forseen all of the possible gray market circumstances and that the appropriate approach to §526 is case-by-case adjudication in the district courts. A successful plaintiff in a district court proceeding would then be entitled to have the parallel imports excluded by Customs.[30] The Supreme Court recently denied certiorari.[31]

The next major challenge to the customs regulations occurred in *Coalition to Preserve the Integrity of American Trademark v. U.S. ("COPIAT"). COPIAT* was a declaratory judgment action that alleged the Customs Service's §526 regulations were inconsistent with §526 of the Tariff Act of 1930 and §42 of the Lanham Act.

The district court sustained the Customs Service's §526 regulations in a very similar manner to *Vivitar*.[32] The court found the Customs Service's interpretation of the involved statutes met the sufficiently reasonable standard for review of agency regulations. This conclusion was based on the Custom Service's consistent interpretation of §526 and §42, which was found to be entitled to considerable weight. Also, previous decisions had construed §526 to prohibit only the entry of merchandise which copied or simulated registered trademarks and not to bar genuine articles. *Katzel* was distinguished as being a case where a foreign manufacturer had sold its U.S. business and trademark to a U.S. purchaser. Congress recognized Customs Service's interpretation of §526 and §42 during consideration of the Customs Procedural Reform and Simplification Act of 1978,[33] but did not take action to change the statute.

COPIAT was appealed to the D.C. Circuit Court of Appeals. It was argued on January 21, 1986.

It should be noted that the Department of Justice has argued the traditional Customs Service's point of view in the *Vivitar* and *COPIAT* appeals instead of the view it espoused in the *Mamiya* appeal.

In the recent *Olympus* case,[34] Olympus sought an injunction prohibiting the United States from enforcing the provisions of its customs service regulations that permit importation of trademark gray market goods. The court denied Olympus' motion for summary judgment on the ground that to do so would put Customs' officials

> in the position of having to determine at the time of border crossing whether the domstic trademark holder had developed an independent public image in this country.[35]

The court found the determination of copying and confusion is appropriately resolved through litigation in the courts where a full factual record can be developed.[36]

Thus, the *Olympus* court essentially followed the CAFC decision in *Vivitar* in the sense that it held a trademark infringement suit based on §42 requires a factual record. That approach requires a factual analysis in each case before a determination can be made as to whether §526 will be applied to bar parallel imports. However, the *Olympus* court firmly held that §526 should be construed in the same narrow way as the lower courts in *Vivitar* and *COPIAT*.[37]

THE GRAY MARKET AND TRADITIONAL TRADEMARK INFRINGEMENT ISSUES

The Mamiya cases also had trademark infringement claims in them, namely trademark infringement under the Lanham Act, unfair competition under the Lanham Act, common law unfair competition, trademark dilution under the N.Y. law, and conspiracy to commit trademark infringement under the N.Y. laws. However, the lower court in *Mamiya* did not specifically analyze the elements of the various causes of actions. Instead, it discussed, as mentioned previously, its view that the courts follow the territorial view of trademarks and not the universality theory. It also analyzed why it disagreed with *Guerlain* both as to antitrust doctrine and as to the interpretation of §526.

Most important with respect to trademark theory was its discussion of the theory of trademarks. It said that trademarks identify a single source of origin of goods. Where a merchant owns a trademark it did not manufacture, the term origin was said to indicate "the party responsible for exercising judgment respecting the quality of the good it distributes to the public."[38] That result was said to follow from the territorial theory of trademarks. Based on that theory, it disagreed with the *Guerlain* court's statement that firms which did not manufacture a trademarked product, who "merely" distribute the product and were not independent of the manufacturer of the product could not qualify for protection under §526.[39] Instead, the *Mamiya* court said that the distributor of the trademarked goods was responsible for the creation of the goodwill in its market.[40]

On appeal, the Second Circuit reversed because the lower court had not shown irreparable injury. The Second Circuit suggested the lack of warranties on the gray market cameras did not constitute irreparable harm since labelling could be used to make consumers aware of lack of a warranty.[41]

The next act in the *Mamiya* cases was *Osawa & Co. v. B & H Photo et al.*,[42] where similar causes of action were alleged as had been in the *Mamiya* case but against a different gray marketer. The court found likelihood of confusion because not only had defendant not indicated the gray market cameras had no warranties, but defendant had even claimed that warranties would be honored at authorized distributors of Mamiya cameras.

Irreparable harm was found based on a dramatic decline in sales, a 40% decline in the number of dealers, and the cost of honoring warranties on cameras sold by the gray marketers. The court found the decline in sales would lead to a reduced advertising budget which

> means reduced opportunity to publicize the markets and consequently further reduced sales. The widespread disaffection among authorized dealers by reason of the gray market price competition creates a substantial risk of loss of enthusiasm or bad-mouthing (where it matters most since buyers are likely to look to dealers for advice on brands and equipment). Delay in performing warranty repairs as a result of staff reductions also creates resentment directly against the brand.[43]

The district court rejected the suggestion of the Second Circuit that a label on the gray market camera indicating there was no warranty would dispel confusion. It found many consumers would not realize they lacked a warranty until they sought to make a warranty claim. Also rejected was the Second Circuit suggestion that an accounting could protect plaintiff. The cameras had apparently been brought into the U.S. by defendant, despite recordation of the *Mamiya* trademark with the Customs Service, defendant's records were informal and there were many dealers in gray market merchandise. The court entered an injunction on the basis of the trademark infringement counts and §526.[44]

The final act in the *Mamiya* cases was the bankruptcy of Osawa, its sale of the trademarks to Berkey Photo, and a consent decree between Masel and Berkey Photo in which Masel acknowledged Berkey Photo was an independent U.S. company that could obtain an exclusion order from the Customs Service pursuant to §526. Also, Masel agreed not to purchase cameras that did not originate from Berkey or its predecessor, Osawa.

There have been a few other gray market cases, which will be briefly mentioned. In *Model Rectifier Corp. v. Takachiho International, Inc.*,[45] the Ninth Circuit affirmed the lower court's grant of an injunction,[46] against a gray marketer brought by an assignee of a trademark on model automobile kits. The Ninth Circuit relied on *Katzel* and the lower court decision in *Mamiya.*

The district court in *Parfums Stern, Inc. v. U.S. Customs Service and certain John Doe defendants*,[47] denied a preliminary injunction. It found the facts were dissimilar to *Katzel* and *Mamiya* because plaintiff was part of a single international enterprise that owned the U.S. and foreign trademarks. It also relied upon *Guerlain* and found plaintiff had not shown a substantial likelihood that it would succeed on the merits. Also, the court found irreparable injury had not been shown because plaintiff had not previously challenged the importations which had been going on for some time. In balancing the harm, the court found greater injury would occur to defendants than to plaintiff. Finally, the court found there was no showing the public would be harmed by the continued importation.

A second category of trademark infringement cases is those cases where the U.S. trademark owner initially authorizes the placement of its trademark on goods manufactured by an unaffiliated foreign manufacturer and later refuses to accept delivery of the products. In two cases with those facts, sales by the foreign manufacturer in the U.S. were not found to constitute trademark infringement. *Monte Carlo Shirt, Inc. v. Daewoo Int. (America) Corp. et al.*;[48] *El Greco Leather Products Co., Inc. v. Shoe World, Inc.*[49] 224 U.S.P.Q. 921 (E.D.N.Y. 1984). Both cases may be narrowly interpreted to stand for the proposition that where trademarked goods sold by gray marketeers are genuine, planned, sponsored by the U.S. trademark owner, and produced for it on contract for future sale, no trademark infringement occurs. However, both cases contain expansive language and could be argued to stand for the proposition that it is not trademark infringement to import genuine goods without authorization from the U.S. trademark owner.

THE INTERNATIONAL TRADE COMMISSION ("ITC") DURACELL OPINION

The ITC found unauthorized importation and sale of gray market Duracell alkaline batteries into the United States constituted a violation of section 337 of the Tariff Act of 1930, 19 U.S.C. §1337.[50] *Duracell* involved the importation and sale in the United States of Duracell batteries made in Belgium in a Duracell factory and packaged with labels bearing several European languages, including English, for sale in Europe.[51] Having found a violation, the ITC issued an exclusion order that directed the Customs Service to deny unlicensed entry into the United States of Duracell alkaline batteries.[52]

The ITC majority found a violation of §337 based upon six independent grounds: (1) infringement of a registered trademark under the common law of trademarks; (2) violation of §42 of the Lanham Act, 15 U.S.C. §1124; (3) violation of §32(1) of the Lanham Act, 15 U.S.C. §1114; (4) misappropriation of trade dress; (5) false designation of origin, 15 U.S.C. §1125; and (6) violations of the Fair Packaging and Labeling Act, 15 U.S.C. §1452 and §1453.[53]

The majority adopted the territoriality theory. It found a trademark has a separate legal existence under each country's law and that trademarks have the purpose of symbolizing the local business good will of the owner of the mark in the United States.[54] Having decided that the territoriality principle applied, the ITC majority found that the sale of foreign Duracell batteries prevented Duracell from reaping the exclusive benefits from the goodwill which it had developed through its extensive advertising and sale of quality batteries. Importers were found to have infringed Duracell's trademark by having "appropriated the benefits of Duracell's goodwill for themselves which they have not helped to create."[55]

As noted earlier, the ITC Commissioners, with one exception, deferred to the Customs Service's interpretation of §526. However, the majority did not defer with respect to §42 of the Lanham Act. Rather, the majority held that Congress, in reenacting §27 as §42, had incorporated the Supreme Court's interpretation of §27 in *Katzel.* Thus, it found §42 did apply.[56]

The majority found that §32(1) of the Lanham Act was violated for three reasons. First, foreign Duracell labels were copies of Duracell's U.S. trademark. Second, there was evidence that the mark had been used in connection