

# SECOND PRIZE WINNER OF THE ANDREW P. VANCE MEMO- RIAL WRITING COMPETITION

## ADDRESSING THE GREY MARKET—WHAT THE SUPREME COURT SHOULD HAVE DONE

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### INTRODUCTION

The Supreme Court of the United States recently decided a case<sup>1</sup> which resolves the scope of the Copyright Act of 1976<sup>2</sup> (Copyright Act). The result of this decision affected an area of international trade known as grey market or parallel importing. Due to the Supreme Court decision, grey market imports are no longer prohibited in the United States.

Coincidentally, the Court of Justice of the European Communities also recently decided a similar case which resulted in the opposite result.<sup>3</sup> In the European Community, grey market imports *are* prohibited. If two such distinguished Courts can come to diametrically opposed decisions regarding the issue of grey market imports, one wonders if the reasoning involved in at least one of the Courts is sound.

This Note will first define the grey market import and situations in which parallel importing can occur. Next, this Note will examine trademark and copyright laws and their

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1. See *Quality King Distribs., Inc. v. Lanza Research Int'l, Inc.*, 523 U.S. 135 (1998).

2. See 17 U.S.C. §§ 101-1101 (1994).

3. See Case C-355/96, *Silhouette Int'l Schmied GmbH & Co. KG v. Harlauer Handelsgesellschaft mbH*, 1998 E.C.R. I-4799, [1998] 2 C.M.L.R. 953 [hereinafter *Silhouette Int'l*].

applicability to a grey market importer. This examination includes a brief look at relevant case law which will be followed by a closer look at the Copyright Act of 1976. The Supreme Court decision which resolves the applicability of U.S. law to grey market imports will then be discussed. This decision will be followed by the Court of Justice of the European Communities' decision regarding a similar issue. This Note will then attempt to find a realistic compromise between the two decisions by essentially narrowing the European Court of Justice's holding and broadening the Supreme Court's. Finally, methods will be examined in which U.S. firms can circumvent the unfortunate effects of the Supreme Court decision.

#### I. PARALLEL IMPORTING DEFINED

Consider the following example:

Widgette, Inc. is in the business of manufacturing and selling widgets both in domestic and international markets. Widgette sells its product in the United States for \$10. It also sells its product in France, but because of the differences in currency exchange rates and increased competition, the price of the widget is only \$5 in French markets.

The Great Parisian Trading Company decides to purchase a large shipment of widgets at the French price of \$5 a widget. After some prospecting for a distributor, The Great Parisian Trading Company finds Hellman's Bargain-marts, Inc. to sell the widget in the United States. The shipment of widgets is sold to Hellman's at \$7 a widget. Hellman's turns around and sells the widget in the United States for \$8 a widget. In doing so, Widgette, Inc., the manufacturer of the widget, finds itself in the unusual circumstance of having to compete with its own product in the United States market. The widgets being re-imported are grey market or parallel imports.

The scenario described above is one example of how grey market imports can occur. The main reason parallel importation occurs is "because of price differences in the global marketplace."<sup>4</sup> For example, a business may attempt to enter a very competitive foreign market. As a marketing strategy, that business introduces its product in the foreign market at a

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4. Lawrence M. Friedman, *Business and Legal Strategies for Combating Grey-Market Imports*, 32 INT'L LAW. 27, 28 (1998).

substantial discount compared to its sales price for the product in the domestic market. Depending on the size of the discount, intermediaries may be able to purchase the product in the foreign market and re-import it into the domestic market for resale.

Sometimes a producer will attempt to create a consumer perception of high quality or class in regards to its product.<sup>5</sup> To assist in such a strategy, the producer will limit its distribution to upscale retailers.<sup>6</sup> Discount retailers sometimes find the product available abroad at discounted prices and import it for resale.<sup>7</sup> This undercuts the intentions of the producer.

With few exceptions, the manufacturer of the good seeks to prohibit the unauthorized importation of the good. In the United States, there are a number of strategies that may be pursued by the manufacturer of the good in order to prevent the grey market good's importation.<sup>8</sup> The main body of law which addresses this issue of grey market goods resides in copyright and trademark law.<sup>9</sup> This Note is limited in its scope as it only addresses those goods produced by companies that are authorized to do so. The issue of counterfeit merchandise will not be discussed.

## II. THE APPLICATION OF TRADEMARK AND COPYRIGHT LAWS TO THE GREY MARKET IMPORTER

### A. Trademarks

This Note will examine first how U.S. trademark law can help the manufacturer. Possessing a trademark for a good gives its owner the expectation of being able to prohibit another party from selling goods under the same trademark. A brief look at the history of case law in this area will help shed light upon whether trademark law will assist the trademark owner in preventing grey market imports.

In 1923, the Supreme Court decided *A. Bourjois & Company, Inc. v. Katzel*.<sup>10</sup> The Court held that "[o]wnership of the

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5. *See id.*

6. *See id.*

7. *See id.*

8. *See id.* at 49-50.

9. 17 U.S.C. §§ 101-1101 (1994); 15 U.S.C. §§ 1051-1127 (1994).

10. 260 U.S. 689 (1923).

goods does not carry the right to sell them with a specific mark. It does not necessarily carry the right to sell them at all in a given place."<sup>11</sup> The end result of this case seems to be that trademark holders have the right to prohibit an owner of their goods from importing and selling them.<sup>12</sup> Therefore, generally speaking, grey market goods are prohibited by U.S. trademark law.

However, in 1924, the Supreme Court seemed to advocate certain situations in which grey market goods are not prohibited by trademark law when it decided *Prestonettes, Inc. v. Coty*.<sup>13</sup> The rule taken from this case appears to be that an importer of grey market goods could rely upon the trademark to identify the good (and the source of the good), but could not use the mark to deceive the consumer where he or she would be led to believe that the trademark holder was the seller.<sup>14</sup>

The justification for this ruling comes from the Court's recognition that a U.S. trademark holder has an interest in protecting the goodwill it has generated with the U.S. consumer.<sup>15</sup> If a grey market importer was allowed to apply the trademark in a way that would lead the consumer to believe the trademark holder and the seller were one and the same, it would receive the benefit of the goodwill generated.<sup>16</sup>

The court further developed the idea of preventing confusion to the consumer with grey market imports in the cases of *Lever Brothers Co. v. United States*<sup>17</sup> and in *Societe Des Produits Nestle, S.A. v. Casa Helvetia, Inc.*<sup>18</sup> These cases regarded instances in which the grey market good was different than the good offered domestically. The *Lever* case, for example, involved a soap producer that had developed a soap designed for British tastes and a soap for U.S. tastes.<sup>19</sup> Through grey market importing, the soap designed for British tastes ended up in the U.S. markets.<sup>20</sup> The Court concluded that

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11. *Id.* at 692.

12. *See id.*

13. 264 U.S. 359 (1924).

14. *See id.* at 361, 365-66.

15. *See id.* at 368.

16. *See id.*

17. 877 F.2d 101 (D.C. Cir. 1989).

18. 982 F.2d 633 (1st Cir. 1992).

19. *Lever Brothers*, 877 F.2d at 103.

20. *See id.* at 102-03.

material physical differences in a grey market product mean that the merchandise is prohibited by U.S. trademark law.<sup>21</sup> Material differences can include many different factors, which include packaging, product configuration, product composition, and quality control procedures.<sup>22</sup> To support its conclusions, the Court stated:

We conclude that the existence of any difference between the [trademark] registrant's product and the allegedly infringing grey good that consumers would likely consider to be relevant when purchasing a product creates a presumption of consumer confusion sufficient to support a Lanham Trade-Mark Act claim. Any higher threshold would endanger a manufacturer's investment in product goodwill and unduly subject consumers to potential confusion by severing the tie between a manufacturer's [sic] protected mark and its associated bundle of traits.<sup>23</sup>

To summarize, U.S. trademark laws will prohibit grey market imports only if the importer attempts to deceive the consumer into believing that the importer and the trademark holder are one and the same or if the grey market good is materially different from the domestically sold product.

### B. Copyrights

When trying to prevent grey market imports, a manufacturer may turn to copyright law for assistance. When a person (or entity) possesses a copyright, the owner has the "exclusive right to distribute copies" of that work.<sup>24</sup> If someone were to purchase a copyrighted work, then that party is prevented from selling, renting, or otherwise distributing copies of that work without the permission of the copyright holder.<sup>25</sup>

To understand how a grey market import might be prohibited under the U. S. copyright law, a familiarity with the Copyright Act is required. Within the Act is an importation provision applying to non-pirated copies,<sup>26</sup> a provision applying to

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21. *See id.* at 111.

22. *See Societe Des Produits Nestle*, 982 F.2d at 642-43.

23. *Id.* at 641.

24. 17 U.S.C. § 602(a) (1994).

25. *See id.* §§ 106(3), 602(a).

26. *See id.* § 602(a).

distribution,<sup>27</sup> and a provision applying to first sales.<sup>28</sup> The courts have had some difficulty in resolving these three provisions because their purposes appear inconsistent and thus open to a number of different interpretations.

The Copyright Act establishes that a copyright owner possesses distribution rights for his or her copyright.<sup>29</sup> Section 602(a) extends the copyright owner's distribution rights to bar imports of the copyrighted work: "[i]mportation into the United States, without the authority of the owner of [the] copyright under this title, of copies or phonorecords of a work that have been acquired outside the United States is an infringement of the exclusive right to distribute copies or phonorecords under section 106."<sup>30</sup> This provision gives copyright owners the ability to prohibit the importation of lawfully made copies whose "distribution in the United States would infringe [upon] the U.S. copyright owner's exclusive rights."<sup>31</sup> As mentioned above, section 106(3) grants the copyright holder the exclusive right to "distribute copies . . . of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending."<sup>32</sup> The distribution right's purpose is to give copyright owners the power to control the first public distribution of a copy.<sup>33</sup>

If we equate the importation right to the copyright owner's distribution right, then it stands to reason that the two rights should be subject to the same restrictions, including the limitation known as the first sale doctrine. Confusion arises, however, when one attempts to reconcile the provision of section 109, which provides the first sale doctrine limitation on the distribution right, with the importation right. Section 109(a) states: "[n]otwithstanding the provisions of section 106(3), the owner of a particular copy . . . lawfully made under this title, or any person authorized by such owner, is entitled, without the authority of the copyright owner, to sell or otherwise dispose of

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27. *See id.* § 106(3)

28. *See id.* § 109(a).

29. *See id.* § 106(3).

30. *Id.* § 602(a).

31. H.R. REP. NO. 94-1476, at 70 (1976); S. REP. NO. 93-983, at 200-01 (1974).

32. 17 U.S.C. § 106(3) (1994).

33. *See* MELVILLE B. NIMMER & DAVID NIMMER, 2 THE LAW OF COPYRIGHT § 8.11[A], at 8-141 to 8-144 (1998).

the possession of that copy . . . .<sup>34</sup> Sometimes called the exhaustion theory, the first sale doctrine provides that once a copyright owner has released the work into the market, he or she loses the right to control any subsequent distribution of that copy.<sup>35</sup> The doctrine states that a rightful buyer of a copyrighted work can decide not only whether or not to distribute the copy (free of interference from the copyright holder), but also the conditions under which that buyer can make future sales.<sup>36</sup>

Therefore, the copyright owner who desires to prevent parallel importing of his or her work must overcome the first sale doctrine. If the copyright owner is allowed to bar the importation of copies that have already been through more than one seller, then that act is in conflict with the first sale doctrine.

The question that courts must decide is whether the first sale doctrine trumps the exclusive distribution rights (which includes importation rights) of the copyright holder. Producers of grey market goods rely upon the importation right of section 602 as a means of excluding their own goods from the U.S. market.<sup>37</sup> They argue that any "unauthorized importation is a violation of the distribution right and, therefore, an infringement."<sup>38</sup> On the other side, grey market importers seize upon the first sale doctrine to justify their conduct.<sup>39</sup> The theory is that any merchandise that is purchased abroad (legitimately) can be transferred in any way the purchaser sees fit, including the importation of the product back into the country for resale.<sup>40</sup>

The Third and Ninth Circuits split over the issue of whether the importation right is subject to the first sale doctrine. The Third Circuit in *Sebastian International, Inc. v. Consumer Contacts Ltd.*,<sup>41</sup> decided that once a copyright holder sells a copy of the work, the copyright holder has no right to

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34. 17 U.S.C. § 109(a).

35. *See id.*

36. *See id.*

37. *See* Friedman, *supra* note 4, at 36.

38. *Id.*

39. *See id.* at 37.

40. *See id.*

41. 847 F.2d 1093 (3d Cir. 1988).

control future transfers.<sup>42</sup> Furthermore, the court based its decision on the principle that the copyright holder receives his or her reward for the use of that work after the copyright holder makes a voluntary sale of a copy of the work.<sup>43</sup> In addition, the court also determined that the importation right of section 602 is not separate from the distribution right of section 106.<sup>44</sup> Therefore, both importations and domestic sales fall under the first sale doctrine.

The Ninth Circuit addressed the issue in *Parfums Givenchy, Inc. v. Drug Emporium, Inc.*<sup>45</sup> The conclusion in this case was that section 602(a) did not fall under the first sales doctrine.<sup>46</sup> Therefore, the court found, the first sales doctrine only applies to sales made within the United States.<sup>47</sup> Importations are exempt.<sup>48</sup> To find otherwise, the court noted, would render the language of section 602(a) meaningless.<sup>49</sup>

### III. *QUALITY KING DISTRIBUTORS, INC. v. L'ANZA RESEARCH INTERNATIONAL, INC.*—A RESOLUTION

The split between circuits was resolved by the Supreme Court in *Quality King Distributors, Inc. v. L'anza Research International, Inc.*<sup>50</sup> L'anza Research International, Inc. (L'anza), was a Californian manufacturer and seller of hair care products in both the United States and international markets.<sup>51</sup> Within the United States, L'anza entered into exclusive distributorships each of which had specified limits on geography and authorized retailers.<sup>52</sup> L'anza extensively advertised its products and provided special training for its retailers within the United States.<sup>53</sup> However, its foreign markets did not receive the same aggressive marketing strategies

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42. *See id.* at 1094.

43. *See id.* at 1096-97, 1099.

44. *See id.* at 1097.

45. 38 F.3d 477 (9th Cir. 1994).

46. *See id.* at 479.

47. *See id.* at 481.

48. *See id.*

49. *See id.*

50. 523 U.S. 135 (1998).

51. *See id.* at 138.

52. *See id.*

53. *See id.*

and, as a result, L'anza's foreign prices were significantly lower than those within the United States.<sup>54</sup>

In 1992 and 1993, L'anza's Malta distributor sold three multi-ton shipments of hair care products to Quality King Distributors, Inc. (King) at foreign prices.<sup>55</sup> Following the purchase, King, without L'anza's permission, imported the products into the United States and sold the products to various distributors at a discount.<sup>56</sup>

L'anza filed suit in federal court alleging that King violated the exclusive distribution rights under the Copyright Act. The district court spurned King's defense based upon the first sale doctrine and granted summary judgment to L'anza.<sup>57</sup> The Ninth Circuit affirmed the decision by concluding that reading section 109(a) (the first sale provision) to supersede section 602(a) (the exclusive importation provision) would render the latter meaningless.<sup>58</sup> It further stated that Congress enacted section 602(a) to protect U.S. copyright holders from unauthorized importations.<sup>59</sup> Grey market goods would prevent copyright holders from reaping the full benefit of their copies in the United States because the copyright holder would be unable to control his or her channels of distribution.<sup>60</sup>

The Supreme Court unanimously reversed the holding of the Ninth Circuit.<sup>61</sup> The Court determined that, after the first sale of a product, whether foreign or domestic, the buyer becomes an "owner" within the meaning of section 109(a).<sup>62</sup> "The whole point of the first sale doctrine is that once the copyright owner places a copyrighted item in the stream of commerce by selling it, he has exhausted his exclusive statutory right to control its distribution."<sup>63</sup> Therefore, the first buyer is entitled to resell the copyrighted product according to the literal terms of section 109(a).<sup>64</sup> Section 602(a) makes only unlawful impor-

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54. *See id.* at 139.

55. *See id.*

56. *See Quality King Distribs., Inc.*, 523 U.S. at 139.

57. *See id.* at 140.

58. *See L'anza Research Int'l, Inc. v. Quality King Distribs., Inc.*, 98 F.3d 1109, 1114-15 (9th Cir. 1996), *rev'd*, 523 U.S. 135 (1998).

59. *See id.* at 1115-16.

60. *See id.* at 1116.

61. *See Quality King Distribs., Inc.*, 523 U.S. at 137.

62. *See id.* at 142.

63. *Id.* at 152.

64. *See id.* at 145.

tation an infringement of the distribution rights guaranteed by section 106(3).<sup>65</sup> As a result, the Court found, the first sale doctrine trumps the rights of the copyright holder.<sup>66</sup>

As stated above, the conclusion of the Supreme Court in this case led to grey market import permissibility. Interestingly, the European Court of Justice took a different stance on this subject.

#### IV. THE COURT OF JUSTICE OF THE EUROPEAN COMMUNITIES

The European Court of Justice addressed the issue of parallel importing in *Silhouette International Schmied GmbH & Co. v. Hartlauer Handelsgesellschaft mbH*.<sup>67</sup> Silhouette was an eyeglass manufacturer that targeted its product towards higher income markets around the world under the trademark "Silhouette", which was registered in Austria and elsewhere.<sup>68</sup> Hartlauer was an eyeglass distributor that sold "bargain" eyeglasses in Austria.<sup>69</sup> Silhouette would not supply Hartlauer because it believed that distribution by Hartlauer would damage its "high quality" image perceived by consumers.<sup>70</sup>

In October of 1995, Silhouette sold some of its outdated product to a Bulgarian company, Union Trading.<sup>71</sup> Silhouette instructed that the eyeglasses be sold only in Bulgaria or the countries of the former Soviet Union and not elsewhere.<sup>72</sup> However, Hartlauer was the ultimate purchaser of the shipment and brought the eyeglasses to Austria for sale in December of 1995.<sup>73</sup>

Silhouette went to the Landesgericht Steyr (a regional law court) for an interim injunction to restrain Hartlauer from offering the eyeglasses for sale in Austria.<sup>74</sup> Silhouette based its demand upon the fact that it owned the Silhouette trademark and that its product had not been placed into the Euro-

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65. *See id.*

66. *See id.*

67. *See Silhouette Int'l, supra* note 3, at 676.

68. *See id.* at 681.

69. *See id.*

70. *See id.*

71. *See id.*

72. *See id.*

73. *See Silhouette Int'l, supra* note 3, at 681.

74. *See id.* at 682.

pean Economic Area (EEA) by it or with its permission.<sup>75</sup> Hartlauer argued that the trademark protection not be applied because Silhouette had not sold the shipment or consignment subject to any restriction on re-importing into the European Community.<sup>76</sup> The Landesgericht Steyr dismissed the action, and, on appeal, the Oberlandesgericht Linz (higher regional court) also dismissed Silhouette's action.<sup>77</sup> Finally, Silhouette appealed to the Oberster Gerichtshof (highest regional court).<sup>78</sup> The Court examined the First Trade Mark Directive<sup>79</sup> (Directive) and the explanatory memorandum to the legislation which transposed the Directive into Austrian law.<sup>80</sup> The memorandum indicated that the question of international exhaustion of trademark rights (that a trademark owner's rights were exhausted once the trademarked product was placed on the market anywhere in the world) was one to be left to judicial decision.<sup>81</sup> Therefore, the Oberster Gerichtshof referred this issue to the European Court of Justice for a ruling.<sup>82</sup>

The European Court of Justice needed to address the question of whether Austria's trademark law applied without regard to the Directive. Austrian trademark law supported international exhaustion.<sup>83</sup> In other words, the trademark owner lost his or her rights after the product was put on the market anywhere in the world. The owner could not restrict the re-importation of the product after exhaustion took place. So, in Silhouette's case, if the Austrian trademark law ruled then Hartlauer could re-import the eyeglasses and sell them in Austria.

The Directive called for exhaustion of trademark rights only if the trademarked product was placed in the European Community's market.<sup>84</sup> Therefore, if the law of the European

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75. *See id.*

76. *See id.*

77. *See id.*

78. *See id.*

79. First Council Directive of 21 December 1988 to Approximate the Laws of the Member States Relating to Trade Marks 89/104, 1989 O.J. (L 40) 1 [hereinafter Directive].

80. Explanatory Memo to the Directive. Com (80) 635.

81. *See Silhouette Int'l, supra* note 3, at 682.

82. *See id.*

83. *See generally id.*

84. *See* Directive, *supra* note 79, art. 7(1); *Silhouette Int'l, supra* note 3, at

Community held reign, then only those trademarked products which were sold outside of the Community could be prohibited from re-importation by the trademark holder. A trademarked product sold into another area of the European Community (e.g., from Austria to France) would subsequently lead to the trademark holder's rights being exhausted. Because Silhouette sold its eyeglasses outside of the Community, the trademark would not be exhausted under the Directive.

The European Court of Justice determined that the Directive limited the national trademark laws of the member states (in this case, Austria).<sup>85</sup> Its reasoning was based upon the Directive's preamble which provided for the harmonization of the substantive rules which most directly affected the internal market.<sup>86</sup> The Court held that trademark exhaustion laws fell under this categorization and therefore should be harmonized within the Community.<sup>87</sup> As a result, the European Community would adopt a trademark exhaustion policy within the Community only.<sup>88</sup> Therefore, parallel imports would be restricted if the importation came from outside the Community, but not if the trademarked product came from another member state of the Community.

#### V. THE SUPREME COURT VERSUS THE EUROPEAN COURT OF JUSTICE: WHO'S RIGHT?

To summarize, the United States, as a result of the Supreme Court's decision in *Quality King*, does not prohibit grey market imports. The European Community, as a result of the Court of Justice of the European Community's decision, prohibits grey market imports that come from outside the Community. The question that needs to be addressed is: do the benefits of allowing grey market imports outweigh the detriments?

Generally speaking, "[t]he copyright law of most countries includes an exclusive right to distribute copies of a work to the public."<sup>89</sup> Most copyright laws also provide for a first sale doc-

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85. See *id.* at 677, 688.

86. See *id.* at 684; Directive, *supra* note 79, pmbl.

87. See *Silhouette Int'l*, *supra* note 3, at 684-88.

88. See *id.*

89. Neil Weinstock Netanel, *Asserting Copyright's Democratic Principles in the Global Arena*, 51 VAND. L. REV. 217, 322 (1998).

trine of some sort.<sup>90</sup> The resulting contentious issue is whether copyright and other intellectual property holders should have the right to carve up world markets by disallowing parallel or grey market imports. One must also determine if the manufacturer's "right" to a market share (by prohibiting grey market competition) is outweighed by the consumer's "right" to have a more efficient economy.

Another important question is who should bear the cost of enforcing prohibitions of grey market imports. If the state places restrictions on them, then the manufacturer may seek to enforce these restrictions through the state's government (such as Customs in the United States). If this is the case then, in essence, the taxpayer bears the cost of restricting the grey market import. In the alternative, the manufacturer can place restrictive clauses in the foreign distributor's contract. These clauses would restrict the foreign distributor (or licensee) to selling the product within designated geographical markets. After such restrictive clauses are in place, the manufacturer has a means in which to restrict re-importation. If any grey market importation takes place, the manufacturer would bear the cost burden by seeking enforcement of the contract's restrictive clauses through the courts.

The benefits of allowing grey market imports are straightforward. Basically, price differences in the world marketplace cause grey market importation.<sup>91</sup> When a consumer is presented with two identical products, but one has a lower price, he or she will choose the cheaper one. Grey market importers argue that they provide the consumer (and sometimes retailer) with an alternative, cheaper source of merchandise which results in better price competition.<sup>92</sup> In addition, grey market importers argue that they prevent producers of affluent goods from price discrimination.<sup>93</sup>

Allowing the grey market import, or endorsing the principle of international exhaustion, has other possible benefits. Proponents of grey market importing argue that not only does it benefit consumers, but it better comports with a global mar-

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90. See *id.* at 322, n.414.

91. See Friedman, *supra* note 4, at 28.

92. See *id.*

93. See *id.*

ket by preventing economic protectionism.<sup>94</sup> As a result of removing protectionist barriers, the standard of living is improved for the country's consumers.<sup>95</sup>

One can also argue that the domestic licensor has already received a royalty for the manufacture of the good (in the form of the licensing payment). With a prohibition on grey market imports, the grey market importer would need the domestic licensor's permission to re-import the identical goods. This permission would most likely only be given for a price (perhaps a percentage of profits on re-imported goods, or a one-time fee). So, in essence, the domestic licensor receives a royalty on his or her product twice.

Although the above mentioned reasons for allowing grey market imports may have been considered by the Supreme Court in making its decision, it seems that the decision was justified more upon just an arcane exercise in statutory interpretation. In fact, the Court even inserts in their opinion the following:

The wisdom of protecting domestic copyright owners from the unauthorized importation of validly copyrighted copies of their works, and the fact that the Executive Branch has recently entered into at least five international trade agreements apparently intended to do just that, are irrelevant to a proper interpretation of the Act.<sup>96</sup>

Because people often conform their behavior to a legal rule, courts should consider the effects of their holdings on future behavior, especially in areas of law that are based upon economic incentives such as copyright law.<sup>97</sup> It seems clear that the Supreme Court did *not* consider the effects of its decision, based upon the quoted excerpt from *Quality King*.

By preventing grey market imports, a country adopts what is known as a national exhaustion policy.<sup>98</sup> This policy quite clearly benefits the copyright or intellectual property right holder. The opponents of grey market imports argue that it

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94. See Netanel, *supra* note 89, at 323.

95. See *id.*

96. *Quality King Distribs., Inc.*, 523 U.S. at 153-54.

97. See Frank H. Easterbrook, *The Court and the Economic System*, 98 HARV. L. REV. 4, 12-13 (1984).

98. See Netanel, *supra* note 89, at 323.

"interferes with their contracts with exclusive licensees."<sup>99</sup> In some situations, allowing grey market imports also provides the unauthorized reseller a free ride on the copyright holder's marketing expenditures and experience.<sup>100</sup> Therefore, an authorized U.S. licensee does not receive the full benefit of its licensing fees.

Also, many authorized sellers are bound by contract to provide quality control procedures for the product.<sup>101</sup> A grey market importer is not bound by such a contract and therefore is not required to provide any quality control procedures. As a result, the consumer may be deceived into thinking that such quality controls are in place and would therefore form a negative perception of the product purchased. An example of this would be if the consumer brings the product back for service under a warranty. The grey market reseller has no obligation to honor the warranty. As a result, the consumer receives no service for the product purchased and is deprived of a perceived benefit.<sup>102</sup>

Opponents of grey market imports argue that copyright holders should be allowed to engage in setting different prices for different territories to account for variable consumer demand and buying power.<sup>103</sup> An additional argument is that if copyright holders are unable to prevent the grey market import, then not only will they no longer export the product to other countries, but will "suffer a serious erosion of their incentive to create cultural works at all."<sup>104</sup>

If the United States were to adopt a policy of national exhaustion, copyright holders would be able to prohibit grey market imports and "distribute expressive works in developing countries at a considerably lower rate of return than in developed countries."<sup>105</sup> This could lead to greater public access to the work(s) than if the international exhaustion policy was

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99. See Friedman, *supra* note 4, at 28.

100. See *id.* A situation in which this would not occur is when the foreign distributor (from whom the importer purchased the product) has invested a similar amount in marketing as the copyright holder. This added marketing expense would be passed on to the importer by raising the price of the product.

101. See *id.*

102. See *id.* at 28-29.

103. See Netanel, *supra* note 89, at 324.

104. *Id.*

105. *Id.* at 325.

adopted.<sup>106</sup> Otherwise, less developed countries would be left out of the loop when it came to distribution of copyrighted works because copyright holders would not want to risk their own goods coming back into their own country. Having such works available to the developing country is important because "exposure to foreign works contributes to the building and consolidating of democratic institutions and democratic cultures in developing countries . . . ."<sup>107</sup>

It stands to reason that the primary beneficiaries of prohibiting grey market goods are copyright holders. The industry that maintains the majority of copyright holders is the entertainment business.<sup>108</sup> The United States' largest exporting industry also happens to be the entertainment industry.<sup>109</sup> With these facts in mind, the Supreme Court, with its decision in *Quality King*, has dealt a severe blow to one of the United States' most prevalent industries. During the recent TRIPS and WIPO Copyright Treaty negotiations, U.S. representatives worked very diligently in order to establish a national exhaustion regime within these international treaties.<sup>110</sup> However, these negotiations have not led to worldwide support for this position as of yet.

The European Court of Justice, in adopting a national exhaustion policy, has raised economic protectionist barriers for the European Community. These barriers, as stated above, will benefit the intellectual property right holder at the expense of the consumer.<sup>111</sup> The European Court of Justice's decision goes beyond the necessary scope by excluding the grey market import. It seems counterproductive that the few (the manufacturers) should prosper at the expense of the many (the consumer).

However, the Supreme Court's decision in allowing grey market imports, while benefitting the consumer, will impose problems for the manufacturer. The Supreme Court's ruling fails to take into account the manufacturer who depends upon retailer support of its product. The grey market importer can

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106. *See id.*

107. *Id.* at 326.

108. *See* Professor James Halsey, Music Business Seminar at Oklahoma City University (Jan. 15, 1994).

109. *See id.*

110. *See* Netanel, *supra* note 89, at 324-25.

111. *See infra* Part V.

sidestep the quality controls put in place by the manufacturer (customer support, warranties, etc.) and jeopardize the goodwill the manufacturer has endeavored to maintain with the consumer. The potential result is that both the manufacturer and the consumer suffer.

It is generally recognized that manufacturers can insert contractual provisions limiting the distribution of its product to certain geographical markets.<sup>112</sup> However, the foreign licensee may not always conform to these provisions (and thus grey market imports may occur). The Supreme Court's decision fails to address the possibility that the manufacturer may not be able to enforce these contractual provisions due to the foreign forum's unsophisticated legal system, the inability to gain jurisdiction in a domestic court, or other various reasons. As a result manufacturers may be left with little effective recourse.

Therefore, the Supreme Court's decision should be modified to allow prohibition of grey market imports by the intellectual property right holder in two specific circumstances. The first is when the manufacturer's product is dependent upon substantial retailer support. This situation arises when the manufacturer has invested in setting up significant quality control measures to ensure customer satisfaction with the product. In addition, these measures must be of a nature whereas they can only be reasonably monitored or implemented by the retailer. If the manufacturer can take a direct hand in the quality control measures by eliminating the retailer as a middleman (depending upon the product and the measure, an example would be setting up a direct customer support help line to the manufacturer), then any grey market import that may occur would not fall under the prohibition because retailer support would not be as vital.

The other circumstance would be when the manufacturer's contractual provisions with the foreign licensee are ineffective in preventing the grey market import from occurring. This situation would arise when the foreign licensee ignores the geographical market limitation provision placed in the licensing agreement and the manufacturer is unable to seek redress in any court. Although it can be argued that the manufacturer

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112. See Robert W. Clarida, *How to Stop Parallel Imports Despite Quality King Ruling*, INTELL. PROP. STRATEGIST, May 1998, at 1.

can simply cease to do business with that foreign licensee to stop the grey market importing, it seems unreasonable that the Supreme Court would want U.S. manufacturers to stop exporting their goods entirely as a result of the *Quality King* case. Therefore, the decision should be modified to prohibit grey market imports when the manufacturer's contractual provisions fail and are unable to be enforced in either a foreign forum or a domestic one.

#### VI. HOW TO FIGHT THE GREY MARKET WITHOUT THE SUPREME COURT'S HELP

Because the current legal regimes do little to stop parallel imports in the United States, manufacturers have to seek alternative methods to protect their interests. Copyright holders can stop or at least minimize the effects of the grey market in several ways.

The most conventional way to prevent grey market imports is to include geographical restrictions in distribution contracts.<sup>113</sup> This allows the producer to control where the product eventually goes. The problem is that the copyright holder may have difficulty in enforcing the contract within the United States.

Another way to fight grey market imports is to simply not export to countries which are known to be sources of grey market goods.<sup>114</sup> If this cannot be determined, then the manufacturer can simply cease to export entirely. Unfortunately, this will diminish the manufacturer's profitability. Most likely, the negative impact of the grey market goods will not outweigh the negative impact of ceasing to sell products abroad.

Producers can also price their exported product to more closely match their domestic prices.<sup>115</sup> Without a large enough gap between the foreign price and the domestic price, the possibility of arbitrage diminishes and the likelihood of grey market imports also diminishes because the incentive to resell the U.S. export is no longer there.<sup>116</sup>

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113. *See id.*

114. *See id.*

115. *See id.*

116. *See id.*

Another possibility is for the manufacturer to repackage its exported product so it no longer resembles its domestic product.<sup>117</sup> This strategy works if the manufacturer has invested substantially in advertising its product domestically.<sup>118</sup> Hence, when a less expensive grey market good appears, it does not resemble the domestic product with which the consumer is familiar. The name or look of the product is different. This method takes advantage of the average consumer's "aversion to the unfamiliar."<sup>119</sup>

#### CONCLUSION

The policy of international exhaustion will lead to more benefits than detriments for the nation that adopts it. The European Court of Justice's decision goes beyond the scope of necessity by allowing manufacturers too much control over their products and limiting the consumer's potential benefits from access to grey market imports. However, a nation that does adopt an international exhaustion policy must do so with certain restrictions. Grey market imports must be restricted when the manufacturer relies upon substantial retailer support. In addition, the restriction should also apply to manufacturers who are unable to restrict foreign licensees from distribution that leads to grey market importing.

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117. *See id.*

118. *See generally* Lever Brothers Co. v. United States, 877 F.2d 101.

119. *See* Clarida, *supra* note 112, at 1.