THE PARALLEL IMPORTATION OF UNAUTHORIZED GENUINE GOODS: ANALYSIS AND OBSERVATIONS OF THE GRAY MARKET

RICHARD M. ANDRADE*

1. INTRODUCTION

Trade in goods across international boundaries is the lifeblood that sustains the world's economies. Faced with a climate of international integration and the tumbling down of national, economic boundaries, so too must trade policies in trademarked goods embody that notion of unification and free movement.

The parallel importation of unauthorized genuine goods is commonly referred to as the gray market. The gray market is the innovation of the entrepreneurial arbitrageur who purchases legitimately trademarked goods at a low price in one market and then resells the same good in a higher-priced market. The goods are "unauthorized" in the sense that a manufacturer has, through assignment or sale of his trademark, authorized certain individuals—not the arbitrageur—to distribute his product in a certain geographic market. It is therefore this "intra-brand" competition between the arbitrageur and the holder of the local trademark that causes the gray market controversy.

The basic concerns are the following: (1) Should these gray market goods be allowed entry into the market? and (2) What is the proper mechanism for implementing a solution—trademark law, trade regulation, or otherwise?

This Comment proposes that the law of trademarks is wholly

* J.D. Candidate, 1994, University of Pennsylvania Law School; B.S., 1991, University of Florida. The author wishes gratefully to acknowledge receipt of the annual Samuel F. Pryor, III, Prize for Most Distinguished Comment. It is an honor to receive this award. The author also wishes to thank Anita E. Knibbe and all others for their suggestions and support. All errors are mine.
inappropriate to deal with the problem of the parallel importation of genuine goods. Trademark law is better suited to situations where trademarked goods are copied or simulated, not where the goods are genuine. Also, a national policy of excluding gray market goods at a country’s boundary is not desirable. Such blanket prohibitions tend to be over- or under-inclusive and disrupt the workings of a free competitive market. Thus, this Comment submits that through pronouncement of a clear rule of law, that is, that trademark law and exclusionary trade policies will be unavailable to seek redress, parties will be able to create their own private law through contract and organize their relationships according to those terms that will maximize their investments.

Since there is no blanket solution that will resolve all gray market disputes, the flexibility of the law of contract is the best mechanism for enforcement of any exclusive agreements between foreign trademark holders and domestic trademark holders. In some scenarios, it will be economically efficient to pursue the gray marketeer; in others, it will not. Enforcement power must be vested only in those parties which the contract contemplates. Such allocation of power will lead to the free movement of goods and to an efficient free market solution.

In order to fully understand the controversy and the prior as well as current treatment of gray market goods, this Comment is structured as follows: Section 1 defines gray market goods and outlines the controversy; Section 2 submits different theories as to why price differentials exist across international boundaries. Section 3 discusses the historical treatment of gray market goods in two parts: Section 3.1 examines the functions of trademark law to expose the conflicting interests which result when trademark law is applied and Section 3.2 discusses the theories of trademark existence and protection—universality, territoriality, and exhaustion. Section 4 sets forth the arguments on both sides of the controversy: the free-rider problem, the consumer deception problem, the trademark erosion problem and the international price discrimination issue. Section 5 attempts to discount the arguments in Section 4 by submitting that the gray market is a correction mechanism for market failure, and offers free trade as a normative preference. The Comment concludes with the proposition that the dilemmas of the gray market are best dealt with through private ordering instead of through cumbersome models of trademark law or trade policy.

https://scholarship.law.upenn.edu/jil/vol14/iss3/4
2. GRAY MARKET GOODS

Gray market goods are genuine goods that enter the marketplace through unauthorized channels of distribution. The goods are legitimately manufactured by the trademark owner or under specific authorization by such trademark holder. As such, gray market goods are not counterfeits, simulations, or copies of some original product. Nevertheless, courts and commentators have become entangled in gray market analysis that centers on the law of trademark. This focus presents an unfortunate predicament given that the tradition of common law trademark evolved to protect against counterfeits and other unauthorized simulations. Even when courts have resolved gray market controversies under the rubric of the tariff acts, the courts’ focus still improperly shifted to trademark considerations. Thus, if the merchandise at issue is of genuine and legitimate manufacture, why the controversy and confusion with respect to the regulation and treatment of gray market goods under trademark law and trade policy?

---

1 The use of the term “gray market” is perhaps inappropriate. Although the term appears throughout this Comment, it is not intended to presume any illegality or impropriety by the impression that such goods are close to being “black market” goods. A more neutral term, and for purposes of this Comment, an interchangeable term for “gray market” is “parallel import.”

2 The term “genuine” is interpreted by different commentators differently. See Kenneth W. Dam, Trademarks, Price Discrimination And The Bureau of Customs, 57 Trademark Rep. 14, 15 (1967) (goods bearing a mark which has been lawfully affixed in a foreign country, under the laws of that country are genuine); E.C. Vandenburgh, The Problem of Importation of Genuinely Marked Goods Is Not A Trademark Problem, 49 TRADEMARK REP. 707, 713 (1959) (genuine means goods that indicate the same source of origin as that which it means to the purchasing public); Michel Waelderboeck, Trademark Problems In The European Common Market, 54 TRADEMARK REP. 333, 351 (1964) (goods manufactured and trademark applied by the same person as the one who supplies the authorized trademark owner himself are genuine).

3 This point is important in considering the difficulty of applying traditional trademark law doctrine to the parallel-imports market dilemma. The Lanham Act, 15 U.S.C. §§ 1051-1127 (1988), which provides causes of action for trademark infringement, specifies that infringing goods are those that “copy or simulate” duly trademarked products. As such, the analysis of gray market goods under trademark principles is at times contorted because the goods at issue are “genuine.”

4 Since the U.S. Court of Appeals decision in A. Bourjois & Co. v. Katzel, 275 F. 539 (2d Cir. 1921), rev’d, 260 U.S. 689 (1923), there has been conflict and a lack of doctrinal guidance with respect to parallel imports. The 1980’s saw an increased level of litigation in this field that resulted in a split among
The legal and policy problems raised by the emergence of gray markets arise from conflicting interests and the desire to achieve a certain balance among a variety of property, tort, contract, antitrust, and trade considerations. Moreover, adding to the conundrum, the inability to conclusively determine the reasons for the existence of a particular gray market makes finding a readily acceptable solution to the effects of the gray markets more difficult. The following section explores the underlying circumstances that give rise to gray markets.

3. HOW AND WHY THE GRAY MARKET EMERGES

The perceived causes of gray markets that have been espoused are the following: (1) fluctuation in currency exchanges; (2) price discrimination by international manufacturers; and (3) price differentials in the authorized chains of distribution linked to legitimate, unmanipulated cost differentials. These three situations allow entrepreneurial importers to benefit from the arbitrage of international price differentials in the same product. If a product that costs $100 in the United States can be purchased for $60, including shipping costs, in France, the gray marketeer can stand to make considerable arbitrage profits by selling the imported good in the United States at a price less than $100. Thus, as to why the gray market emerges, the

the circuits as to the proper interpretation of the Customs regulations implementing section 526 of the Tariff Act of 1930, 19 U.S.C. § 1526 (1988). Although the Supreme Court attempted to clear up this murky area of the law, it was far from successful. Currently, the legislature has actively proposed legislation but nothing has come of it so far. It is this search for a sound and consistent analysis for the treatment of parallel imports that this Comment aims to address.

If one believes that gray markets arise because of $X$, then the legal and policy analysis for dealing with the effects of the market will vary from someone who believes the market arises because of $Y$. For example, if one believes that international price discrimination is responsible for the gray market, a practice that most would agree is socially undesirable and inefficient, then one's proposed treatment of parallel importers would differ from someone who believed the gray markets arose from the legitimate cost differentials engendered by doing business in the United States.

"Perceived" in the sense that the real causes of gray markets may be either too difficult to ascertain or are such a mixture of causes so as to impair the ability to identify one discrete and actual cause.

The arbitrageur will be able to undersell the authorized U.S. seller thereby diverting revenues and profits from the $100 seller into the importer's pocket. The intra-brand competition, created by the parallel importer should lower
answer is simple: there are handsome profits involved. It is the question of how gray markets emerge that is more difficult to answer.

3.1. Currency Fluctuations

The least outcome determinative explanation for price differentials that permit the existence of gray markets is the fluctuation of currency exchanges. During periods when the dollar is strong compared to other currencies, gray markets will emerge in the United States. The exchange rate differentials create the necessary price disparities that allow gray marketeers to reap their profits.

Assume an Italian manufacturer charges $100 per unit to an authorized U.S. distributor and Fr 100 to an authorized French distributor. Assume also that both sellers are required to place a 25% mark-up per unit for investment in the value of the trademark. Note further that shipping costs from France to the United States are Fr 10. When the exchange rates are $1 = Fr 1, parallel imports are economically impossible and unattractive. In the U.S. market, the price of the good will consist of the $100 per unit manufacturer's price plus a $25 per unit

the price of the good to $60 in a competitive market. To determine whether this result is good or bad, see the discussion infra Section 5 on the pros and cons of parallel imports.

Perhaps the question may be more specifically phrased: "How does the price differential that makes importation attractive come about?"

In the 1980's, the strength of the dollar dramatically increased relative to other world currencies. See Jacqueline M. Nolan-Haley, The Competitive Process and Gray Market Goods, 5 N.Y.L. SCH. J. INT'L & COMP. L. 231, 232 (1984). Not since the 1920's had so much gray market litigation been pursued in the courts, raising again the issue of how to deal with the trade and trademark problems presented by the gray market.

The other two explanations developed, price fixing and unmanipulative cost differentials, require certain presumptions that may be determinative of the desired solution; that is, they "put the rabbit in the hat." Since rate exchange fluctuations are caused by many factors beyond an individual importer's control, the analysis under this explanation can proceed on sounder doctrinal grounds.

The trademark investment can consist of advertising, point of sale displays, handsome storefronts, status ambience, etc. Note that for purposes of this illustration the trademark investment is assumed to stay constant at $25 and Fr 25 even after the currency fluctuation. This assumption may be realistic since these trademark investments are incurred in the United States and, as such, are not affected by the strength of the dollar relative to the franc.
local trademark investment, a total of $125. In the French market, the result is also Fr 125 (Fr 100 per unit manufacturer's cost plus Fr 25 local trademark investment cost). Because the exchange rate is 1:1, the dollar price in the French market is $125. A parallel importer would thus have to pay Fr 125 ($125) plus Fr 10 ($10) per unit shipping costs or a total of Fr 135 ($135) to import the good in to the United States. Accordingly, a gray market would not arise as there would be no arbitrage opportunities for the importer; that is, the importer is unable to acquire a low cost position relative to the authorized U.S. distributor.

However, if the exchange rate between dollars and francs were to change to $1 = Fr 2, the circumstances would be ripe for a gray market in the United States. The Italian manufacturer would continue to charge Fr 100 per unit to the French distributor. Yet, because the dollar value of the product in France is now $50 (Fr 100 = $50), the manufacturer's charge to the authorized U.S. distributor will be decreased from $100 to $50 as a result of competition from the foreign trademarked goods. Assuming the trademark investment remains the same in the United States notwithstanding the currency fluctuation, the total U.S. price for the trademarked good will be $75 ($50 plus $25). The total French price for the good will be Fr 125 (Fr 100 plus Fr 25). But given the 1:2 exchange rate, the dollar price of the French good will be $62.50 (Fr 125 = $ 62.50 at a $1 = Fr 2 exchange rate). Assuming shipping costs to be Fr 10 ($5), the price of the trademarked good to the gray marketeer will be $67.50. Thus, the exchange rate has effectively created a $7.50 price differential between the U.S. market and the French market that allows a parallel importer to earn substantial arbitrage profits by importing the French goods into the United States for resale.

Later in this Comment, consideration is given to the effects of the intra-brand competition generated by the parallel importer. Next, however, a second and more nefarious cause of the gray market is explored: the intentional creation of price disparities by international entities to exploit the benefits of price discrimination.
3.2. Anti-Competitive Price Discrimination

The proponents of allowing the parallel importation of goods often rely on the argument that to do otherwise would only sanction international price discrimination.\(^\text{12}\) Foreign manufacturers can behave in an anti-competitive manner by manipulating the price that they charge in different nations. For example, the manufacturer may charge $100 for the trademarked good in Japan, $110 in Germany, $75 in the UK, and $200 in the United States. It is argued that, if parallel imports are excluded from the U.S. market, the price of the trademarked good will be artificially high. The lack of intra-brand competition will allow the foreign manufacturer to extract non-competitive profits from U.S. consumers. Thus, the absence of competition leads to an inefficient valuation of the trademarked product that does not reflect the quality or the goodwill of the trademark holder.\(^\text{13}\)

Although the foregoing argument is persuasive, it is not without its weaknesses. Before an entity can price discriminate, it must exercise market power. Whether a manufacturer exercises or can exercise market power will depend on a variety of factors. Primarily, the inquiry will greatly turn on how one defines the “market” at issue.\(^\text{14}\) For example, does the market consist of the entire market of wrist watches or is the market comprised only of a particular brand of wrist watches?\(^\text{15}\) Or is the market


\(\text{\textsuperscript{13}}\) The reference to quality and goodwill relates to what has been perceived as the purpose of trademark protection. The investment in trademark capital incorporates different factors and can provide a signaling mechanism for consumers. Additionally, trademarks reduce informational costs to consumers. See John M. Illo, Vivitar Corp. v. United States: Protection Against Gray Market Goods Under 19 U.S.C. §1526, 60 S. Calif. L. Rev. 179, 211-12 (1986) (in defining “market” at issue, one should look at owner’s market power, level of competition from others, and barriers to market entry). See generally LAWRENCE A. SULLIVAN, HANDBOOK OF THE LAW OF ANTITRUST §§12 to 21 (1977) (defining relevant market).

\(\text{\textsuperscript{14}}\) See United States v. E.I. DuPont de Nemours & Co., 351 U.S. 377, 393 (1956) (footnote omitted) wherein the Court, rejecting the concept that a powerful trademark could make a single product a relevant market, states, “one cannot theorize that we have monopolistic competition in every nonstand-
defined as some intermediate position between these two alternatives? If the market is defined as anything but the market for a particular brand of goods, it will be very difficult to show that a manufacturer exercises the requisite market power to price discriminate. Without market strength, a manufacturer trying to level intra-brand competition is faced with substitute products,\textsuperscript{16} inter-brand competition,\textsuperscript{17} variations in the elasticity of the demand curve,\textsuperscript{18} and other market phenomena that undermine his attempt to extract non-competitive profits through international price fixing.

3.3. Cost Differentials Among Nations

Price differentials in authorized distribution chains can also arise because of legitimate, unmanipulated cost differentials and other market-specific circumstances. Manufacturing costs

ardized commodity with each manufacturer having power over the price and production of his own product. However, this power that... manufacturers have over their trademarked products is not the power that makes an illegal monopoly." \textit{See also} Model Rectifier Corp. v. Takachiho Int'l, Inc., 709 F.2d 1517 (9th Cir. 1983) (unpublished decision) (natural monopoly that trademark owner has over its product does not necessarily violate antitrust laws). \textit{Cf.} United States v. Guerlain, 155 F. Supp. at 83-84 (Judge Edelstein referring to the reasonable interchangeability test for determining a relevant product market established by \textit{E.I. DuPont de Nemours}, yet still finding that each trademarked product is its own relevant market).

\textsuperscript{16} The availability of substitute goods precludes charging prices above the competitive price. For example, if the competitive price of a product was $10 and the price-fixing manufacturer wanted to extract an extra $5 by changing the price to $15, then if substitute goods exist at a price of less than $15, the price fixer's attempts would be in vain. All consumers would rather purchase an acceptable substitute good at the lower price.

\textsuperscript{17} Inter-brand competition is competition between different manufacturers and trademark owners that produces a product that fulfills the same consumer needs. For example, Coca-Cola and Pepsi engage in inter-brand competition. Intra-brand competition occurs when the same trademarked product is priced differently in the same market or priced similarly yet lacks certain attributes, such as service and warranty packages. Thus, gray markets create intra-brand competition.

\textsuperscript{18} If the demand curve is inelastic, that is, very steep, price changes will cause only slight changes in volume. This allows a seller to increase his prices considerably without losing much volume. If there was a cure for AIDS, its demand curve would be very inelastic. If one increased the price above equilibrium, one would most likely not lose any customers. On the other hand, if the demand curve is very elastic, slight changes in price can result in disproportionate changes in volume. Thus, the anti-competitive manufacturer prefers his products to have an inelastic demand curve.
may differ due to disparities in raw material accessibility,\textsuperscript{19} labor costs,\textsuperscript{20} utility expenses, tax liabilities, efficiency of production facilities, government subsidies,\textsuperscript{21} and other numerous possible expenses. If a manufacturer in a high manufacturing cost nation is to preserve his mark-up profit,\textsuperscript{22} then the price of the good will have to be adjusted accordingly. The result is a difference in prices for the same trademarked good.

Consumer expectations and product life-cycles can also affect the costs involved in properly marketing a product, thereby leading to increased prices and international price disparities. Cultural differences and individualized experiences with certain trademarked products within a given country may translate into costs for some manufacturers/sellers. Also, depending on the stage of development of the product,\textsuperscript{23} more or less investment in trademark capital may be necessary to properly promote the product. Thus, it is not inconceivable that the price differentials that give rise to the gray markets occur because of cost considerations largely outside the control of the manufacturer and trademark owner. Viewed in this light, it then becomes easier to understand the gray market as a natural by-product of a working competitive market, and arguably, a desirable market mechanism to promote efficiency and low cost providers of goods.

\textsuperscript{19} There may be shipping cost differentials if all raw materials are coming from, for example, India and there are multiple destinations around the globe. Shipping to Africa may be less expensive than shipping to the United States.

\textsuperscript{20} The existence of strong labor unions or government controls can cause great discrepancies in the cost of labor per unit of manufacture. Compare wages and benefits of the non-unionized workers in Mexico with those of the unionized U.S. worker.


\textsuperscript{22} If you do not allow a seller to maintain his mark-up profit, the seller will opt to exit the market. And to the extent that it is desirable for consumers to have the product available in the market, it is socially costly to drive the seller out of the market. This assumes there are no other suppliers of the good and foreign manufacturers of the good are precluded from importing the good because of trade restrictions.

\textsuperscript{23} A newly introduced product will need more advertising and other efforts to get it accepted in the market than a mature product, which already enjoys name recognition and other attributes.
4. HISTORY OF LEGAL GRAY MARKET TREATMENT

The first case to address the gray market question was *Apollinaris Co. v. Scherer*, in which the court refused to exclude genuine goods imported into the United States through unauthorized channels. This holding was illustrative of the then dominant belief of the universality of trademark rights. Subsequently, the Court of Appeals for the Second Circuit in *A. Bourjois & Co. v. Katz* also held that a U.S. trademark owner could not preclude the entry of genuine goods into the United States. The case involved the importation and sale of genuine trademarked goods without the consent of the U.S. trademark owner. The U.S. trademark owner had purchased the United States operations of a French face powder manufacturer, including the rights to two U.S. trademarks: "Java" and "Bourjois." The district court enjoined the sale. On appeal, although it was established that the U.S. trademark owner had invested considerable sums in the development of a domestic market, the Court of Appeals reversed the holding of the district court and held that there could be no trademark infringement because the sale of genuine goods did not confuse consumers. It was this Court of Appeals decision that catalyzed the dispute and controversy over the proper application of trademark law and whether the exclusion or inclusion of gray

---

24 27 F. 18 (C.C.S.D.N.Y. 1886).
25 A series of other decisions had held that the importation and sale of genuine articles could not constitute trademark infringement because the purpose of trademarks is to denote authenticity. See, e.g., Hunyadi Janos Corp. v. Stoeger, 285 F. 861 (2d Cir. 1922); Fred Gretsch Mfg. Co. v. Schoening, 238 F. 780 (2d Cir. 1916) (interpreting section 27 of the Trademark Act of 1905); see discussion infra Section 3.2 concerning the universality/exhaustion principle of trademark law.
26 275 F. 539 (2d Cir. 1921).
27 Id. at 540.
28 Id.
29 Id.
30 Id. at 539-40.
market imports should be advocated.

While *Katzel* was pending appeal to the Supreme Court, Congress, prodded by the perceived inequities of the Second Circuit's decision, passed section 526 of the Tariff Act.\(^\text{32}\) Section 526 denies access to the U.S. market of any goods that bear a registered trademark owned by a U.S. corporation or citizen unless the importer has permission from the trademark owner.\(^\text{33}\) It is the interpretation of this "midnight amendment"\(^\text{34}\) to the Tariff Act that has fueled the confusion in the area of gray market goods.\(^\text{35}\)

As the U.S. Customs Service is responsible for the interpretation of section 526, it is useful to consider the agency's treatment of this section before advancing arguments in favor of different interpretations of section 526. The customs regulations have had an erratic history. The regulations originally adopted after enactment of section 526 in 1922 and its reenactment in the 1930 Act, although providing little guidance, appeared consistent with the letter of the Tariff Act.\(^\text{36}\)

In 1936, the regulations were amended by adding a provision that did not exclude the genuine imports if "the same person, partnership, association or corporation" owned the foreign and


\(^{33}\) Section 526 provides in part:

> [I]t shall be unlawful to import into the United States any merchandise of foreign manufacture if such merchandise, or the label... bears a trademark owned by a citizen of, or by a corporation or association created or organized within, the United States, and registered in the Patent and Trademark Office... unless written consent of the owner of such trademark is produced at the time of making entry.

*Id.* § 1526(a).

\(^{34}\) The full Senate debated § 1526 under a "five minute rule," 62 CONG. REC. 11,602 (1922), during which time it was characterized by the senator from New Hampshire as a "midnight amendment." *Id.* at 11,603. See also *Vivitar Corp. v. United States*, 761 F.2d 1552, 1563 (Fed. Cir. 1985), *cert. denied*, 474 U.S. 1055 (1986).


\(^{36}\) The regulations provided: "Prohibition of entry—Entry is prohibited of imported merchandise *bearing a genuine trade-mark* when such trade-mark is recorded with the Treasury Department and registered under the trade-mark law of February 20, 1905...." *Vivitar Corp. v. United States*, 761 F.2d 1552, 1566 (Fed. Cir. 1985), *cert. denied*, 474 U.S. 1055 (1986).
domestic marks. In 1953, there was a further expansion of the 1936 regulations to exempt "related companies" from the reach of section 526. Nonetheless, this interpretation was short-lived as the Customs Service retreated to the 1936 interpretations in 1959.

In 1972, the regulations were again changed to further limit the scope of section 526. While maintaining the "same person" limitation, the new regulations added limitations for situations of "common ownership or control" of the trademark. Very recently, in response to the Supreme Court's ruling in *K Mart Corp. v. Cartier, Inc.* that the "authorized use" exemption is inconsistent with the language of section 526, Customs has again revised the regulations to exclude the former 19 C.F.R. § 133.21(c)(3). This lack of uniformity and consistency as seen in the patchwork of the Customs regulations is representative of the confusion that exists with respect to the importation of unauthorized genuine goods.

---

37 *Id.*

38 "Related companies" refers to that relationship as defined under section 45 of the Trademark Act of 1946, 15 U.S.C. § 1127 (1988). *See Vivitar*, 761 F.2d at 1566 n.20 ("[R]elated company . . . means any person who legitimately controls or is controlled by the registrant or applicant for registration in respect to the nature and quality of the goods or services in connection with which the mark is used.").

39 *Vivitar*, 761 F.2d at 1567.


41 486 U.S. 281 (1988). *K Mart Corp.* was a consolidation of three cases that challenged the validity of the Customs regulations interpreting section 526. A unanimous Court agreed that the regulations were valid as they applied to the *Katzel* case scenario and to a foreign parent/U.S. subsidiary scenario. A 5-4 majority (Brennan, White, Marshall, Stevens, and Kennedy) approved the regulations as they applied to an incorporated foreign subsidiary of the U.S. firm and to an unincorporated foreign division of the U.S. firm. A different 5-4 majority (Rehnquist, Blackmun, O'Connor, Scalia and Kennedy) held the "authorized use" exemption as invalid. *See Supreme Court Upholds Most of Customs Regulations Allowing Gray Market Imports, 54 Antitrust & Trade Reg. Rep. (BNA) No. 1368, at 953 (June 2, 1988).*


43 Recently, there has been much proposed legislation in the gray market area. Rep. Chandler (R-Wash.) introduced a bill called the "Price Competitive Products Act of 1989," H.R. 771, 101st Cong., 1st Sess. (1989). This bill would go beyond the holding in *K Mart Corp.* by upholding the right of retailers to purchase gray market merchandise. Sen. Chafee (R-R.I.) also tried to introduce a bill that would codify the 1972 customs regulations into the text of section https://scholarship.law.upenn.edu/jil/vol14/iss3/4
This Comment disavows the history of the regulations interpreting section 526 on the theory that this section of the tariff legislation resulted from a fatal misunderstanding of the 

Katzel case.

While it is evident that Congress intended to overrule Katzel, it is also clear that Congress did not understand the situation presented by the facts of the case. The Senate misunderstood the identity of the gray market importer. Evidence of this confusion is adduced from the comments of certain senators. Sen. Howard Sutherland (R-W. Va.) argued that the purpose of the bill was to protect U.S. individuals that have purchased trademarks from foreigners who then "deliberately violate the property rights of those to whom they have sold these trademarks by shipping over to this country goods under those identical trademarks." A similar misperception as to the gray market perpetrator was also evidenced by the comments of Sen. Porter McCumber (R-N.D.). He perceived the Second Circuit's decision as holding that ownership of a trademark "did not protect the party at all against importations of the article from the very firm which sold [the trademark]."

Upon a reading of the Katzel case, it is clear that the importer was a third party, not the original trademark holder as was misunderstood by the senators. Further, as indicated by the


46 62 CONG. REC. 11,602, 11,603 (1922).

47 BIOGRAPHICAL DIRECTORY, supra note 45, at 1369.

48 62 CONG. REC. at 11,605.

49 From the comments made by the senators, it would seem that the intended purpose of section 526 was to protect U.S. purchasers of foreign owned
conference report on the legislation, Congress was also under the mistaken impression that *Katzel* was an import exclusion case rather than a trademark infringement case. As a result, it is fruitless to grapple with section 526 and the Customs regulations in attempting to arrive at a solution to the problem of gray market goods.\(^5\) The focus should shift from trying to conform to the framework of the regulations and the Tariff Act\(^6\) to an analysis of the functions of trademarks and to the question of whether trademark laws are reliable sources for use in resolving dilemmas in trade policy.

### 4.1. The Functions Of Trademarks\(^7\)

Trademarks perform certain functions that, although not determinative of the proper treatment of gray market products, 

trademarks from fraud and breaches of contract by the vendors of such marks. Yet, if this is the case, then it weakens further the trademark foundations of section 526. Fraud and breach of contract can be more appropriately dealt with under tort and contract principles, not trademark principles. For a discussion of contract enforcement in foreign nations, see 3 ERNST RABEL, *THE CONFLICT OF LAWS: A COMPARATIVE STUDY* 357-91 (2d ed. 1964).

\(^5\) It has been argued that had the Supreme Court decision in *Katzel* been handed down sooner, section 526 would not have been enacted. Also, it is argued that the holding in *A. Bourjois & Co. v. Aldridge*, 263 U.S. 675 (1923) (memorandum opinion) (answering in the affirmative questions certified by the Second Circuit that genuine goods entering the market through unauthorized channels can infringe a domestic trademark) would have similarly obviated the need for section 526 of the Tariff Act. See *Vivitar*, 761 F.2d at 1565 (noting the aforementioned arguments).

\(^6\) There are many varied cases that have come out one way or the other by manipulations of the statute and the regulation to mean whatever the court wishes them to mean. *See, e.g.*, Model Rectifier Corp. v. Takachiho Int’l, 221 U.S.P.Q. 502 (9th Cir. 1983) (finding genuine goods as causing the requisite confusion for infringement); Selchow & Righter Co. v. Goldex Corp., 512 F. Supp. 19 (S.D. Fla. 1985). *But see* Bell & Howell: Mamiya Co. v. Masel Supply Co., 719 F.2d 42 (2d Cir. 1983) (finding no confusion from genuine goods); Monte Carlo Shirt, Inc. v. Daewoo Int’l (America) Corp., 707 F.2d 1054 (9th Cir. 1983); El Greco Leather Products, Inc. v. Shoe World, Inc., 599 F. Supp. 1380 (E.D.N.Y. 1984), rev’d, 806 F.2d 392 (2d Cir. 1986), cert. denied, 484 U.S. 817 (1987). Such inconsistent results among the circuits led to the Supreme Court’s ruling in *K Mart Corp.*, an ill-advised attempt to provide guidance in the area of gray market goods.

\(^7\) For the judicial development of trademarks from merchant’s marks (indicia of ownership) and production marks (indicia of origin of source of manufacture), see ROGER E. SCHECHTER, *HISTORICAL FOUNDATIONS OF TRADE-MARK LAW* (1925). *See also* Standard Brands, Inc. v. Smidler, 151 F.2d 34, 37-43 (2d Cir. 1945) (Frank, J., concurring).

https://scholarship.law.upenn.edu/jil/vol14/iss3/4
may provide some guidance in steering towards an adequate solution. These functions are: (1) the origin function, (2) the quality guarantee function, (3) the consumer-informational-cost reduction function, (4) the manufacturer’s goodwill manifestation function, and (5) the advertising function.

The origin function of trademarks serves to identify the source of the goods. Although “origin” traditionally refers to a certain manufacturer or certain distribution channel, because of the likelihood that certain trademarked goods may be manufactured by different parties, the origin function also serves to identify the product at issue, irrespective of the manufacturer.

The quality guarantee function of trademarks assures consumers that all products bearing a certain trademark will conform to an expected level of quality. Note that the trademark does not necessarily denote high quality; it only denotes that the similarly trademarked products will be of consistent quality. This guarantee function of trademarks is based on consumer experience and expectancy.

Next, trademarks reduce the information gathering costs to consumers. Arguably, in a world without trademarks, it would be very costly and inefficient for consumers to seek out information about every product before committing to a purchase. Consumers would have to rely on the market for information and risk deception or other market failures in attempting to acquire goods. The existence of trademarks assures a minimum level of information concerning the origin and the quality of the goods as previously discussed. Thus, trademarks offer a more efficient method for consumers to go about their purchases by reducing the aggregate information costs.

Further, trademarks are an objective manifestation of the intangible capital invested in goodwill and other reputation-maintenance investments. Hence, this function of trademark
allows a seller to conceptualize the fruits of his investment. Without trademarks, all investments in goodwill and reputation may be disparaged by goods that perform similar tasks. The enforcement of trademarks precludes the ability of others to misappropriate the investments of a certain mark owner; that is, it minimizes the free-rider problem.\(^{57}\)

Lastly, the trademark also plays an important role in selling and advertising. Prestige or fad items are purchased because of the trademarks affixed thereto. An item may become more desirable and its demand curve less elastic if accompanied by a stylish trademark. The mark is a "merchandising short-cut which induces a purchaser to select what he wants, or what he has been led to believe he wants."\(^{58}\) Trademarks also benefit the manufacturer through the exposure of the mark to consumers at no extra charge. For example, the more consumers are exposed to X brand, the more likely they are to remember the product and thereby be induced to make a purchase.

The functions of trademark have served as the basis for many of the arguments for and against excluding gray market goods. In fact, the dichotomy in court opinions that either allow or disallow parallel imports is maintained by disputes as to the purpose of trademarks vis-a-vis genuine goods.\(^{59}\) The following section of this Comment develops the theories advanced by the various participants in the gray market controversy.

4.2. Trademark Right Theories

The theories espoused concerning trademark rights are the following: (1) the universality principle, (2) the territoriality principle, and (3) the exhaustion principle.

Under the universality principle, trademark rights are considered an extension of the personality of the first user. The

---

\(^{57}\) The free-rider problem refers to the ability of market participants to partake in other sellers' returns of trademark investment. This can be seen in the case of counterfeit products. See discussion infra Section 5.1 ("The Free-Rider Problem").

\(^{58}\) Mishawaka Rubber & Woolen Mfg. Co. v. S.S. Kresge Co., 316 U.S. 203, 205 (1942) (arguing that "[i]f it is true that we live by symbols, it is no less true that we purchase goods by them.").

\(^{59}\) It is posited that those decisions allowing the importation of unauthorized genuine goods under some analysis bearing the trappings of trademark law are better understood as rejecting the applicability of trademark law in the gray market context—an approach this Comment seeks to advocate.
inquiry will only proceed as far as whether the trademark had been lawfully affixed in a foreign country. Thus, based on universality, the trademark represents the good on a world-wide basis. Genuine goods, either from authorized or unauthorized channels, alert the consumer as to the proper source of origin. By so signaling the consumer, the requisite element of confusion that is tantamount to a claim of trademark infringement is nonexistent. As Justice Holmes has said, "When the mark is used in a way that does not deceive the public we see no such sanctity in the word as to prevent its being used to tell the truth." Universality thus focuses on the origin of the goods and the desire to avoid consumer deception. It advocates protection of trademarks for the consumer's sake, not the trademark owner's sake.

In a sequel case to *Katzel*, the Supreme Court effectively overruled the principle of universality and advanced the territoriality principle. Territoriality provides the trademark holder with a separate set of rights and protections in each individual country in which the trademark is registered. The principle recognizes that the U.S. trademark owner's rights belong to the owner only in the United States, and that, within the United States, the mark indicates that the goods come from the trademark owner. The underpinning of the territoriality principle is that the domestic trademark holder has made significant investments in trademark capital. Since there

---

60 For an example of the universality theory, see Apollinaris Co. v. Scherer, 27 F. 18, 20 (C.C.S.D.N.Y. 1886) (trademark name vouches for genuineness of the article by which it has become identified by association) and the Second Circuit's decision in A. Bourjois & Co. v. Katzel, 275 F. 539, 543 (2d Cir. 1921) (if goods sold are genuine goods covered by trademark, the rights of the trademark owner are not infringed), rev'd, 260 U.S. 689 (1923) (Holmes, J.) (holding that ownership of goods does not carry the right to sell them with a specific mark).


62 A. Bourjois & Co. v. Aldridge, 263 U.S. 675 (1923) (per curiam). See also John F. Atwood, Import Restrictions on Trademarked Merchandise—The role of the United States Bureau of Customs, 59 TRADEMARK REP. 301, 305 (1969) (noting that the generally accepted effect of *Katzel* and *Aldridge* was to overrule the classic universality principle); J. McCarthy, TRADEMARKS AND UNFAIR COMPETITION §§ 26.12, 26.17 (2d ed. 1984) (defining the territorial scope of trademark rights); *Katzel*, 260 U.S. at 692.

63 2 McCarthy, supra note 62.

64 *Katzel*, 260 U.S. at 692.

65 Trademark capital refers to the development of goodwill and business
may be disparities among the amount of capital invested in foreign countries by holders of the same mark, trademark law rooted in territoriality should seek to preserve the investment of the trademark holder. The focus is no longer upon consumer confusion but preservation of a seller’s goodwill, thus evincing a greater concern for property rights.\footnote{Justice Pitney has expressed this property rights notion:
Common-law trade-marks, and the right to their exclusive use, are of course to be classed among property rights; but only in the sense that a man’s right to the continued enjoyment of his trade reputation and the good-will that flows from it, free from unwarranted interference by others, is a property right, for the protection of which a trade-mark is an instrumentality. Hanover Star Milling Co. v. Metcalf, 240 U.S. 403, 413 (1916) (citations omitted).}

The exhaustion theory exists in two variations. The first is that trademark rights are universally exhausted when a trademark owner places the goods into the stream of commerce.\footnote{Note the similarity with the universality principle; that is, the exhaustion applies on a world-wide basis.} The buttressing thrust of this variation is that the trademark owner has already realized the returns on trademark capital by placing the goods in the marketplace. In this sense, although the end result—allowance of parallel imports into the market—is the same as under the universality theory, the focus is no longer on the origin of the goods and consumer protection. The analysis rests on the trademark owner realizing the expected benefits of the trademark investments.\footnote{This distinction is important in the case where there is no consumer confusion as to origin, yet for some reason there has been no return on trademark capital. The universalist would not exclude the gray market good as the requisite confusion is missing while the exhaustionist would exclude the good. For the exhaustionist, the trademark rights have not ceased to exist because the terminating event—realization of the trademark benefit—has not occurred.}

The second variation of the exhaustion theory is perhaps nothing more than a reiteration of the territoriality principle. The second variation applies when the trademark owner has developed a separate and independent local goodwill. Since exhaustion hinges on the realization of trademark returns, those that adhere to the second variant of exhaustion argue that the foreign manufacturer’s introduction of the product into the market, although exhausting that manufacturer’s rights, does not affect
the local owner's trademark rights. Doctrinally, these rights can only cease to exist upon realization of returns on the added individual investment incurred in developing a local reputation. Yet, this seems to be the same as the territoriality argument made above. Recall that the territoriality principle allows rights to exist in separate countries because of a desire to preserve the local owner's investment. So too, the focus of exhaustion principles is the preservation of investment returns.68

As far as which of the foregoing principles is best suited to deal with the gray market, this Comment argues that any theory grounded in trademark law is improper. Nevertheless, the universality theory and the first variant of the exhaustion theory are attractive in that they are less restrictive of free trade. The anti-exclusion effect of these two approaches may in fact be a recognition, possibly subconscious, that trademark law should not be used to exclude genuine goods from the marketplace. That the courts did not find trademark infringement indicates that the law of trademarks is inapposite. As will be developed later, it is argued that the laws of torts, contracts, and economics are sufficient to deal with the gray market phenomenon.

5. ARGUMENTS IN THE CONTROVERSY

The arguments advanced by those that seek to exclude gray market products are the following: (1) parallel imports free-ride on the trademark investments of the local trademark owner; (2) parallel imports deceive the consumer; and (3) allowing parallel imports causes erosion of trademark rights, thus destroying investment incentives in trademark capital. On the other side of the gray market battle, advocates for not excluding parallel market goods argue that to do so would only sanction international price discrimination. After examining each of the foregoing arguments, this Comment attempts to refute their validity and conclusions.

---

68 It is noted that a distinction between this “exhaustion by territory” theory and the “territoriality” theory is that under territoriality, trademark rights, to the extent they exist, will vary from nation to nation depending on the validity of trademark rights in that jurisdiction. Under exhaustion, the principle is solely grounded on the ability of the mark holder to extract returns on his capital trademark investment, irrespective of the genesis of his trademark rights.
5.1. The Free-Rider Problem

The free-rider problem can be succinctly stated as follows: if a trademark owner has spent considerable amounts of money and time in creating a demand for a trademarked product, it is undesirable to allow an unauthorized importer to reap the benefits of the trademark’s goodwill without contributing to the mark holder’s investment.70 Allowing parallel imports into the market thus sanctions the gray marketeer’s misappropriation of the authorized seller’s returns on invested trademark capital. Thus, the free-rider argument is rooted in strict notions of property.71 The trademark, “of course to be classed among property rights,”72 should allow the mark holder to invest and realize a return on his investment.

Although the free-rider argument is an attractive device for demonstrating the possible inequities that arguably result from the gray markets, in reality, the alleged conversion of capital returns may be unfounded. First, the presumption that gray marketeers do not engage in activities such as advertising and promotion to maintain the trademark’s goodwill is inaccurate. Given an environment in which stores compete for a limited number of consumers, the parallel importer has as strong an interest in advertising and maintaining the product’s image as any other retailer, authorized or not. As such, it is likely that the unauthorized retailer is engaging in as much trademark investment as the authorized retailer. Second, since large-scale

---

70 Alternatively, free-riding also occurs if the importer has only paid part of the costs of the trademark investment. The result being that the unauthorized importer receives a larger return on his investment than the authorized seller. To illustrate, suppose (as discussed supra Section 3.1 (“Currency Fluctuation”)) that the exchange rate between dollars and French francs is $1 = Fr 2. The trademark investment under the $1 = Fr 1 exchange rate is $25 or Fr 25. After the appreciation of the dollar, the trademark capital investment in France costs only $12.50; the U.S. seller must invest $25 for the same benefits. As such, it is argued that the parallel importer is not paying his own way.

71 International News Service v. Associated Press, 248 U.S. 215, 240 (1918) (arguing that “he who has fairly paid the price should have the beneficial use of the property.”); Aetna Casualty & Surety Co. v. Aetna Auto Finance, Inc., 123 F.2d 582, 584 (5th Cir. 1941) (enjoining conduct when it appears that “there is a purpose to reap where one has not sown, to gather where one has not planted, to build upon the work and reputation of another . . . .”), cert. denied, 315 U.S. 824 (1942).

72 Hanover Star Milling Co., 240 U.S. at 413.
advertising is likely to be conducted by the foreign manufacturer, the costs of such investments will be incorporated into the price that the gray marketeer pays when purchasing the goods in the market. Hence, the unauthorized importer contributes to the costs of trademark capital indirectly through the manufacturer's pricing mechanism, even if it spends less money on independent goodwill.

If the parallel importer contributes its fair share to maintain the goodwill, how then is this merchant able to undersell the authorized retailer? One explanation is that the discount gray marketeer is more efficient than the authorized retailer. The discounter, unlike the authorized retailer, is able to sell the product more efficiently through different cost-reducing marketing techniques, such as just-in-time or zero-inventory techniques, no-frills selling floors and other such cost reduction techniques not available to the authorized retailer. If, in fact, the gray marketeer is more efficient, his actions should be supported, not suppressed. Some free-riding, to the extent he exists, should be outweighed by the increased efficiencies that the gray market imparts.

5.2. The Consumer Deception Problem

The consumer deception argument proposes that the unauthorized parallel importer defrauds the consumer. The consumer is led to believe that he is purchasing products from

---

73 Assume a situation where there is only one manufacturing entity and many national distributors who concurrently hold the trademark rights in each of their own countries. The sole manufacturer may want to control all of the advertising for its own products, for centralized advertising will ensure the manufacturer a consistent international image. In addition, the use of the mass media will have a larger impact upon the trademark's value than any advertising done by independent distributors or retailers.

74 Yet, if the unauthorized parallel importer is in fact more efficient than the authorized importer, would not the unauthorized importer become an authorized importer? The answer depends on the demands of the manufacturer. If a manufacturer has strict requirements as to point of sale displays and methods of marketing, a more efficient discount retailer that does not provide such specialized services would not likely be allowed to become an authorized retailer.

the authorized distribution chain, when in fact he is not.\textsuperscript{76} The main argument is that given the quality guarantee function\textsuperscript{77} of trademarks which serves to preserve the quality expectations of repeat consumers, a consumer is misled when purchasing a good coming from an unauthorized source. Whereas the consumer can expect a certain quality from goods distributed by A—the authorized importer—the consumer does not know what quality to expect of goods from B—the unauthorized importer. As such, the consumer's reasonable expectations may not be met. Decreasing the value of this argument, though, is the often forgotten reality that the gray good is genuine, i.e., not an unauthorized reproduction or simulation. Further, in the context of multiple authorized manufacturers, as urged earlier, consumers look to trademarks to identify products, not specific manufacturers.\textsuperscript{78} Therefore, since the consumer is indifferent as to the manufacturer, his expectations are unaffected regardless of whether he receives a good from A or from B.

Proponents of the deception argument also assert that the gray goods may be of lesser quality than the authorized goods. It is contended that perishable or fragile goods that require certain particular accommodations may deteriorate during the process of parallel importation. This argument is unpersuasive, however, because deterioration is just as likely through authorized importation. Surely the parallel importer will take the same necessary precautions as the authorized importer to assure that the goods are saleable. Rotting perishable goods are of no value to the parallel importer.

Another quality argument advanced is that the parallel goods are not subject to the same safety and quality controls as the authorized goods. This assertion is untenable. Although the goods may enter the United States through unsanctioned channels of distribution, the goods are still genuine goods. The goods ultimately originate from the foreign manufacturer. Given that quality control will likely occur at the manufacturing level, the

\textsuperscript{76} Although a case can be made for excluding goods because consumers may, due to the local trademark owner's goodwill, think that a foreign article actually originated in the United States, such consumer ignorance is costly and should not be condoned. See Dam, \textit{supra} note 2, at 25.

\textsuperscript{77} See discussion \textit{supra} Section 4.1 on the quality guarantee function.

\textsuperscript{78} See discussion \textit{supra} Section 4.1 on the origin-signaling function of trademarks.

https://scholarship.law.upenn.edu/jil/vol14/iss3/4
optimal level at which to repair or otherwise conform the goods to specifications, the goods that the parallel importer purchases from the foreign manufacturer or a foreign distributor have already passed the scrutiny of quality and safety controls.

5.3. Trademark Erosion Problem

The trademark erosion problem is an extension of the free-rider problem, as it similarly focuses on the property rights aspect of trademarks. The argument proceeds as follows: not allowing an authorized trademark owner the power to exclude gray market goods through trademark infringement actions erodes the value of the trademark. With the exclusivity component of the trademark right denied, property rights advocates argue that the value of the trademark is obviated. A property right without the right to exclusive possession is useless.

As convincing as the argument may seem to those who champion the protection of property rights, it begs the question of whether or not there has been an infringement of the trademark. Although an exclusive right is certainly valuable, the fact that it would have money value if it existed is not a conclusive reason for recognizing that right. Furthermore, basing legal protection on economic value, when the economic value of a trademark depends upon the extent of its legal protection, is circular and therefore unpersuasive.

Secondly, it is argued that the erosion of trademark rights leads to a pernicious scenario: under-investment in trademark capital. This argument can be stated as follows: investors in trademarked goods invest only because there are certain expected returns; the gray market erodes those future returns; therefore, when expected returns are obviated by the gray marketeer, investment in trademarked goods will decline significantly, to

---

79 Although it could be argued that the parallel importer is purchasing second-hand goods, that is, goods sold by foreign consumers which may contain consumer imposed defects notwithstanding quality controls at the manufacturing level, such argument is unsupported by economic realities. Parallel importers would find it incredibly costly and inefficient to purchase their goods from isolated foreign consumers. The transaction costs of parallel importation in this manner would be prohibitive.

80 Chadwick v. Covell, 23 N.E. 1068, 1069 (Mass. 1890).

the detriment of society. This argument fails on three grounds: (1) trademark owners will continue to invest in trademark capital until returns reach zero; \(^{82}\) (2) if the returns of some trademark owners do reach zero, the exit of those sellers from the market is merely a market adjustment to purge inefficient participants, and thus not problematic; \(^{83}\) and (3) as noted above, this argument is circuitous and it begs the question of infringement.

5.4. International Price Discrimination

The price-discrimination argument which claims that allowing trademark holders to exclude genuine goods from the marketplace only sanctions international price discrimination relies on too many assumptions, and, as discussed earlier, does little to advance the inquiry of how to deal with the gray market phenomenon. \(^{84}\)

6. Observations

Parallel importers of genuinely trademarked goods should not be denied access to the U.S. market. Although, concededly, there is a balancing of interests involved, the justifications for granting gray marketeers access to the U.S. market outweigh the considerations for precluding market entry for the following reasons: (1) gray markets emerge to correct an informational market failure when there are unexpected and unforeseeable changes in currency exchange rates and production costs, (2) the free-rider problem is minimal, (3) consumer losses are minimal compared to the gains to be realized from permitting parallel imports into the marketplace, (4) there are benefits to intra-brand competition, and (5) free trade is desirable as the globalization

\(^{82}\) As long as there are positive returns on an investment, one is better off. Thus, there are no disincentives to investing in trademark capital. Of course, if other goodwill-creating investments began to yield a higher return than trademark investments, the trademark holder would pursue those alternatives instead. However, while it is true that trademark investments would decrease in this scenario, such decrease would be efficient and therefore desirable.

\(^{83}\) If some returns reach zero while others do not, then the market is better off without those trademark owners who cannot realize a competitive return. Only least-cost providers should prevail in a competitive market. Waste occurs if inefficient parties are allowed to remain in the market. Capital should flow to those who can put it to its best use.

\(^{84}\) See supra Section 3.2 (“Anti-Competitive Price Discrimination”) for the analysis as to the weaknesses of the price discrimination argument.
of markets continues.

6.1. Gray Markets As A Correction Of Market Failure

If a U.S. trademark holder is to make independent capital trademark investments, he will require premium assurances from the manufacturer to compensate for the risks of distributing the trademarked product. The parties will make contractual arrangements providing that the manufacturer will preserve the returns on the local mark holder's investment. These long-term agreements are necessary to induce a domestic business to purchase the foreign manufacturer's trademark and distribute his product.

As noted in the "Currency Fluctuation" section above, when the dollar appreciates, the premium charged for invested capital in the United States is $25 while the premium in France is only $12.50. Assuming competitive markets, the premium in the United States should decrease to $12.50 as well because of competition with the French manufactured product. Unfortunately, because of the vertical distribution agreements between the manufacturer and the U.S. trademark holder, the premium remains at $25 even though the optimal premium should only be $12.50. As such, the foreign manufacturer is forced to absorb the loss of $12.50 ($25-$12.50). In order to avoid this per-unit loss without breaching contractual obligations with the domestic trademark owner, the foreign manufacturer may sell goods into the gray market. By selling into the gray market, the manufacturer forces intra-brand competition in the United

---


86 The primary risk involved here is the likelihood of currency fluctuations and changing cost conditions.

87 These agreements will tend to be long-term because the recoupment of invested trademark capital generally occurs over an extended number of years.

88 Usually, the vertical agreements between the parties include accommodations for foreseeable changes in market conditions. In such a scenario, the terms of the contract would somehow allow the premium to adjust to the competitive level. Unfortunately, when changing market conditions are unanticipated and unforeseeable, the parties will not be able to draft contracts which accommodate for these unforeseeable circumstances. This Comment argues that the gray markets emerge to combat this contractual inflexibility.
States to indirectly lower the over-investment in trademark capital. In this sense, the parallel marketeer functions to push the market to optimal conditions, i.e., removes the inefficient over-investment in trademark capital.

6.2. The Free-Rider Problem Is Minimal

The free-rider problem, as discussed above, is minimal and should not preclude gray market goods from the U.S. market. The free-rider problem, to the extent it exists, is of little consequence because: (1) the gray marketeer/discounter does advertise and contribute to the goodwill of the product and therefore does not free-ride, (2) the parallel importer does not free-ride because the price he pays for the goods overseas already includes a premium for trademark investment, and (3) the gray marketeer is not free-riding; he is simply a more efficient low-cost provider. Given these considerations, it is unreasonable to attach much weight to the free-rider problem.

6.3. Consumer Losses Are Minimal In Comparison To Consumer Gains

Parallel imports should not be disallowed on the grounds of consumer deception and subsequent losses because such losses, to the extent they exist, are minimal. The argument that consumer expectations are not met by gray market goods is unpersuasive in that: (1) given that the goods are genuine and not counterfeits, there is no reason why a genuine product will not satisfy the expectations of the consumer; and (2) given that consumers are indifferent as to the identity of the actual manufacturer, being more concerned with the identity of the product, goods from unauthorized importer B as opposed to the same goods from authorized importer A should not alter the consumer's expectations. Also, the argument that parallel imports are of lesser quality are equally tenuous because: (1) the gray marketeer has the same economic incentives to provide a saleable,

---

89 The absolute returns, i.e., dollar premiums, on invested capital are a reflection of the amount of capital invested. A high premium reflects a larger amount of investment than when the premium is low, all things being equal. The U.S. trademark holder is said to have over-invested in the sense that his premium is $25 when it should have been $12.50—a reflection that the optimal investment is lower than that which produced a $25 premium.
i.e., quality, product to the consuming public and thus no quality loss occurs; and (2) quality and safety controls will generally be conducted at the manufacturing level, thus the genuine goods that the importer purchases for resale have already passed the scrutiny of the manufacturer. Therefore, little weight should be attached to the argument that parallel imports cause losses to consumers. In fact, as it will be argued in the next section, parallel imports actually benefit the consumer.

6.4. The Benefits Of Intra-Brand Competition

The intra-brand competition created by gray markets benefits the consumer and forces efficient operation of the market. Allowing parallel imports to compete in the market with authorized goods produces lower prices for consumers and increases the consumer's range of choices. Hence, the consumer loss from restricted competition that results if parallel imports are restricted is greater than the loss caused by confusion when parallel goods are allowed to enter the market.

Gray market goods also assure that there is no possibility for international price discrimination by manufacturers, foreign or domestic. Any attempt to charge one price in country X and another price in country Z would be obfuscated by the workings of the clever gray marketer. Furthermore, as discussed above in Section 5.1, the parallel market corrects inefficient over-investment in trademark capital. Therefore, the unauthorized genuine imports preserve the efficiency of the market.

6.5. Free Trade As A Normative Preference

In light of the globalization of international markets and the ever increasing ties among global economies, a philosophy of free trade is far more desirable than any protectionist regime. Free trade allows for the development of emerging nations by providing them with access to working markets. It also allows developed nations to tap into the resources of the world's nations through a competitive economy, while ensuring that there will be no exploitation of nations holding weak bargaining positions by inefficient international rent seekers. The United States should adopt a progressive stance and not exclude parallel imports from the U.S. marketplace.
7. CONCLUSION

This Comment advocates a position of free trade and questions the validity of arguments in favor of excluding gray market goods. After analyzing the arguments in favor of gray-good exclusion, it is concluded that the problems advanced should not be remedied through the trademark law mechanism. The role of trademarks should be limited to protect the trademark owner only in those instances where goods "copy or simulate," i.e., counterfeit, the owner’s trademark. Trademark law has no application to genuine goods. Further, if courts and legislatures perceive the gray market as a trade policy dilemma—as opposed to an intellectual property issue—then settling matters of trade policy by entanglement in the strictures of trademark law is unwise.

This Comment submits that through articulation of a clear rule of law, specifically a pronouncement that trademark law and exclusionary trade policies will be unavailable to seek redress, parties will be able to create their own private law through contracts and organize their relationships according to those terms that will maximize their investments.

Since there is no one blanket solution that will resolve all gray market disputes, the flexibility of contract law is the best mechanism for the enforcement of any exclusive agreements between foreign trademark holders and domestic trademark holders. Enforcement power must only be vested in those parties which the contract contemplates. In some scenarios, it will be economically efficient to pursue the gray marketeer; in others, it will not. Such allocation of power will lead to the free movement of goods and to an efficient market solution.

Nevertheless, this Comment does not pretend to solve the conundrum surrounding the treatment and analysis of gray market goods; there is still much to be resolved. Thus, only through careful consideration of the United States’ goals with respect to international relations and trade will a readily acceptable solution be unearthed, be it through the mechanisms of anti-competition, trade, tort, or contract law.