Title
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Journal
UCLA Pacific Basin Law Journal, 11(1)

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Publication Date
1992

DOI
10.5070/P8111022036

COMMENTS

RELEASING THE GRAYS: IN SUPPORT OF LEGALIZING PARALLEL IMPORTS

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I. INTRODUCTION

Imagine for a moment, or fantasize if you wish, that you have come upon a large sum of money and have decided to spend it on a new imported luxury car. You tour the lots of various authorized importers—Lexis, BMW, Mercedes, and so on. You compare prices, models, and colors. Perhaps you have even decided on the car which is perfect for you, let's say a BMW seven series. Now a friend tells you that you have not really exhausted your options. You can buy a round-trip ticket to Germany, purchase your BMW there, pay for transport to the United States, customs duties and costs for conversion to U.S. emissions and safety standards and still save money, not to mention the free trip to Europe.[1] You won't be breaking the law—in fact, President Reagan referred to similar imports by members of his administration as "standard practice."[2]

Your friend has inspired you to do some creative thinking of your own. You recall that your neighbor, Fred, is also contemplating purchasing a luxury import. If you bought two cars while in Europe, you could save Fred the cost of purchasing through an au-

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† J.D. expected 1994, UCLA School of Law. The initial research for this Comment was conducted in Taipei, Taiwan. My sincerest thanks to Robin Winkler, Gene Chao, and Mark Grady for their generous assistance and insightful comments.

1. Estimates range as to how much can be saved by importing cars independently depending on the model of car and the fluctuation of currency rates between markets. By 1985 estimates, consumers could knock $8000 off the price of certain Mercedes models by purchasing them abroad and paying for conversion to U.S. standards. *See* Edward Boyer, *The Assault on the Right to Buy Cheap Imports,* FORTUNE, Jan. 7, 1985, at 89. Elsewhere it has been found that foreign car purchasers can knock 25% off the price of some models by purchasing them from abroad and importing them into the United States. *See* Maks Westerman, *The $7 Billion Gray Market: Where It Stops, Nobody Knows,* BUS. WK., Apr. 15, 1985, at 86.

2. Westerman, *supra* note 1, at 86.

thorized distributor and make a tidy profit at the same time. You are now ready to join the ranks of the parallel importers.[3] After all, why stop at a car for you and Fred? There could be a career here.

You would not be alone. Estimates of the size of the parallel import or "gray" market ranged from $5.5 to $7 billion by the mid 1980s.[4] To be sure, the increasing size and sophistication of the gray market is not without controversy. Trademark holders and authorized distributors claim that parallel importers are stealing their market.[5] They argue that gray marketeers confuse or dupe consumers into thinking that lower priced parallels offer the same services provided by authorized distributors.[6] For example, Fred might not realize that his luxury import comes without a dealer-supplied warranty. Worse yet, parallel importers and their customers have been accused of free-riding on authorized distributors' investments in goodwill.[7] Fred might be able to convince the local BMW dealer to fix his car, either out of loyalty to BMW customers or because the dealer mistakes Fred's car for an import that was sold through U.S. distribution channels and thus is covered by local warranties. Yet defenders of parallel importing argue that local distributors are simply afraid of competition.[8] Parallel imports threaten to disturb authorized distributors' insulated pricing schemes. These schemes allow distributors to charge the highest possible prices in each of their foreign markets without fear of com-

3. *See* J. THOMAS MCCARTHY, TRADEMARKS AND UNFAIR COMPETITION § 39:35 (2d ed. 1984) (defining gray market goods). "Parallel importing" and "gray marketing" will be used interchangeably in this comment. Parallel importing involves trademarked goods purchased abroad and sold in competition with goods distributed by the domestic registered trademark holder. Parallel importing is a polite term for gray marketeering. *See* Riley, *"Gray Market" Fight Isn't Black & White*, NAT'L L.J., Oct. 28, 1985, at 1 (noting that importers of goods outside of standard distribution channels prefer the term parallel importer to gray marketeer as the latter suggests that the imports are somehow less than legal).

4. Dan Goodgame, *Inside the Gray Market; Discount Retailers Offer Brand-Name Bargains for the Wary*, TIME, Oct. 28, 1985, at 76 (suggesting that the gray market accounted for a $5.5 billion slice of the retail market in 1985); Boyer, *supra* note 1, at 89 (estimating gray market retail sales totaled $6 billion in 1984); Westerman, *supra* note 1, at 86 (estimating gray market sales at $7 billion in 1984).

5. Westerman, *supra* note 1, at 86 (quoting Robert Miller, President of Charles of the Ritz, who commented of gray marketeers: "[i]ts the same as if they had walked into my office and taken it over").

6. *Id.* See also Coalition to Preserve the Integrity of Am. Trademarks v. United States, 598 F. Supp. 844, 850 (D.C. Cir. 1984), in which plaintiff trademark holders argued that parallel importing activities confuse consumers and diminish the value of a mark's goodwill.

7. For a discussion of free-riding, see *Coalition to Preserve Integrity*, 598 F. Supp. at 850 (noting that gray marketeers may reap the benefits of advertising and servicing efforts by local distributors without contributing any of their own capital).

8. Westerman, *supra* note 1, at 86 (quoting A. Robert Stevenson, Vice-President of K Mart, who referred to proposed restrictions on parallel imports as "a smoke screen for the fact that the distributors don't want to be price competitive").

petition between markets.[9]

Though gray marketing is not illegal, it is likely to face legal impediments. As much of Asia and the EEC are moving to open their borders to competition from parallel imports, the recent trend in the United States has been towards greater restriction of gray markets. Customs bureau[10] and recent Supreme Court[11] interpretations of the Tariff Act of 1930[12] mandate restraining the flow of parallel imports in certain instances.[13] Moreover, although the U.S. position on parallel importing may contravene its status as a cosignatory of the Paris Convention[14] and its membership in GATT,[15] some theorists have suggested that an even more stringent standard be applied to gray marketeers.[16]

This Comment examines the controversy over the gray market and argues for resolution in favor of the parallel importer. Part II briefly considers the worldwide status of parallel importing and argues that the United States should adopt a parallel importing policy suggested by recent developments in Asia. Parts III and IV provide a detailed critique of the current status of parallel importing in America by analyzing U.S. policy, first in the context of trademark law, and then in the context of economic concerns.[17] Part III examines the threshold issue of whether parallel importing is consistent with traditional trademark concerns. It first defines the principal elements of trademark protection and then refines and prioritizes these elements in the context of parallel importing. Part III concludes that a policy of unrestrained parallel importing is entirely harmonious with the modern tenets of trademark law. Part IV con-

9. *See* Boyer, *supra* note 1, at 89 (quoting William A. Niskanen, senior member of Reagan's Council of Economic Advisors, who referred to parallel import restraints as "an instrument for enforcing price discrimination between U.S. and foreign markets").

10. 19 C.F.R. § 133.21(b) (1987) (revised April 1, 1991 and codified at 19 C.F.R. § 133.21 (1992)).

11. K Mart Corp. v. Cartier, Inc., 486 U.S. 281 (1988).

12. 19 U.S.C. § 1526 (1988).

13. For a full discussion of the U.S. position and its implication, see *infra* part III.

14. *See* Kaoru Takamatsu, *Parallel Importation of Trademarked Goods: A Comparative Analysis*, 57 WASH. L. REV. 433, 438-39 (1982) (suggesting that the Tariff Act in its current form may violate the principle of national treatment under the Convention of Paris for the Protection of Industrial Property, Mar. 20, 1883, 21 U.S.T. 1583, 1631, 161 Consol. T.S. 409).

15. *See* Michael Remington, *Comments on* K Mart v. Cartier: *Gray Market Trade and EEC Law*, J. WORLD TRADE 93, 101 (1990) (discussing controversy over the U.S. position on parallel importing arising within GATT).

16. *See, e.g.*, Dwight L. Miller, *Restricting the Market in Trade-Marked Goods: Per Se Legality*, 76 TRADEMARK REP. 363 (1986) (proposing a complete ban on the flow of gray market goods into the United States).

17. The trademark and economic analyses are necessarily kept separate, as the fragility of intellectual property rights occasionally justifies their protection from competitive market forces. Any argument that parallel imports are economically favorable may therefore be vulnerable to the argument that intellectual property rights are necessarily insulated from market forces.

siders the economic consequences of the gray market by analogizing parallel import restrictions to a system of vertical territorial restraints, and finds that separate restrictions on parallel imports reduce economic efficiency. In closing, this Comment argues that the United States should take steps to align itself with the developed and developing economies in Europe and Asia by adopting a rule of per se legality for parallel imports.

II. A GLOBAL PICTURE OF PARALLEL IMPORTING

In May 1992, the Civil Division of Taiwan's High Court decided a case involving the Taiwan Coca-Cola Bottling Company and third party importers of Coke into Taiwan from Malaysia, Indonesia, and the United States.[18] The case presented a classic parallel importing scenario.[19] Taiwan Coca-Cola, the registered domestic holder of the Coca-Cola trademark, was being forced to compete with concededly genuine Coke imported by the appellants.[20] Licensed distributors in Taiwan had been vocal for some time prior to the decision about the threats posed by gray marketeers.[21] Several features specific to Taiwan, such as appreciation in currency rates[22] and high import tariffs,[23] rendered the island a fertile territory for parallel importing. Thus, when the Taipei district court considered the *Coca-Cola* case, it issued an injunction against the flow of parallel imports on the ground of trademark infringement.[24] However, the High Court reversed the district court's deci-

18. Judgment of May 25, 1992 (Gin Yu Hsin Co v. Coca-Cola Co.), Taiwan High Ct. 81 Nien Tu Su Tzu —.

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

20. *Coca-Cola*, 81 Nien Tu Su Tzu —.

21. *See, e.g.*, RESPONSIBLE TRADE SUBCOMM., AM. CHAMBER OF COMMERCE R.O.C., RESPONSIBLE TRADE IN TAIWAN (1990) (detailing parallel importing competition suffered by distributors in the food and beverage, packaged goods, automotive, health care, computer and appliance industries); Lucinda Horn, *Parallel Imports Pose Problems*, S. CHINA MORNING POST, Apr. 24, 1992, at 1; *To Prevent Parallel Importers from Freely Selling Goods, Foreign Companies in Taiwan Harshly Demand that Customs Inspections of Product Labels Be Intensified*, ECON. DAILY NEWS, Sept. 25, 1990, at 8.

22. *See, e.g.*, NATIONAL TRADE DATA BANK MKT. REP., U.S. DEP'T OF COMMERCE, TAIWAN OVERSEAS BUSINESS REPORT (1991) (noting that the New Taiwan dollar appreciated against the U.S. dollar by 40% from 1985 to 1988). In 1985 the Taiwan dollar traded at 40:1 against the U.S. dollar. In 1993 it trades at approximately 25:1. Appreciation in currency rates in a domestic market increases the margins realized on imports, creating an incentive for parallel importers to undercut domestic distributors.

23. *Foreign Trade and Exchange Controls*, Business International Forecasting, Feb. 1, 1992, *available in* LEXIS, Asiapc Library, ALLASI File (noting that import tariffs on automobiles and agricultural products brought into Taiwan were 35% and 21.6% respectively). Opponents of parallel importing suggest that high import tariffs allow the parallel importer to underinvoice and thus to undercut the prices of authorized distributors by defrauding customs agents.

24. Judgment of May 16, 1991 (Coca-Cola Co. v. Gin Yu Hsin Co.), Taipei Dist. Ct., Civ. Division (Taiwan).

sion, giving parallel importers complete freedom to import, display and distribute Coca-Cola "[i]n the absence of any trade-mark counterfeiting/imitation and any act in violation of good morals."[25]

The High Court's decision to reject a territorial notion of trademark protection[26] swung Taiwan into parity with Malaysia, Indonesia, Japan, and the EEC, among others. However, the Taiwanese parallel importers of Coca-Cola would not have fared nearly as well in the United States, where similar imports are restrained under the Tariff Act of 1930[27] following the U.S. Supreme Court's interpretation of the Act in *K Mart Corp. v. Cartier, Inc.*[28] This section will trace the burgeoning trend towards protection of parallel importing in Europe and Asia, and will argue that the policies adopted in these regions suggest a direction for reform for the American market.

A. Asia

Taiwan is the latest entrant into a gray market in which many developed Asian countries are players. Singapore, Hong Kong, and to a lesser degree Japan have long been known as major markets for parallel imports.[29] Japan's position on parallel importing represents one of the more cautiously reasoned approaches to the gray market.

Kaoru Takamatsu[30] traces the antecedents of Japan's parallel importing stance to the *Parker Pen* cases.[31] The Plaintiff, Schulyro Trading Company, was the exclusive distributor of Parker pens in Japan. Schulyro encountered competition from a parallel importer of genuine Parker pens from Hong Kong, and responded by filing a petition with Japan's Customs Office. Schulyro received what amounted to a temporary injunction from the Tokyo district court; the order denied import permits to any importer of Parker pens

25. Judgment of May 25, 1992 (Gin Yu Hsin Co v. Coca-Cola Co.), Taiwan High Ct. 81 Nien Tu Su Tzu —.

26. For a discussion of the principle of territoriality, see Takamatsu, *supra* note 14. Essentially this principle posits that the use of a trademark is valid within a region only when applied by or authorized by the registered trademark holder in the region.

27. 19 U.S.C. § 1526 (1988).

28. 486 U.S. 281 (1988).

29. *See Freedom to Sell*, Country Report, July 1, 1990, *available in* LEXIS, Asiapc Library, ALLASI File (noting that there are no restrictions on parallel importing in Singapore and that "[i]n fact, Singapore is often a dumping ground for overruns and excess regional production"); Monica Gwee, *Hong Kong: Discount Shops Sitting Pretty in Perfume War*, S. China Morning Post, May 10, 1992, at A1. For a full discussion of parallel importing in Japan, see *infra* notes 30-40 and accompanying text.

30. Takamatsu, *supra* note 14, at 441.

31. Judgment of June 1, 1964 (Schulyro Trading Co. v. K.K. Aki Shokai), Tokyo Dist. Ct. (unreported case), *summarized in* Turoro Doi, Digest of Japanese Court Decisions in Trademarks and Unfair Competition Cases 68 (1971); Judgment of Feb. 27, 1970 (N. MC Co. v. Schulyro Trading Co.), Osaka Dist. Ct., 234 Hanta 57, *reprinted in English in* 16 Japanese Ann. Int'l L. 113 (1972) [hereinafter JAIL].

who lacked the express permission of Schulyro.[32] When the Osaka District Court considered the case they found inter alia that the pens imported by the defendant were genuine Parker pens; that the Parker trademark was a guarantee of quality from the manufacturer and not the distributor; and that parallel importation of the pens would promote "free and fair competition."[33]

Administrative agencies responded quickly to the Osaka decision. The Customs Division of the Ministry of Finance established procedures to prohibit the exclusion of parallel imports where the foreign and domestic trademark holders were the same entity or where they were found to be constructively the same on the basis of a special relationship.[34] Japan's Federal Trade Commission was even more generous to parallel importers, finding that antitrust laws prevented sole distributors from restricting parallel imports.[35]

Liberal legislative guidelines have continued to shape Japan's gray market in the decades following the *Parker Pen* decisions. In 1990, Japan's Federal Trade Commission, under pressure from the United States to remove trade barriers,[36] drafted guidelines prohibiting the use of sole agency importers as a means of frustrating gray marketeers.[37] In 1992, parallel importing was widely reported as a source for price competition in the lucrative beer and liquor industry.[38] A year earlier, after Apple Computer attempted to frustrate parallel imports of computers and peripheral equipment by setting up a two-tiered system of software pricing, Japan's Federal Trade Commission responded by issuing a warning and instituting an investigation of possible violations under the Antimonopoly Law.[39]

Japan's markets have proven receptive to the parallel importer.

32. DOI, *supra* note 31, at 70.

33. JAIL, *supra* note 31, at 131-34.

34. The Procedures for Application of Import Prohibitions of Goods Infringing Intellectual Property Rights, 1972 Finance Ref. No. 1443, at ¶¶ 4-5 (Customs Division, Japanese Ministry of Fin.).

35. Antimonopoly Act Guidelines for Sole Import Distributorship Agreements, (Nov. 21, 1972) (Japanese Fair Trade Comm'n).

36. *See* A. E. Cullison, *Japanese Targeting Import Monopolies*, CHI. TRIB., Nov. 18, 1990, at C12 (noting that the new FTC guidelines "are the government's first serious response to Washington's demands that Japan strengthen its anti-monopoly law to remove barriers to expanded imports").

37. *See FTC Creates New Anti-Monopoly Standards Draft*, DAILY NEWS TOKYO FIN. WIRE, Sept. 19, 1990, *available in* LEXIS, Asiapc Library, ALLASI File.

38. *See* Neil Wineberg, *Opportunity Knocks for Foreign Brewers; with Non-Japanese Beers Gaining a Foothold, an 'Immature' Market May Be Coming of Age*, NIKKEI WKLY., May 9, 1992, at 11 (noting of beer sellers that "large retailers now are regularly cutting prices for foreign labels, partly through parallel imports"); *Japanese Prefer Tailor-Brewed Imports; When Brewed to Japanese Tastes, Scotch Fetches Higher Prices*, NIKKEI WKLY., July 18, 1992, at 13 (noting that prices on most conventional labels of whiskey have dropped as the result of competition from parallel imports).

39. *Briefs*, Report from Japan, Feb. 28, 1991, *available in* LEXIS, Asiapc Library, ALLASI File.

Indeed, in a statement of opinion commissioned by Coca-Cola on the issue of the parallel importing of Coke, Professor Tururo Doi of Waseda University stressed that the courts would likely find that the goodwill of the local distributors was indistinguishable from the goodwill of the product in general, and that threats to a distributor's local monopoly did not justify restricting parallel imports.[40] Japan's Supreme Court, apparently satisfied with the policy carved out by the various administrative agencies, has not yet decided a case on parallel importing. The *Parker Pen* cases remain good law in Japan, and the country can be expected to continue to allow parallel imports to flow relatively free from restraint.

B. THE EEC[41]

The EEC provides a striking example of developed nations cooperating to realize the efficiency of parallel imports. Protection of parallel importing has been referred to as a "centerpiece" of trade enforcement in the European Economic Community.[42] Parallel importers are likely to be able to defend their activities either under the principle of free movement of goods, codified in articles 30 and 36 of the Treaty of Rome,[43] or on the basis of antitrust principles incorporated into article 85.[44] These articles work together to prevent an "artificial sealing-off of the markets"[45] within the European Community.

40. Tururo Doi, Statement of Opinion Regarding the Possibility Under Japanese Law to Enjoin Unauthorized Importation of, or Sale of Imported, Genuine Goods Bearing Coca-Cola Trademark Together with the Word "Classic" 11 (1990) (on file with the *Pacific Basin Law Journal*). Professor Doi also suggested that the only way in which distributors could restrict parallel imports would be on the basis of consumer confusion. This argument would stem from the fact that the U.S. product additionally includes the word "Classic," even though the contents are the same as the locally produced Coke. *Id.* at 12.

41. The European Economic Community, or EEC, was created in 1958 by the Treaty of Rome, signed by France, West Germany, Italy, the Netherlands, Belgium and Luxembourg. The United Kingdom, Ireland, Denmark, Greece, Spain and Portugal have since joined, bringing the total number of member states to twelve. Formal applications for membership have been filed and are being considered for Austria, Cyprus, Malta, Sweden and Turkey.

42. Remington, *supra* note 15, at 97.

43. Treaty Establishing the European Economic Community [hereinafter Treaty of Rome], Mar. 25, 1957, 298 U.N.T.S. 3.

44. There is wide concurrence on the notion that articles 30, 36 and 85 of the Treaty of Rome supply the principal enforcement mechanisms available to parallel importers. *See* Laurence J. Cohen & Adam N. Cooke, *How Trademarks and Other Rights May Be Used to Limit Parallel Imports in Europe*, 18 TRADEMARK REP. 371, 371 (1991); Hans-Christian Kersten, *EEC Antitrust Policy on 'Grey[sic] Market' Exports and Imports Within the Common Market*, 16 INT'L. BUS. LAW. 134, 134-35 (1988); Remington, *supra* note 15, at 94-101; Takamatsu, *supra* note 14, at 448.

45. Hans-Christian Kersten, *"Gray Market" Exports and Imports Under the Competition Law of the European Economic Community*, 78 TRADEMARK REP. 479, 504 (1988).

Article 30 broadly forbids all "[q]uantitative restrictions on importation."[46] The article is subject to several caveats expressed in article 36, of which the one most relevant to parallel importers is that import restrictions may be "justified on grounds of the protection of industrial and commercial property."[47] Article 36 therefore appears to leave ample room for restricting parallel imports on the basis of a local distributor's trademark rights and/or her investment in goodwill. However, the European courts have proven extremely hostile to restricting the flow of parallels in the name of trademark protection.

In *Deutsche Grammophon Gesellschaft mbH v. Metro-SB-Grossmarkte GmbH & Co., KG*,[48] the European Court considered the case of a record manufacturer with exclusive distribution rights under its trademark in Germany. The manufacturer attempted to enjoin imports of its records sold at lower prices through a subsidiary in France under the same mark. The court found for the parallel importers and, in applying article 30, held that any restriction on the distribution of goods originally put into circulation by the manufacturer would be incommensurate with the notion of a Common Market.[49]

In a series of cases decided in the early 1970s, the European Court applied increasingly liberal interpretations of "manufacturer control" over the circulation of a trademarked good. In *Sirena S.r.l. v. Eda S.r.l.*,[50] the Court found that the Italian company that manufactured cosmetics under a trademark acquired in 1937 from an American concern, Mark Allen, could not enjoin parallel imports of Mark Allen cosmetics under the same mark. In *Van Zuylen Freres v. Hag AG*,[51] the Court considered a case in which separate Belgian and German companies were both manufacturing coffee under the "Hag" trademark. The Belgian company originally had been a subsidiary of the German Hag but had been confiscated by Belgium after the Second World War as enemy assets and sold to shareholders. The court found that the Belgian Hag could not prevent imports of German-manufactured coffee bearing the Hag mark because the companies had once been controlled by the same entity.[52]

Antitrust provisions included in article 85 will likely foil any attempts by authorized distributors within the European Community to circumvent the free movement of goods through the use of

46. Treaty of Rome, *supra* note 43, art. 30.
47. *Id.* art. 36.
48. Case 78/70, [1971] 2 E.C.R. 487, 10 C.M.L.R. 631 (1971).
49. *Id.* at 500.
50. Case 40/70, [1971] 1 E.C.R. 69, 10 C.M.L.R. 260 (1971).
51. Case 192/73, 1974 E.C.R. 731, 14 C.M.L.R. 127 (1974).
52. *Id.* at 746.

contractual or licensing restrictions.[53] One of the earliest examples of the exercise of article 85 is *Establissements Consten SARL v. Commission of the European Economic Community*.[54] There, a German manufacturer designated a French trading company as the sole distributor of its trademarked goods. When a parallel importer attempted to bring genuine German-manufactured goods into France under the same mark, the manufacturer sued. The European Court of Justice found that the enforcement of the sole distributorship agreement was a restraint on competition which was illegal under article 85.[55]

The net effect of the EEC provisions is to give free reign to parallel importers unless the domestic and foreign trademark holders are independent and possess trademark rights which arose independently. Although the Treaty of Rome only governs Member States and thus does not apply to parallel imports from outside the EEC,[56] the European Court of Justice's frequent emphasis on avoiding sealing-off territories would make it difficult for the Court to broadly restrict parallel imports from outside the European Community without appearing hypocritical. As with Japan, the EEC therefore can be expected to continue to broadly sanction the flow of parallel imports.

C. The Future Direction of Gray Markets

Parts III and IV of this Comment will argue that a more liberal policy of parallel importing in the United States would be consistent with U.S. trademark law and would produce greater economic efficiencies. However, before looking at parallel imports in the relative isolation of the American market, it is important to understand the impact of the United States' current conservative stance within the international arena.

We have already seen that Japan makes frequent use of parallel imports to foster price competition within its markets. Increasingly, the impetus for such competition comes from U.S. pressure to boost import sales within Japan. By failing to provide a similar structure for competition as in Japanese markets, the United States threatens

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53. Article 85(1) requires the prohibition of

> [a]ny agreement between enterprises, any decisions by associations of enterprises and any concerted practices which are likely to affect trade between the Member States and which have as their object or result the prevention, restriction or distortion of competition within the Common Market.

Treaty of Rome, *supra* note 43, art. 85(1). Article 85(2) declares any agreement in violation of article 85(1) to be null and void. *Id.* art. 85(2).

54. Joined Cases 56 & 58/64, 1966 E.C.R. 299, 5 C.M.L.R. 418 (1966).

55. *Id.* at 303.

56. *See* Case 51/75, EMI Records Ltd. v. CBS UK Ltd., [1976] 2 E.C.R. 811, 8 C.M.L.R. 235 (1976).

to erode the credibility of its claimed interest in an even playing field. The EEC is also in the difficult position of having at once to advocate free trade between its Member States and to protect itself from non reciprocating trading partners outside of the Community. As markets continue to globalize, these two functions of the EEC can be expected to grow increasingly irreconcilable. The European Community will likely respond by pressuring non-Member States to adopt reciprocal trading policies, particularly with respect to parallel imports. As emerging markets such as Taiwan and Singapore adopt parallel importing stances consistent with Japan and the EEC, the focus increasingly shifts to America to justify its aberrant position.

The remainder of this Comment seeks to show that the U.S. position on gray markets cannot be supported either on principles of intellectual property law or on economic grounds. Because its stance nets no economic gain, the United States' position risks international condemnation to appease a vocal minority. We can avoid this unenviable position by following the lead of our trading partners abroad and opening our markets to the flow of parallel imports.

III. A TRADEMARK ANALYSIS OF PARALLEL IMPORTING[57]

Typically, arguments in favor of restricting parallel imports on trademark grounds focus on issues of fairness.[58] By allowing gray markets to flourish, so the argument goes, we compromise property interests duly established and maintained by the trademark holder.[59] Such arguments rarely stray far from economic consider-

57. By separately analyzing the economic and trademark components of the parallel importing debate, this Comment does not mean to suggest that trademark law has developed independently of economic considerations. But, as with other components of intellectual property law, trademark theory operates on the principle that an unrestrained market will not adequately protect the property interests of rights holders.

58. *See* Theodore H. Davis, *Applying Grecian Formula to International Trade:* K Mart Corp. v. Cartier, Inc. *and the Legality of Gray Market Imports*, 75 VA. L. REV. 1397 (1989); Mario Franzosi, *Gray Market - Parallel Importation as Trademark Violation or an Act of Unfair Competition*, 21 INT'L REV. INDUS. & COPYRIGHT L. 194 (1990); Timothy H. Hiebert, *Foundations of the Law of Parallel Importation: Duality and Universality in Nineteenth Century Trademark Law*, 80 TRADEMARK REP. 483 (1990); Jacob Laufer, *Good Faith and Fair Dealing with the American Consumer*, 1 COLUM. BUS. L. REV. 167 (1987); Seth Lipner, *Trademarked Goods and Their Gray Market Equivalents: Should Product Differences Result in the Barring of Unauthorized Goods from the U.S. Markets?*, 18 HOFSTRA L. REV. 1029 (1990); Daniel M. McClure, *Trademarks and Unfair Competition: A Critical History of Legal Thought*, 69 TRADEMARK REP. 305 (1979); Steve Stern, *The Parallel Importation of Trademarked Goods*, 9 EUR. INTELL. PROP. REV. 259 (1986); Michael B. Weicher, K Mart Corp. v. Cartier, Inc.: *A Black Decision for the Gray Market*, 38 AM. U. L. REV. 463 (1989).

59. *See, e.g.*, Hiebert, *supra* note 58, at 485; McClure, *supra* note 58, at 342-43.

ations, however, as parallel import proponents are quick to counter by claiming that the trademark monopoly affords local trademark holders the opportunity to overcharge consumers.[60] Any analysis of parallel importation on purely trademark grounds therefore is suspect, as it apparently fails to consider monopoly issues.

Nevertheless, trademark theorists have had some success in demonstrating that trademark theory *does* account for economic concerns, principally by enlisting consumers in the fairness debate.[61] Accordingly, trademarks have been promoted as providing bifurcated protection to both the consumer and the trademark holder.[62] Protection of the trademark holder's property interest ensures that she will continue to invest in the consistent quality of her trademarked goods. The consumer, in turn, is able to rapidly assess the quality of the goods on the basis of the trademark displayed.[63] Parallel imports, therefore, harm not only the property interests of trademark holders but also harm consumers, whose confusion over the authorized source of the goods may lead them to misassess the value of their purchase.[64]

This section considers some flaws in the viability of the trademark theorists' notion of bifurcated protection. It then analyzes the argument for restraining parallel imports on the grounds of trademark infringement in light of these weaknesses. It concludes first that consumer confusion is a thoroughly secondary concern in American trademark law. Second, it argues that in the course of protecting the trademark holder's property interest, consumer interests may actually be compromised.

A. Questioning Trademark's Bifurcated Protection

In tracing the antecedents of modern trademark law, Timothy Hiebert uncovers some of the confusion and misperceptions surrounding trademark's celebrated dual protection.[65] Controversy apparently arose with the earliest reported trademark case,[66] in which

60. *See, e.g.*, Weicher, *supra* note 58, at 489 (arguing that the Supreme Court's decision in K Mart Corp. v. Cartier, Inc., 486 U.S. 281 (1988) serves as an enforcement of trademark owner monopolies); *see also* Remington, *supra* note 15, at 99 (noting that in an effort to prevent monopoly pricing where mark holders have a dominant position in the market, the EEC Commission has used Article 86 of the Treaty of Rome to prevent discriminatory source pricing when the goods are known to be going to different markets).

61. *See, e.g.*, Hiebert, *supra* note 58, at 484.

62. McCarthy, *supra* note 3, § 2:1.

63. *Id.*

64. The nature of this confusion will depend on the specifics of the parallel importing scenario. *See infra* notes 82-89 and accompanying text.

65. Hiebert, *supra* note 58, at 486-97.

66. The case is not reported, but is cited according to various reports of *Southern v. How* (also spelled *Southerne v. Howe*) as being in 22, 23 or 33 Eliz. *See* 79 Eng. Rep. 1243 (K.B. 1686); 81 Eng. Rep. 635 (K.B. 1676); 79 Eng. Rep. 400 (K.B. 1659).

a clothier copied on his goods the mark of a competing clothier. In three separate discussions of the case, there is general disagreement about whether the plaintiff was the affected clothier or the disgruntled consumer.[67] This confusion resurfaced periodically in trademark cases until the early twentieth century. Though the dual-nature theory of trademark protection was well established by the late nineteenth century, an examination of early cases involving the parallel import of "genuine goods" raises questions about the actual scope of this protection.[68] Local trademark holders urged that their property rights were being infringed, but the courts suspected that the import of genuine goods under a common trademark neither harmed the consumer nor diminished the value of the mark.[69]

Trademark owners finally achieved a resounding victory with the midnight amendment to the Tariff Act of 1930,[70] which effectively vacated the Second Circuit decision in *A. Bourjois & Co. v. Katzel* Co.[71] *Katzel* involved the parallel importation of trademarked face powder from France. The powder was then sold in competition with the plaintiff, an American who had purchased the rights to the mark and registered it in the United States. The court found that the imported goods were genuine and that "the rights of the owner of the trade mark are not infringed."[72] However, the Senate acted quickly to make the importation of genuine goods unlawful without the consent of the American trademark holder.

The amended Tariff Act embodies several notable misunderstandings of the facts in *Katzel.* The first was that the case involved a foreign manufacturer deliberately violating the terms of its agreement with an American trademark holder.[73] In fact, Katzel was a

67. Hiebert, *supra* note 58, at 490. This debate has apparently since been resolved in favor of the view that the case was brought by the clothier. *Id.* at 492. The question remains whether the consumer ever expressed any concern over the fact that he had purchased goods with a counterfeit mark.

68. *See* Russia Cement Co. v. Frauenhar, 133 F. 518 (2d Cir. 1904); Apollinaris Co. v. Scherer, 27 F. 18 (C.C.S.D.N.Y. 1886).

69. *See, e.g., Apollinaris*, 27 F. at 19, in which Judge Wallace's opinion notes:

> The name has no office except to vouch for the genuineness of the thing which it distinguishes from all counterfeits; and until it is sought to be used as a false token to denote that the product or commodity to which it is applied is the product or commodity which it properly authenticates, the law of trade-mark cannot be invoked.

70. 19 U.S.C. § 1526 (1988).

71. 275 F. 539 (2d Cir. 1921), *rev'd*, 260 U.S. 689 (1923).

72. *Id.* at 543.

73. Senator Sutherland articulated the sentiments of proponents of the bill in a floor debate, which was limited to ten minutes of discussion, noting:

> I believe that the Senate is in favor of protecting the property rights of American Citizens who have purchased trade-marks from foreigners, and when those foreigners deliberately violate the property rights of those to whom they have sold these trade-marks by shipping over to this country goods under identical trade-marks.

62 Cong. Rec. 11,603 (1922).

third party who realized that she could purchase the foreign manufacturer's goods for the retail price abroad, repackage them and import them into the United States, and still undercut the price of the registered American trademark holder. A second misunderstanding was believing that the Second Circuit was correct in finding that the defendant was importing the "same"[74] face powder. Actually, as the district court noted, the plaintiff was free to buy his goods from any manufacturer, and even employed his own selection process in choosing which of the goods supplied by the foreign manufacturer he wished to sell.[75] The latter misunderstanding is particularly troublesome because the ensuing reliance on the court's version of the facts resulted in a ban on the parallel import of *identical* goods sold under a registered mark in the United States. Despite the faulty assumptions underlying the amended Tariff Act, theorists have argued that it represents a coherent position on the parallel importing, as it allows the registered American trademark holder to control the quality of imported goods.[76] Thus, emphasis on control over quality appears to preserve the notion that trademarks act as dual protectors of the interests of the consumer and the trademark holder.

A close examination of the legal paradigms underlying the parallel import debate shows the courts and the legislature straining to comport their decisions with this bifurcated notion of trademark protection. In actuality, the law solicitously protects the property interest of the trademark holder in relative disregard for the consumer, a conclusion that becomes apparent through an analysis of the statutory and case law responsible for the current status of parallel imports in the United States.

1. *A Modern Interpretation of Statutory and Administrative Law: Favoring the Mark Holder's Right*

The Tariff Act of 1930 granted United States trademark holders broad powers to restrict essentially all nonconsensual imports of goods bearing their mark.[77] The Bureau of Customs, however, has

74. 275 F. at 539.

75. A. Bourjois & Co. v. Katzel Co., 274 F. 856, 857 (S.D.N.Y. 1920).

76. *See* Laufer, *supra* note 58, at 173.

77. The Act states in relevant part:

> [I]t shall be unlawful to import into the United States any Merchandise of foreign manufacture if such merchandise, or the label, sign, print, package, wrapper, or receptacle, bears a trade-mark owned by a citizen of, or by a corporation or association created or organized within, the United States, and registered in the patent office [Patent and Trademark Office] by a person domiciled in the United States . . . unless written consent of the owner of such trade-mark is produced at the time of making entry.

19 U.S.C. § 1526 (1988).

taken action to moderate this position on several fronts.[78] In response to an antitrust suit brought by the government in *United States v. Guerlain, Inc.*,[79] Customs adopted administrative regulations allowing parallel importation where the foreign and domestic marks are commonly owned or controlled.[80] Relief was also available to parallel importers in cases where "the articles of foreign manufacture bear a recorded trademark or trade name applied under authorization of the U.S. owner."[81]

As noted by the Supreme Court in *K Mart Corp. v. Cartier, Inc.*, the combined effect of the Tariff Act and the attendant administrative regulations defines three parallel import scenarios, or "cases."[82] In all three cases a local distributor faces competition from trademarked goods imported through unauthorized channels. The only factor varying between the cases is the relationship between the local distributor and the manufacturer. In case one, as in *Katzel*, the distributor is totally independent of the foreign manufacturer and may be fully vested in all rights to the local mark, including the right to select other manufacturers. In case two, the foreign manufacturer and the distributor are affiliated, either through their common ownership of the local trademark or because of a structured corporate association.[83] Finally, in case three, the domestic mark holder authorizes a foreign manufacturer to use the trademark. In its sweeping consideration of the status of parallel importing, the Supreme Court held that imports should be restrained in cases one and three but that they should be allowed to flow in case two.[84]

The Supreme Court's decision in *K Mart* exposes the degree to which formalism operates in resolving parallel import disputes. If a driving concern in trademark law was preventing consumer confusion, one would expect parallel imports to be treated leniently where confusion is unlikely and strictly where confusion is prob-

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78. *See* 19 C.F.R. § 133.21 (1992).

79. 155 F. Supp. 77 (S.D.N.Y. 1957), *vacated*, 358 U.S. 915 (1958), *dismissed*, 172 F. Supp. 107 (S.D.N.Y. 1959).

80. 19 C.F.R. § 133.21(b) (1992).

81. *Id.*

82. *See* K Mart Corp. v. Cartier, Inc., 486 U.S. 281, 286 (1988) (Kennedy, J., writing for the majority and reviewing the three contexts in which gray markets arise).

83. Affiliation in case two is generally defined in 19 C.F.R. § 133.21(c)(1)-(3) (1992). Structured affiliation occurs when distributor and manufacturer "are parent and subsidiary companies or are otherwise subject to common ownership and control." 19 C.F.R. § 133.21(c)(2) (1992).

84. *K Mart*, 486 U.S. at 294. *But see* Lever Brothers Co. v. United States, 877 F.2d 101, 111 (1989) (suggesting in dicta that the Customs Bureau exception, at 19 C.F.R. § 133.21(b) (1992), allowing for parallel imports where the manufacturer and domestic mark holder are affiliated, might conflict with section 42 of the Lanham Act of 1946, 15 U.S.C. § 1124 (1988)). For an excellent discussion of the Supreme Court's opinion in *K Mart*, see Weicher, *supra* note 58.

able. But this observation is not borne out in the Court's treatment of the three gray marketing scenarios.

Take, for example, the distinction between parallel imports in case one and case two. In each instance the foreign manufacturer and enterprising third parties represent the two possible sources of gray market goods. The affiliation of the foreign manufacturer and the American trademark holder in case two does not affect the ability of third parties to purchase name brands in a foreign retail market in an attempt to undercut the price of the domestic distributor. These third parties may or may not pose a real source of consumer confusion, but they provide no basis for distinguishing between case one and case two parallel imports.

What, then, about the ability of the *manufacturer* to engage in parallel importing? Proponents of parallel import restrictions have argued that a coherent distinction between cases one and two lies in the affiliated manufacturer's diminished incentive to compete with the local trademark holder in case two.[85] Assuming that the manufacturer is supplying the domestic trademark holder in both cases one and two,[86] her economic incentive to parallel import is identical. In either case, diminution in the value of the mark will result either in decreased sales or profit margins in the future. This future loss must be offset against current gains from increased sales. The distinction between cases one and two is that the manufacturer will have a greater propensity to share her profits from parallel importing with the affiliated American mark holder in case two than with the independent mark holder in case one. In either case, however, a manufacturer is free to adopt an importing policy which is confusing to consumers. Therefore, the only coherent rationale for the Supreme Court's distinction between cases one and two rests upon

85. In addition to diminished incentive to compete arguments, there are also antitrust issues raised in United States v. Guerlain, Inc., 155 F. Supp. 77 (S.D.N.Y. 1957), *vacated,* 358 U.S. 915 (1958), *dismissed,* 172 F. Supp. 107 (S.D.N.Y. 1959). However, insofar as real worries persist that a monopoly on international trade could exist via exclusive manufacturer/distributor agreements restricting parallel imports, the solution arrived at by the Supreme Court in *K Mart* is purely formalistic. Instead of affiliated manufacturers and distributors achieving monopoly profits, manufacturers and distributors are now forced to share monopoly profits through the vehicle of a licensing agreement. It is unlikely, therefore, that anyone would persist in drawing a distinction between case one and case two parallel import restrictions on antitrust grounds.

86. The parallel imports opponent's arguments become somewhat stronger in the case in which the local trademark holder's agreement allows it to purchase from a manufacturer of its choice. Even in this case, however, the consumer confusion argument suffers from two deficiencies. First, parallel importing by the foreign manufacturer is likely to constitute a violation of its licensing agreement with the local mark holder. Legal remedies in the form of both injunctive relief and damages are therefore available to the American trademark holder without having to separately restrict the flow of parallel imports. Second, even where the manufacturer of like-marked goods differs, consumer confusion can be eliminated simply by requiring that packaging or labels bear an indication of the origin of the goods. *See* Laufer, *supra* note 58, at 168.

the concern for providing greater protection to mark holders who appear to be more vulnerable in case one.

A similar preference for the interests of the mark holder becomes apparent in examining case three, in which restrictions are placed on parallel importation of goods manufactured abroad under the authorization of an American mark holder. To be sure, the domestic mark holder may license a number of manufacturers to produce her goods. In the interests of maintaining control over quality, she may choose to restrict the import of the goods of certain manufacturers into the United States.[87] Such quality control would appear to benefit the consumer to the extent that it prevents unwitting purchases of inferior quality goods under the same mark.[88] No such benefit accrues to the consumer, however, where the local mark holder purchases and distributes the goods of a single manufacturer. In this instance, the exclusion of parallel imports may simply represent an attempt to protect disparate pricing schemes in different markets.

Regardless of whether the local mark holder licenses one or several manufacturers abroad, parallel imports will weaken her profitability. In one instance, however, consumers may share in the concerns of the mark holder, while in another they may benefit from price competition triggered by the parallels.[89] Adopting a blanket restriction on parallel imports in case three scenarios without attempting to measure the effect of these imports on the consumer prefers the interests of the trademark holder over those of the consumer.

87. Apparently this was the issue in Pepsico, Inc. v. Giraud, Consolidated Nos. 87-01887 and 87-01930, 1988 U.S. Dist. LEXIS 12864 (D.P.R. Mar. 14, 1988). There, defendants were third party importers of cola produced by authorization under the Pepsi-Cola trademark in Puerto Rico. The imported cola was found to vary markedly in quality from the Pepsi produced in the United States. *See also* Dial Corp. v. Encina Corp., 634 F. Supp. 951 (S.D. Fla. 1986) (soap manufactured in Greece under the Dial label differs in composition from the American counterpart); Parfums Stern, Inc. v. United States Customs Serv., 575 F. Supp. 416 (S.D. Fla. 1983) (allegedly counterfeit or adulterated products sold under the Oscar de la Renta label in the United States); Vivitar Corp. v. United States, 8 Ct. Int'l Trade 109 (1984) (Vivitar-labelled electronic equipment manufactured in the United States and abroad is alleged to vary in composition).

88. The confusion engendered by having separate manufacturers can itself be eliminated by requiring that labels indicate the origin of the goods. *See infra* note 112 and accompanying text.

89. Simply because the American trademark holder purchases from a single manufacturer abroad does not evidence a lack of control over quality. It may be the case, for example, that the mark holder selects from amongst the manufacturer's goods those which are appropriate to a given market. Undiscriminating import of the manufacturer's wares might therefore cause consumer confusion. This fact does not alter the basic analysis of case three imports, because the restriction on such imports makes no effort to determine whether the domestic mark holder is engaging in selective quality control.

2. *Case Law: Emphasizing the Mark Holder's Property Interest*

As might be expected, the formalism permeating gray market legislation has carried over into the case law on parallel imports. Some of the most vociferous arguments against parallel importing on consumer confusion grounds are made in case one scenarios, where the manufacturer and the distributor are wholly *independent*.[90] In many of these instances the trademark holder's sole contribution to the distributed goods is the exercise of selective quality control and the development of its own goodwill in marketing and services. Thus, case one parallel imports present an ideal opportunity to measure the degree to which the local mark holder's interest is aligned with an interest in preventing consumer confusion.

Consumer confusion is by no means a dead issue. On occasion courts have dismissed suits to restrain parallel imports on the ground that they failed to make any showing of consumer confusion.[91] However, plaintiffs frequently satisfy courts by raising consumer confusion issues based on shoddy semanticism.[92] A particularly egregious example is presented in *Osowa & Co. v. B & H Photo.*[93] *Osowa* followed an action brought by the same plaintiffs under a different name and against separate defendants in *Bell & Howell: Mamiya Co. v. Masel Supply Co.*[94] There the Second Circuit dismissed the plaintiff's action for failing to adduce sufficient evidence of the possibility of confusion.[95] In both instances the plaintiff was the exclusive distributor of Japanese-manufactured Mamiya brand cameras and peripheral products. Defendants gray marketed Mamiya products by buying them abroad and substantially undercutting plaintiff's retail prices in the United States.

The plaintiff in *Osowa* argued that it had developed a property interest in the brand name through investments in local goodwill.[96] In considering the consumer confusion arguments that had been lacking in *Bell & Howell*, the *Osowa* court noted two contentions

90. *See, e.g.*, Original Appalachian Artworks, Inc. v. Granada Elecs., Inc., 816 F.2d 68 (2d Cir. 1986); Premier Dental Prod. Co. v. Darby Dental Supply Co., 794 F.2d 850 (3d Cir. 1986); Olympus Corp. v. United States, 792 F.2d 315 (2d Cir. 1986); Debincare U.S.A., Inc. v. TOYS "R" US, Inc., No. C-87-5746-FMS, 1991 U.S. Dist. LEXIS 20236 (N.D. Cal. Dec. 19, 1991); J. Atkins Holdings v. English Discounts, Inc., 729 F. Supp. 945 (S.D.N.Y. 1990); Dial Corp. v. Encina Corp., 643 F. Supp. 951 (S.D. Fla. 1986); International Armament Corp. v. Matra Manurhin Int'l, Inc., 630 F. Supp. 741 (E.D. Va. 1986); Osowa & Co. v. B & H Photo, 589 F. Supp. 1163 (S.D.N.Y. 1984); Bell & Howell: Mamiya Co. v. Masel Supply Co., 548 F. Supp. 1063 (E.D.N.Y. 1983) *vacated and remanded*, 719 F.2d 42 (2d Cir. 1983).

91. *Bell & Howell*, 719 F.2d 42; *J. Atkins Holdings*, 729 F. Supp. 945.

92. *Premier Dental*, 794 F.2d 850; *Osowa*, 589 F. Supp. 1163.

93. 589 F. Supp. 1163.

94. 719 F.2d 42.

95. *Id.* at 45.

96. 589 F. Supp. at 1165-169.

which it found compelling: first, that consumers were potentially led to believe that the warranty offered by the plaintiff would also be available for sales made by the defendant;[97] and second, that consumers were confused by the wide price disparity between identical goods sold by the plaintiff and the defendant.[98] Yet, on closer analysis, these consumer confusion arguments not only turn out to be spurious, but also thinly disguised efforts to protect the plaintiff's property interest in the trademark.

On the issue of warranty confusion there was evidence that the plaintiff itself had contributed to the confusion by agreeing to repair nonwarranted products sold by the defendant.[99] When defendant suggested that it would offer its own warranty distinct from the plaintiff's, the court dismissed the gesture on the ground that there was no guarantee that the defendant would honor its warranties as promised.[100] However, defendant's potential failure to perform presents an issue of fraud properly raised by consumers and not the plaintiff. Defendant's offer to indicate the warranty available at the point of sale certainly seems to be an effective means of eliminating consumer confusion. The court's rejection of this offer out of hand suggests that it is more concerned with protecting the mark holder's investment in goodwill than in preventing real confusion. Other proposals made by the defendant in an effort to distinguish its own servicing from the plaintiff's were countered with the court's cryptic conclusion that "[w]hile it is no doubt true that [they] might diminish confusion[,] this would not deal adequately with the problem of confusion and loss of goodwill."[101]

The court's second argument, that consumers will be confused by the price disparity between goods sold by the plaintiff and the defendant, is acutely circular. This contention requires that we not only assume that there is a qualitative difference between the Mamiya cameras offered by the defendant and the plaintiff, but also that consumers are unaware of any such disparity. If either assumption fails, any price differential results from commonplace price competition. By presuming the existence of consumer confusion rather than requiring an adequate showing by the plaintiff, the court makes plain its preeminent concern: to insulate the plaintiff from price competition at the expense of the consumer.

In other instances, courts have manipulated legislative requirements to resolve parallel importing disputes in a manner which demonstrates their indifference to issues of confusion.[102] In *Debin-*

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97. *Id.* at 1167.
98. *Id.* at 1169.
99. *Id.* at 1167.
100. *Id.* at 1170.
101. *Id.* at 1169.
102. Debincare U.S.A., Inc. v. TOYS "R" US, Inc., No. C-87-5746-FMS, 1991 U.S.

care U.S.A., Inc. v. TOYS "R" US, Inc.,[103] an allotment of diapers trademarked "Denbi" was imported into the United States but never left the Foreign Trade Zone, as the importer was allegedly unable to pay import duties. Two years later, the importer declared bankruptcy and sold all intellectual property rights in its brand name to the plaintiff. One year after that, the plaintiff agreed to allow the bankruptcy court to sell the diapers, subject to an injunction against their resale in the United States or Canada. A full year later, in 1987, the purchaser sold the diapers to the defendant, a retailer which sold them through its stores in the United States. The court ruled in favor of the defendant on the grounds that the plaintiff "had the ability to control the quality of the goods."[104] The court's reasoning was apparently based on the fact that the plaintiff was free to ask the bankruptcy court to intervene in any manner he pleased. His agreement to a sale of the diapers conditioned on the injunction constituted a first sale and introduction of the goods into the stream of commerce.[105] Thereafter, having exercised his control over quality, he was powerless to prevent resale of the goods in the United States.

While this result may seem equitable from the perspective of protecting the interests of the trademark holder, the issue of consumer confusion remains unaddressed. The court never inquired into whether the plaintiff ever inspected the goods. Indeed there were allegations that the initial importer wished to reject the diapers on the ground that they were defective.[106] Though the court concluded the plaintiff exercised control over quality, there is no indication that he in fact ever ascertained the quality of the goods in dispute. Meanwhile, potentially defective diapers were sold under the Denbi brand name to unsuspecting consumers.

A similar deference to the interest of the mark holder is displayed in *International Armament Corp. v. Matra Manurhin International, Inc.*[107] There the plaintiff was the registered United States trademark holder for two "Walther" marks applied to handguns. The plaintiff had been marketing handguns bearing the Walther mark since 1969. At the outset the guns had been manufactured by the defendant in France, shipped to Walther in Germany where some indeterminate amount of finishing was performed, and then imported into the United States as Walther manufactures.[108] In

Dist. LEXIS 20236 (N.D. Cal. Dec. 19, 1991); International Armament Corp. v. Matra Manurhin Int'l, Inc., 630 F. Supp. 741 (E.D. Va. 1986).

103. 1991 U.S. Dist. LEXIS 20236.

104. *Id.* at *7.

105. *Id.*

106. *Id.* at *2.

107. 630 F. Supp. 741 (E.D. Va. 1986).

108. The court specifically rejected arguments that the plaintiff defrauded the

1977, plaintiff began having guns manufactured under the same marks in Alabama. In addition, in 1982 and 1983 the plaintiff sold some 9000 guns manufactured by the defendant bearing Walther markings, as well as the markings of both the defendant and the plaintiff. Summary judgment was granted to the plaintiff in its attempt to prevent the defendant from importing hand guns it manufactured under license from Walther bearing the Walther marks.[109] The court's concern with consumer confusion apparently only extended to confusion over control of the trademark, and not to inconsistencies in the quality of the goods distributed by the mark holder.[110] Indeed, if consumers were desirous of buying genuine European Walthers, they were more likely to be confused by the marketing practices of the plaintiff than the defendant.

3. *Conclusions on Bifurcated Protection*

As the above analysis suggests, consumer confusion issues do not drive trademark-based restrictions on parallel imports.[111] Extant issues of confusion would be more appropriately and thoroughly addressed by comprehensive labelling laws requiring that goods indicate such information as origin and warranty.[112] Instead, the courts protect the domestic trademark holder's ability to control quality irrespective of the fact that confusion may result, even in the case where the mark holder herself is the source of this confusion.[113] Proponents of parallel import restrictions may argue that

United States Customs Service by representing the imported pistols as Walther manufactures when they had only been finished by Walther. *Id.* at 747.

109. *Id.* at 749.

110. This conclusion is stated explicitly in Osowa & Co. v. B & H Photo, 589 F. Supp. 1163 (S.D.N.Y. 1984) as Judge Leval writes: "a trademark['s] . . . proper lawful function is not necessarily to specify the origin or manufacture of a good (although it may incidentally do that), but rather to symbolize the domestic goodwill of the domestic mark holder . . . ." *Id.* at 1171-72.

111. *See supra* notes 65-110 and accompanying text.

112. *See* Laufer, *supra* note 58, at 168 (arguing that confusion can be eliminated by "full and fair disclosure to the consumer of the facts concerning purported differences between the so-called 'authorized' goods and parallel imports"); Weicher, *supra* note 58 at 488 (1989). Note also that California and New York have adopted labelling laws to remedy confusion issues. CAL. CIV. CODE § 1797.81 (West 1988); N.Y. GEN. BUS. LAW § 218aa (McKinney 1988). The concept of labelling as a means of eliminating consumer confusion has long been a tenet of the European Community. *See, e.g.*, Case 120/78, Rewe-Zentral AG v. Bundesmonopolverwaltung fur Branntwein, [1979] 1 E.C.R. 649, 650, 26 C.M.L.R. 494 (1979) (holding that Cassis de Dijon, a French black current liqueur with an alcohol content lower than statutorily mandated in Germany, could still be marketed in Germany as labels adequately distinguished it from Cassis with higher alcohol contents). It has also been raised as an issue in courts in Asia. *See, e.g.*, Judgment of May 25, 1992 (Gin Yu Hsin Co. v. Coca-Cola Co.), Taiwan High Ct., 81 Nien Tu Su Tzu — (arguing that consumer confusion was impossible as both locally distributed goods and parallel imports displayed indications of origin).

113. *See supra* notes 92-110 and accompanying text. It was not always the case that trade-mark law was concerned primarily with preserving the mark holder's control over

while the courts may not be directly concerned with consumer confusion, protection of the consumer is implicit in any protection of the mark holder's control over quality.[114] At the root of this argument is the notion that trademarks are a guarantee of quality in the form of the goodwill of the mark holder.[115] This analysis is, however, suspect for several reasons.

One frequently voiced criticism is that the domestic mark holder is price gouging[116]—either overcharging for services or product or both. The standard response is that the parallel import proponent assumes a monopoly while trying to prove that one exists. If the local trademark holder were really overcharging for goods or services, then she would quickly find herself unable to compete with other entrants in the market. Consumers are not so unsophisticated that they will fail to purchase goods of identical value under another trademark at a lower price. So long as there are no barriers to entry, such competing brands will be readily available. Therefore, the argument goes, in order to show that the trademark holder is pricing monopolistically one must assume that certain monopoly-engendering characteristics, such as barriers to entry, are already present in the market.[117] This rebuttal simply does not ring true. The facts in *Osowa*, for example, indicate that in many instances parallel importers offered identical cameras for less than the wholesale price available to dealers.[118] In these instances local goodwill could not account for the difference in price; nor, apparently, did the presence of other entrants in the market cause the plaintiffs to

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quality. Early trademark legislation was principally concerned with preventing fraudulent activities by defendants. Act of August 14, 1876, ch. 274, 19 Stat. 141 (1876) (punishing trademark counterfeiting and dealing in goods with counterfeit trademarks).

114. The history of parallel import restrictions is punctuated with stories of foreign manufacturers who are unconcerned with the quality of their goods. As the argument goes, the diligent United States trademark holder conscientiously weeds out all examples of poor manufacture, ensuring that only premium quality goods reach the domestic market. By allowing parallel imports we harm both the consumer, who unwittingly buys lower quality trademarked goods, and the United States trademark holder, whose mark is gradually devalued as consumers realize that quality standards have slipped.

115. *See, e.g.*, McClure, *supra* note 58; A. B. Nims, *The Relationship of the Technical Trade-Mark to the Law of Unfair Competition*, 29 HARV. L. REV. 763 (1929); A. R. Rowell, *Trademarks: Relation of Trademark Infringement to the Law of Unfair Competition*, 7 CAL. L. REV. 201 (1918-19); Stern, *supra* note 58. *But see* Case 10/89, S.A. CNL-Sucal NV v. Hag GF AG, [1990] 9 E.C.R. 3711, 59 C.M.L.R. 571 (1990) (arguing that trademarks were a guarantee of both origin and quality); *Coca-Cola*, 81 Nien Tu Su Tzu No. —) (arguing that "the protection of the exclusive right to use a trade-mark is to prohibit any imitation and counterfeiting situation"); Takamatsu, *supra* note 14, at 459 (arguing that trademarks should only be enforced as guarantors of origin and quality).

116. *See, e.g.*, Laurence J. Cohen, *Gray Market Imports and the International Location of Manufacturing*, 11 N.C. J. INT'L L. & COM. REG. 171, 178-79 (1986); Laufer, *supra* note 58, at 168; Weicher, *supra* note 58, at 475.

117. Parallel importing's structural contribution to monopolistic tendencies in the market will be considered *infra* part IV.

118. Osowa & Co. v. B & H Photo, 589 F. Supp. 1163, 1166 (S.D.N.Y. 1984).

independently reduce their prices.[119]

Proponents of parallel imports also argue that the interests of the consumer may be compromised by the local trademark holder free-riding on the product's goodwill—either the goodwill she has created or the goodwill which existed prior to her purchasing rights in the mark.[120] By lowering quality and maintaining price, the trademark holder may significantly increase her margins.[121] Given sufficient lag time produced by slow consumer realization of the reduced quality of the goods, the trademark holder may have an incentive to free-ride on the prior goodwill of the product until an erosion in consumer confidence forces her to reduce the price of the goods commensurate with the quality offered. Therefore, consumer interests may not be protected by entrusting the breadth of trademark concerns solely to the trademark holder.

Trademark law should protect against depreciation in the value of a domestic mark by hindering any illegitimate appropriation of local mark holders' investments in goodwill. This Comment does not mean to ignore this concern. But restraints on parallel imports must be evaluated by contrasting the consumers' interest in price competition with a potentially unfair depreciation of the mark holder's property interest. Thus, the proper question to pose in analyzing gray marketing in the context of trademark concerns is the following: are restrictions on parallel imports the optimal means of ensuring that the mark holder can recover an investment in services attractive to consumers?

B. The Issue of Goodwill

The notion of separately protecting a trademark owner's investment in goodwill has rarely been addressed by U.S. courts. Instead, it has often been held that a joint showing of consumer confusion and a depreciating property interest in the mark is required to restrain parallel imports.[122] In shifting focus to protecting

119. *See also* Boyer, *supra* note 1, at 89 (noting that parallel importers often charge less than authorized distributors); Goodgame, *supra* note 4, at 76 (noting that Yves Saint Laurent's Opium perfume rose in price from $135 per ounce to $165 per ounce in a period when cost to distributors was reduced by 50%).

120. *See* K Mart Corp. v. Cartier, Inc., 486 U.S. 281, 286 (1988) (noting that the purchase of rights to register and sell goods under a trademark is particularly attractive where "the product has already earned a reputation for quality").

121. This may well have been part of the plaintiff's decision in International Armament Corp. v. Matra Manurhin Int'l, Inc., 630 F. Supp. 741 (E.D. Va. 1986) to have its trademarked guns manufactured and finished in Alabama rather than France and West Germany.

122. *See, e.g.*, Weil Ceramics & Glass, Inc. v. Dash, 878 F.2d 659 (3d Cir. 1989), *cert. denied*, 493 U.S. 853 (1989); Lever Brothers Co. v. United States, 877 F.2d 101 (D.C. Cir. 1989); Premier Dental Prod. Co. v. Darby Dental Supply Co., 794 F.2d 850 (3d Cir. 1986); J. Atkins Holdings v. English Discounts, Inc., 729 F. Supp. 945 (S.D.N.Y. 1990); *Osowa*, 589 F. Supp. 1163.

the mark holder's goodwill investment, two propositions present themselves: first, a mark holder can recover her goodwill investment by offering attractive services together with the trademarked goods; second, if consumers wish to forego services in exchange for price reductions, then they should be allowed to do so. The question at the outset, then, is whether goodwill can ever be so ineluctably associated with a mark that free-riding on the domestic mark holder's property interest is inevitable absent gray marketing restrictions.[123]

The theory that all products are marketed with a goodwill component is well established.[124] Mario Franzosi has argued that retail goods inevitably embody a marketing mix comprising both physical and psychological components.[125] The psychological component, or goodwill, may be divided into principal goodwill (supplied by the manufacturer) and secondary goodwill (supplied by the distributor).[126] In certain cases, the goodwill component of a product is so stable that a separation of markets via restrictions on parallel imports is unjustified.[127] In these instances, the principal goodwill greatly outweighs the secondary goodwill. Where the secondary goodwill component is more substantial, the total supply of goodwill may vary from market to market.[128] In these instances it is possible for the parallel importer to free-ride on the goodwill of the local mark holder. The parallel importer incurs lower marginal costs, as she is not providing the services offered by the local distributor. So long as consumers cannot distinguish authorized imports from parallels, the gray marketeer is able to make a low-priced, unserviced parallel look more attractive than its serviced counterpart.

Steve Stern refines the notion of differentiating goodwill, suggesting a division of trademarked goods into "A"- and "H"-types.[129] "H"-type goods (*e.g.*, champagne) have extraordinarily little variable goodwill, evidently because they are marketed with minimal attendant services. On the other hand, "A"-type goods (*e.g.*, electronics) have a large variable goodwill component which

123. A second question posed by the opposition of price competition and investments in goodwill is whether price competition may unwittingly deprive both the consumer and the mark holder of the benefits of an efficient mix of goods and services. This issue will be discussed *infra* part IV.

124. *See, e.g.*, Franzosi, *supra* note 58; Lipner, *supra* note 58; Stern, *supra* note 58; Kamen Troller, *The Parallel Importation of Trade-Marked Goods and the Protection of Selective Distribution Systems*, 3 EUR. INTELL. PROP. REV. 67 (1988).

125. Franzosi, *supra* note 58, at 195.

126. *Id.* at 198.

127. *Id.* at 207 n.36 (arguing that the paradigmatic product with a stable goodwill is a Cartier watch).

128. *Id.* at 200.

129. Stern, *supra* note 58, at 260.

the consumer intimately associates with the trademark.[130] In marketing an "A"-type product without a goodwill component, therefore, the parallel importer may capitalize on the service expectation the consumer derives from the mark. The domestic mark holder is harmed both by the loss of sales to the gray marketeer and by diminution in the value of the mark.

At the outset, the problem with the theories offered by Franzosi and Stern is that both assume the inefficacy of labelling.[131] They would have us believe that consumers may be so enamored with a mark and so convinced of its attendant goodwill that no indication on the package could possibly dissuade them from believing that they will receive the services they expect. This presupposes an unlikely lack of sophistication on the part of the consumer.

Next, Franzosi and Stern fail to provide an adequate means of discerning between "A"- and "H"-type goods.[132] Is it always the case that the consumer expects that her radio will be repaired for free? Does the consumer never expect that services will be supplied by the distributor in the sale of champagne?[133] Even if one were to accept Franzosi and Stern's notion of blind brand loyalty, their theories are vulnerable to the contention that it is the consumer and not the gray marketeer who bears the cost of protecting the local mark holder from parallel imports.

Take, for example, the domestic mark holder's loss of sales due to parallel importing. Assume that the domestic mark holder distributes radios, and that she is encountering competition from a cheaper, though physically identical,[134] parallel import. Assume also that the costs of producing the radios is identical and that the difference in price is due to the cost of local servicing.[135] It is true that the consumer may expect that her radio will come with a de-

130. *Id.* Stern assumes that when buying electronics, for example, consumers expect that their purchases will be repaired free of charge.

131. *See supra* note 112 and accompanying text.

132. Other analysts have attempted to incorporate a distinction between types of goodwill into analytical models. *See* Lipner, *supra* note 58, at 1052. Lipner suggests applying a modified version of the Hand formula in determining when restrictions on parallel imports should be imposed. Accordingly, Lipner would have the courts multiply the "probability of consumer disappointment or confusion by the gravity of the harm if it were to occur." *Id.* at 1053. This theory leaves open to question, however, how the probability of consumer confusion is to be measured. Though it provides a framework in which "A"-type and "H"-type product distinctions may be put to use, it does not tell us how these discernments are to be made.

133. *See, e.g.*, Peter C. Carstensen & Richard F. Dahlson, *Vertical Restraints in Beer Distribution: A Study of the Business Justifications for and Legal Analysis of Restricting Competition*, 1986 WIS. L. REV. 1, 31 (1986) (noting that significant rotation and refrigeration services are required of beer distributors at the point of sale).

134. Note that the assumption that the radios are physically identical does not entail the assumption that they are entirely the same. I am assuming, as do Franzosi and Stern, that the product is comprised of a market mix of physical product and goodwill.

135. If the difference in price were due to differences in manufacturing costs between

gree of service. Indeed, the market may bear proportionate increases in the price of the radio for the purposes of providing these services. But it is going too far to assume that the consumer is incapable of dissociating her desire for services from the radio itself.[136] If the cost of servicing radios increases dramatically, the consumer may be willing to forego service altogether. Similarly, she may be attracted by the presence of identical radios with fewer services at a lower price. The parallel importer may well be capitalizing on the consumer's attraction to varying product mixes, in which case parallel import restraints protect the mark holder at the expense of the consumer.

This analysis also applies to a distributor's loss from the depreciation in the value of the trademark. The domestic mark holder may wish to maintain or augment the value of her mark through an investment in goodwill.[137] She should not, however, be allowed to invoke gray market restrictions in order to force consumers to purchase services they would otherwise have foregone in favor of a cheaper unserviced parallel. If the services offered by the distributor reflect an accurate assessment of consumer demand, unserviced parallel imports pose little threat to market share. Parallel import restrictions insulate the distributor from competitive market forces, providing a sanctuary funded by unwitting consumers.

IV. AN ECONOMIC ANALYSIS OF PARALLEL IMPORTING

Proponents of restrictions on parallel imports have long had to answer the nagging contention that the gray market benefits consumers by increasing competition, reducing prices, and promoting product differentiation.[138] Critics of parallel import restrictions have often analyzed gray market cases in the context of antitrust

markets or to price discrimination, then restrictions on parallel imports would clearly be anticompetitive.

136. *See, e.g.*, *Taiwan: Fair Trade Commission Upholds Parallel Imports*, Business Taiwan, May 4, 1992, *available in* LEXIS, Asiapc Library, ALLASI File (in which C.H. Lin, head of the service department of a major Taiwanese corporation, notes: "It is up to the consumers to decide, . . . if they place emphasis on lower prices instead of after-sales services maintained by authorized agents, this is also a function of market demand and supply"). This theory has been tested in Japan, where stringent competition from parallel importers encountered by Apple computers forced a decision to price operating system software differently for purchasers of parallel imports. *See Apple Puts the Bite on Parallel Import Users*, NIKKEI INDUS. DAILY, July 14, 1990, at 14.

137. *See, e.g.*, Osowa & Co. v. B & H Photo, 589 F. Supp. 1163, 1166 (S.D.N.Y. 1984) (noting that the local camera distributors invested heavily in goodwill in the interests of developing "a continuing relationship between dealer and customer involving advice, service and the future purchase of specialized peripheral equipment"); Troller, *supra* note 124, at 67 (noting inter alia that the distributor "may want to maintain for his products an aura of exclusivity and of specialty").

138. *See, e.g.*, Cohen, *supra* note 116; Lipner, *supra* note 58; Weicher, *supra* note 58.

concerns.[139] The theory is that a scheme that successfully bars parallel imports is analogous to a system of vertical restraints[140] which creates exclusive distributorship territories.[141] So long as neither the government nor the courts regulate the creation of these exclusive territories and simply enforce restrictions on parallel imports,[142] local distributors will be free to engage in pure price discrimination.[143] Defenders of parallel import restrictions have argued that pure price discrimination occurs only rarely.[144] Moreover, much of the recent analysis of domestic territorial restraints suggest that such restraints may actually promote economic

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139. *See, e.g.*, Seth Lipner, *Gray Market Goulash: The Problem of At-The-Border Restrictions in Importation of Genuine Trademarked Goods*, 77 TRADEMARK REP. 77, 93 (1987); Takamatsu, *supra* note 14, at 437; E.C. Vandenburgh, *The Problem of Importation of Genuinely Marked Goods Is Not a Trademark Problem*, 49 TRADEMARK REP. 707 (1959). The antitrust analogy is not peculiar to U.S. markets, as noted in Remington, *supra* note 15, at 97 (noting that articles 85 and 86 of the Treaty of Rome specifically deal with the antitrust implications of limiting trade and that they have been used extensively to frustrate private attempts to limit parallel trade).

140. Vertical restraints are control mechanisms exercised along the manufacturer-distributor-retailer chain in an effort to regulate pricing and availability of goods and services. A classic example of a vertical price restraint is a manufacturer's requirement that its retailers not sell goods above a certain price. A vertical territorial restraint would restrict the number of distributors authorized to operate in a given geographic area.

141. Lipner, *supra* note 139, at 93. Lipner argues that such an "airtight restricted distribution scheme" might be considered illegal even though the Supreme Court held in Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977) that vertical territorial restraints were no longer per se illegal.

142. Recall that parallel imports are not uniformly barred in the United States. However, following the Supreme Court's interpretation of the Tariff Act of 1930, 19 U.S.C. § 1526 (1988), in *K Mart Corp. v. Cartier, Inc.*, 486 U.S. 281 (1988), there are at least two instances in which Customs authorities are required to bar parallel imports of trademarked goods. The first, commonly referred to as the "Katzel Case", is in instances where a United States registered trademark is held independently by a U.S. entity licensed to distribute trademarked goods in the United States by a foreign manufacturer. The second, case three, is in instances where a registered United States trademark holder has licensed a foreign manufacturer to produce the trademarked good abroad. *See supra* notes 77-89 and accompanying text.

143. Price discrimination occurs when different prices are charged for the same goods with the same marginal costs. Where the marginal utility derived from the goods differs among consumers, the producer has the opportunity to engage in price discrimination. If higher prices in a given area are simply a reflection of the higher marginal utility derived from the goods by consumers in that area, then the producer is engaging in *perfect* price discrimination. Where the average marginal utility derived from the goods remains the same across various regions, a higher price represents a reduction in consumer surplus known as *pure* price discrimination. *See generally* MICHAEL L. DENGER ET AL., ABA ANTITRUST LAW SECTION, AM. BAR ASS'N, FEDERAL AND STATE PRICE DISCRIMINATION LAW (1991).

144. *See, e.g.*, Miller, *supra* note 16, at 376 (noting that pure price discrimination requires inter alia a scarcity of competition, which is unlikely to occur consistently). *But see* Andrea Shepard, *Price Discrimination and Retail Configuration*, 99 J. POL. ECON. 30 (1991) (finding that persistent price differences can exist in multifirm markets with no significant barriers to entry).

efficiency.[145]

This section analyzes the synergies between parallel import restrictions and specific vertical restraint schemes. It finds two conclusions to be inevitable, irrespective of the efficacy of such restraints: first, that restrictions on parallel imports in no way contribute to the economic efficiencies that vertical restraints may produce; and second, that parallel imports may effectively counterbalance any economic inefficiencies resulting from these restraints. Restricting parallel imports, therefore, is at best neutral and at worst detrimental to the interests of economic efficiency.

A. Economic Efficiency Arguments in Favor of Vertical Restraints

Robert Bork is largely responsible for popularizing the theory that vertical restraints may contribute to economic efficiency.[146] Bork argues that manufacturers will impose vertical restraints to realize higher profits from increased sales.[147] Consumers will purchase more of a product only if distributors add value by increasing ancillary services, provided that the added cost for these services is less than the incremental value of the services to consumers.[148] Vertical restraints thus allow producers to provide a more desirable and competitive product by amalgamating goods and services.[149] Manufacturers will have no incentive to engage in inefficient behavior by imposing vertical restraints where the cost of services is greater than their incremental value to the consumer, as they would quickly find themselves unable to compete with manufacturers providing lower-priced goods with less services.[150]

At the time Bork proposed his theories, vertical restraints were

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145. *See, e.g.*, Robert Bork, *The Rule of Reason and the Per Se Concept: Price Fixing and Market Division* (pt. 2), 75 YALE L.J. 373 (1966); John J. Flynn, *The "Is" and "Ought" of Vertical Restraints after* Monsanto Co. v. Spray-Rite Service Corp., 71 CORNELL L. REV. 1095 (1986); Benjamin Klein & Kevin M. Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J.L. & ECON. 265 (1988); Wesley J. Liebeler, *Intrabrand "Cartels" Under* GTE Sylvania, 30 UCLA L. REV. 1 (1982); Howard P. Marvel, *Exclusive Dealing*, 25 J.L. & ECON. 1 (1982); Richard A. Posner, *The Next Step in the Antitrust Treatment of Restricted Distribution: Per Se Legality*, 48 U. CHI. L. REV. 6 (1981).

146. *See* Bork, *supra* note 145. *But see* F.M. Scherer, *The Economics of Vertical Restraints*, 52 ANTITRUST L.J. 687 (1983) (tracing arguments for the efficiency of vertical mergers to the economists Joseph Spengler and Lester Telser).

147. Bork, *supra* note 145, at 397.

148. *Id.* at 397-405.

149. Howard Marvel also contends that failure to prevent free-riding reduces the competitiveness of consumer goods. *See* Marvel, *supra* note 145, at 13-21 (concluding that the inability of pattern fabric manufacturers to recover their property interests in the intangible design component of their fabrics led to reductions in design expenditure and simplicity in patterns).

150. Bork, *supra* note 145, at 403.

illegal per se under judicial interpretation of the antitrust laws.[151] Any dealer voluntarily providing or contractually obliged to provide services was likely to encounter classic "free-rider" problems. Consumers would take advantage of the services provided by the full-service dealer, but would purchase the goods from discounters offering lower prices without services. Largely in response to the free-rider problem, the Supreme Court backed away from its per se rule in *Continental T. V., Inc. v. GTE Sylvania, Inc.*,[152] holding that the "rule of reason" governs the legality of vertical territorial restraints.[153] In the fifteen years since the *Sylvania* decision, considerable academic attention has focused on whether territorial restraints alone can reduce free-rider problems and thereby produce economic efficiency.[154] As will be seen below, proponents of vertical restraints tend to align themselves with Richard Posner[155] in arguing that both price and territorial restraints should be per se legal on the grounds that they enhance economic efficiency.

Four years after the *Sylvania* decision, Richard Posner expressed the suspicion that territorial restraints alone might prove ineffective in eliminating free-rider problems.[156] Posner argued that dealers could free-ride on manufacturers by foregoing services and reducing prices, thereby capitalizing in the short term on high-margin, high-volume sales.[157] He echoed the solutions proposed by economists in the sixties,[158] which suggested the use of retail price maintenance in conjunction with territorial restraints as a means of alleviating free-rider problems.[159]

Current theories propose an admixture of territorial and price restraints to combat a host of free-rider problems.[160] Benjamin Klein and Kevin Murphy have argued that simple retail price maintenance may preserve free-rider difficulties on at least two fronts.[161] Dealers may free-ride on the services provided by other dealers by

151. *See* Robert Bork, *Vertical Integration and the Sherman Act: The Legal History of an Economic Misconception*, 22 U. CHI. L. REV. 157 (1954).

152. 433 U.S. 36 (1977); *see also* Liebeler, *supra* note 145, at 2 (arguing that elimination of free-rider problems was a major factor motivating the court in Sylvania).

153. *Id.* at 59.

154. *See, e.g.*, Klein & Murphy, *supra* note 145; Liebeler, *supra* note 145; Posner, *supra* note 145.

155. Posner, *supra* note 145.

156. *Id.* at 20.

157. *Id.* at 12.

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

159. Posner, *supra* note 145, at 9. The theory is that by fixing retail prices, the only avenue left open to dealers by which to compete for consumers is through the provision of services. By fixing retail prices in accordance with the marginal cost of service provision, manufacturers can ensure that the desired level of services is provided.

160. *See* Klein & Murphy, *supra* note 145.

161. *Id.* at 266.

reducing their own services and luring customers with cut-price tie-in sales, such as when peripheral components are added to make computer sales more attractive. They may also free-ride on the manufacturer by reducing services undetected by the customer at the point of sale.[162] Because legal enforcement of contractual provisions requiring the supply of services is considered uneconomical,[163] Klein and Murphy conclude that the desired efficient mixture of product and services can only be ensured through private enforcement.[164] This is accomplished by enticing dealers to provide the desired services with the reward of a "quasi-rent stream."[165] Dealers are contractually permitted to share in the manufacturer's profits in return for the provision of services. If the desired services are not provided, the manufacturer simply terminates the contract. So long as the net present value of the quasi-rent stream is greater than the short-term profit from shirking on the service contract, dealers will continue to have an incentive to provide services. In order to maintain the value of the quasi-rent stream, manufacturers will have to employ a combination of vertical restraints such as minimum and/or maximum retail price maintenance and exclusive territories.[166] These restraints may be adjusted dynamically to ensure that the profits from shirking never exceed the discounted value of contractual compliance.[167]

B. The Contribution of Parallel Import Restrictions to Economic Efficiency

Theories on the use of vertical restraints to produce economic efficiency have evolved into a complex mixture of fluctuating restraints and manufacturer monitoring.[168] It is in this context that one may begin to see the contribution of de facto territorial restraints produced by restrictions on parallel imports as superfluous to the goal of increased economic efficiency.

Assume that the American trademark holder, A, is licensed by the foreign manufacturer, FM, to distribute product *x* within the United States. Assume also that A encounters classic parallel import problems. FM-manufactured *x* is imported into the U.S. and sold at prices undercutting A's retail dealers. The proponent of par-

162. *Id.* (citing the rotation of inventory with a limited shelf life as an example of such undetected point of sale services).

163. *Id.* at 267.

164. *Id.* at 267-70.

165. *Id.* at 269. "Quasi-rent stream" refers to the benefit derived by a distributor from the grant of an exclusive sales territory.

166. *Id.* at 270-74.

167. *Id.* at 273 (noting that, to be effective, retail price maintenance must reflect a constant monitoring of "the most obvious forms of non-price competition").

168. *See supra* notes 146-67 and accompanying text.

allel import restraints wants to argue that the parallel imports preclude A's offering the most desirable mix of product and services, thus reducing *x*'s market competitiveness. Assuming that this analysis is correct, FM would also have an interest in A's providing an ideal product/service mix and would do nothing directly to contribute to the flow of parallel imports.[169] It is possible, of course, that distributors of *x* in a country other than the United States are importing *x* in competition with A. Here again, however, FM would have an interest in eliminating the intrabrand competition in A's market, and thus would have a strong incentive to take action against distributors engaged in parallel importing.[170]

A more likely scenario describing the intrabrand competition encountered by A is one in which parallel importing is carried out by third parties who purchase *x* in a retail market outside of the U.S. In order to be able to compete effectively, third party importers will have to be able to add transport costs, import tariffs, distribution costs and their own profit margin to the retail price of *x* in a foreign market and still undercut A's retail price. The ability of third party importers to do just this reflects the fact that A's prices are being driven up by her provision of considerable services in the U.S. market.[171]

We have assumed for the time being that A is voluntarily providing the optimal mix of product and services. It is true, given this assumption, that third party parallel imports reduce A's ability to provide desired services and thus reduce *x*'s competitiveness. But even if parallel imports could be halted, long-term concerns about the continued provision of desired services would remain. Parallel

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169. If FM did directly import *x* into the United States, such imports would be both economically irrational and a violation of FM's licensing agreement with A. There is no reason to believe that A's damages would be more efficiently recovered by suing FM under parallel importing laws than under the terms of the licensing agreement.

170. According to Klein & Murphy, *supra* note 145, FM will conclude that judicially enforcing contracts violated by each of its individual distributors is uneconomical. FM might, of course, respond by using Klein and Murphy's quasi-rent strategy. Distributors would then have a disincentive to violate the conditions of their distributorship agreement, including the requirement that they not engage in sales outside of their designated territory. If the distributors violated these conditions, then FM would simply rescind their contracts, at once lending credibility to their termination threats and increasing the value of the quasi-rents offered to the other distributors. Ironically, given the existence of parallel import restrictions, FM may have less of an incentive to adopt efficient private enforcement strategies. FM may instead conclude that the legal costs of preventing distributor infringement will simply be borne by A through suit under parallel importing laws. Thus, in this context, the existence of laws against parallel importing encourages the adoption of less efficient solutions to parallel importing dilemmas.

171. This analysis assumes that A is not simply charging monopoly profits and additionally that FM is not engaging in pure price discrimination by charging A higher wholesale prices than other distributors. If either assumption is false, the interests of economic efficiency would not be served by protecting these practices through restraints on parallel importing.

import restrictions will effectively eliminate third party free-riding on A's services, but provide no protection against a future decision by A to free-ride on FM's reputation by maintaining *x*'s price and ceasing to provide services.[172] Vertical restraint theorists suggest that FM may reduce the threat of distributor free-riding through a combination of retail price maintenance and territorial restraints.[173] Once these mechanisms are in place, parallel imports will be a virtual impossibility, as importers will be unable to effectively arbitrage retail prices.[174]

It is apparent, therefore, that separate restrictions on parallel imports contribute nothing to efficiencies produced through combined vertical restraints. By the time a manufacturer has instituted a dynamic system to provide quasi-rents, she will have controlled for the kind of price competition represented by parallel imports. Separate elimination of parallel import competition merely alters the variables which manufacturers must consider in calculating quasi-rents, but does not otherwise reduce their costs in monitoring distributors.[175]

C. Vertical Restraint Inefficiency and Other Anticompetitive Arrangements

For some, the Supreme Court's decision in *Sylvania*[176] was a harbinger of vertical restraint proliferation.[177] Others remain skeptical not only because of the possibility of anticompetitive collusion,[178] but also of the economic efficiency of vertical restraints.[179] The remainder of this section considers the economic inefficiencies

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172. The potential for short-term profits derived from cutting services and maintaining price are particularly pronounced in this case, as we have already noted that the retail price of *x* embodies a significant service component. Indeed, it was costly distributor servicing on *x* which invited price competition from parallel imports in the first place.

173. *See* Klein & Murphy, *supra* note 145. It might seem at first that the exclusive territory created by effective parallel import restraints would create a quasi-rent stream sufficient to cause A to continue to provide the desired level of services. Without constant monitoring, however, FM cannot be sure that short-term profits derived from shirking services and maintaining price will not exceed the discounted value of the future rent stream.

174. This phenomenon is noted by Cohen & Cooke, *supra* note 44, at 381 (arguing that "the most obvious way of avoiding parallel imports is to adopt a relatively uniform pricing policy").

175. It may be argued that by illegalizing some if not all parallel importing, monitoring costs will be reduced by allowing manufacturers to efficiently combine manufacturer monitoring through provision of quasi-rents and border policing. However, though reduction in parallel importing opportunities may incrementally reduce monitoring costs, it can be expected that these reductions will be more than offset by the high costs of bringing suit against gray marketeers engaging in illegal importation.

176. 433 U.S. 36 (1977).

177. *See supra* notes 146-67 and accompanying text.

178. *See, e.g.*, Thomas G. Krattenmaker & Steven C. Salop, *Raising Rivals' Costs to*

which may arise from vertical arrangements and the contribution of parallel imports to countering these inefficiencies.

1. *Cartelization Through Restricting Supply*

Krattenmaker and Salop[180] have argued that vertical arrangements between a distributor and a supplier whereby the supplier agrees not to supply to competing distributors may result in the ability to charge monopoly profits.[181] By reducing or cutting off other distributors' access to necessary inputs, the colluding parties may increase competition for the remaining supply of inputs, driving up the marginal costs of competing distributors.[182] If the marginal cost rise is significant, competing distributors will be forced to raise their competitive price, affording the colluding distributor the opportunity to realize monopoly profits.[183] Colluding suppliers, rather than forming supplier cartels, will have an incentive to enter into arrangements that will reduce coordination costs, eliminate the need to police other suppliers and provide for an efficient distribution of monopoly profits.[184]

The insidious feature of these arrangements is that they require that distributors neither control a large portion of the market nor engage in a short-term reduction of price and profit in order to be effective. The primary counterstrategy requires keeping barriers to entry and expansion by noncolluding suppliers to a minimum.[185]

Depending on the industry, such barriers may exist in the form

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Achieve Power Over Price, 96 YALE L. J. 209 (1986); Ian Ayres, *How Cartels Punish: A Structural Theory of Self-Enforcing Collusion*, 87 COLUM. L. REV. 295 (1987).

179. *See, e.g.*, Scherer, *supra* note 146; William S. Comanor, *Vertical Price-Fixing, Vertical Market Restrictions and the New Antitrust Policy*, 98 HARV. L. REV. 983 (1985).

180. Krattenmaker & Salop, *supra* note 178.

181. *Id.* at 224.

182. *Id.* at 234. Krattenmaker and Salop outline a number of techniques which colluding suppliers and distributors may employ in order to raise rivals' costs. *Id.* at 234-42. These include: (1) "Bottleneck," in which all supply of a necessary input is controlled by a distributor in collusion with multiple suppliers; (2) "Real Foreclosure," in which a representative portion of the available supply of inputs is controlled by a given distributor; (3) "Cartel Ringmaster," in which a distributor obtains an agreement from suppliers to sell to its competitors at a higher price; and (4) "Frankenstein Monster," in which enough of the input supply is tied up that remaining unrestrained suppliers can successfully collude and drive up prices to the other distributors.

183. Even if the exclusionary agreements fail to secure power over price, they may reduce production efficiency by causing distributors to substitute less efficient inputs. *Id.* at 247.

184. *Id.* at 224.

185. Increasing or maintaining the supply of inputs will frustrate attempts to drive up their costs.

A secondary counterstrategy to collusive agreements requires frustrating a cartel's self-enforcing mechanisms. A cartel's need to enforce its collusive agreements is discussed in Ayres, *supra* note 178. According to Ayres, the survival of a cartel requires not only that it be able to detect breaches but that it be able to punish these breaches of economies of scale, start-up advertising or plant costs, production quotas or the like. There is, therefore, a significant chance that these arrangements will be effective in raising the market price.

2. Vertical Restraints and the Inefficient Supply of Services

F.M. Scherer discusses the possibility that effective retail price maintenance may result in a situation in which distributors are forced to supply an economically undesirable level of services.[186] Scherer notes that as long as increased service provision forces parallel shifts in demand curves, economic efficiency will be preserved in that gains in consumer surplus will exceed deadweight losses from increases in fixed costs.[187] Put simply, while increased marketing costs drive up the price of the product, they also increase consumer demand. Provided demand increases exceed cost increases, gains in consumer utility will outweigh the loss from additional spending requirements.[188] If, however, retail price maintenance forces nonparallel shifts in the demand curve, the resulting increase in fixed costs may exceed gains in consumer surplus.[189] The nonparallel shift in the demand curve assumes that the distributor is not permitted to maximize her profits. Scherer contends that this is a common byproduct of retail price maintenance, in which either low-volume dealers are not permitted to increase prices to the profit-maximizing point or high-volume dealers are forced to price above the profit-maximizing level.[190]

Greater understanding of the inefficiencies which may result from retail price maintenance may be achieved by concentrating on the distinction between the marginal and the infra-marginal consumer.[191] Marginal consumers are those whose tendency to buy is price/value activated with a relatively high degree of sensitivity. An increase in price of goods which is not commensurate with an increase in perceived value will cause the marginal consumer to buy less. The infra-marginal consumer places a greater value on the product itself and is less sensitive to changes in price and services.[192] Economic inefficiencies may occur particularly where the ratio of infra-marginal to marginal consumers in a given market is high. If the marginal consumers value services less than the in-

credibly. *Id.* at 296. Punishment techniques include use of advertising, increased total supply and decrease in input supply.

186. Scherer, *supra* note 146, at 701.

187. *Id.* at 693.

188. An extreme case occurs when the marginal cost curve is vertical. Scherer shows that in this, situation gains in consumer surplus equal deadweight loss from increased consumer costs. *Id.* at 699. Still, no net economic efficiency results.

189. *Id.* at 700.

190. *Id.* at 701.

191. *See, e.g.*, Comanor, *supra* note 179.

192. *Id.* at 991.

framarginal consumers, then services may be too low. Conversely, if marginal consumers value services more than infra-marginal consumers, then services may be too high.[193] Manufacturers may use retail price maintenance to force provision of a level of services which appeals to the marginal consumer at the expense of the infra-marginal consumer's utility. Economic inefficiencies will occur in the case where losses in infra-marginal consumer utility exceed gains in marginal consumer utility and producer surplus.[194]

D. THE EFFECT OF PARALLEL IMPORTS IN OFFSETTING ECONOMIC INEFFICIENCIES

At first blush, one would expect economists concerned with the anticompetitive effects of vertical restraints to be indifferent to restrictions of parallel imports. The schemes outlined above[195] all require some form of tacit or explicit price control which, as we have seen, may itself prove effective in frustrating parallel importing.[196] Insofar as price control plans are localized, however, parallel importing may prove to be one of the most effective means of counteracting their inefficiencies.

Under Krattenmaker and Salop's model, collusive agreements between dealers and input suppliers would resist counterstrategies, so long as there were real barriers to entry or expansion by substitute suppliers in the form of economies of scale or start-up and advertising costs.[197] Such barriers are uniquely ineffective in the case of parallel imports. Parallels can take advantage of start-up investments and economies of scale in their market of origin. They need not make these investments again in order to compete for price

193. *Id.* at 992.

194. This phenomenon may be better understood by using a numerical example. Suppose a producer's marginal cost for making a product is $1. Without providing any services, the market for this product is comprised of five consumers whose reservation price is $10 and fifteen infra-marginal consumers whose reservation price is $12. The producer will maximize her profit by charging consumers $10 for the goods. She will sell twenty items at $9 profit per item with a total producer surplus of $180. At this price there is consumer surplus of $30 (15 consumers with a reservation price of $12 X $2 which is the difference between their reservation price and the actual price) with an aggregate consumer and producer surplus of $210. Assume that the producer now discovers that by adding services costing $2 she can lure in an additional six marginal consumers with a reservation price for the combined product and services of $12, so that 21 consumers will purchase at $12. The producer now calculates her surplus from 21 sales at $189 (a gain of $9) and thus fixes her retail price at $12 forcing her distributors to supply the desired services. The result is that infra-marginal consumer surplus is reduced to 0. Moreover, the aggregate of consumer and producer surplus is also reduced $21, from $210 to $189. Hence, because of the concentration of infra-marginal consumers in the market, the producer had an incentive to add services in an inefficient manner.

195. *See supra* notes 180-94 and accompanying text.

196. *See supra* notes 168-75 and accompanying text.

197. Krattenmaker & Salop, *supra* note 178, at 268.

against supplier cartels in a foreign market. Moreover, parallel importers are not required to front advertising costs in order to introduce their product, as the trademark is already being sold in the market they are entering. In the event of parallel importing, one can assume that supplier cartels have driven prices up to the point where it is feasible to pay import tariffs and transportation costs and still compete with the cartel's price. Importers will arbitrage this retail differential until the cartels drop their prices back down to competitive levels.

The effect of parallel imports is even more striking in markets where inefficient service provision occurs as the result of high levels of infra-marginal consumers. Parallel imports appeal to precisely those infra-marginal consumers whose surplus is reduced as the result of increased fixed costs attendant to the supply of services. Indeed, parallel importers depend on these infra-marginal consumers for their success. If the market were made up of predominantly marginal consumers, then the value these consumers attached to service provision would make unserviced parallel imports unattractive even at a lower price. Without parallel imports, however, the density of infra-marginal consumers in the market would go untested and potentially inefficient service provision would be allowed to continue unchecked.

As the economic debate over the efficacy of vertical restraints continues, an analogous doctrine of parallel imports emerges unscathed. Accordingly, regardless of where one stands with respect to the efficiency of vertical restraints, one should either be indifferent to or welcome the unrestrained flow of parallel imports across international borders.

V. CONCLUSION

America's current stance on parallel importing traces back to the early twenties and to an impression on the part of Congress that the market would not or could not adequately protect the interests of the consumers and trademark holders. Since then, the courts and administrative agencies have taken pains to lessen the effect of the amendment of the Tariff Act of 1930 to the extent that they felt it underestimated the reliability of the market. Yet, recent judicial and administrative efforts are unsatisfactory because of flaws in the legislative premises which gave rise to the amended Tariff Act. Instead, as we have seen, the market will amply protect and balance the rational interests of the consumer and of local mark holders.

The infrastructure for a rule of per se legality with respect to parallel imports is not yet in place. In particular, comprehensive labelling laws which would provide, at a minimum, indications of origin and warranty on all goods flowing into the United States would be required at the federal level. Such labelling would obviate the need for complex compartmentalization and monitoring of parallel import cases and would increase the efficiency and competitiveness of the domestic market.

The implications of failing to adopt a rule of per se legality, however, go beyond the preservation of a burdensome and inefficient regulatory scheme. America promotes itself as a paradigmatic market economy. It has frequently placed pressure on Europe and Asia when it felt they were unfairly attempting to insulate their markets from competition. Now, America's own distrust of the market threatens to bring it under the scrutiny of free trade advocates abroad. The United States's stance on parallel importing may bear, therefore, not only on the efficiency of its domestic markets but on its international trade posture as well.