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USING IP TO CONTROL GRAY GOODS

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ABSTRACT: THIS AGMA GLOBAL COMMISSIONED ARTICLE, AUTHORED BY MILTON SPRINGUT, ESQ., REVIEWS GRAY MARKET ISSUES, CHALLENGES, STRATEGIES, RELEVANT LAW AND CASE STUDIES. THE READER WILL GAIN PERSPECTIVE ON BUSINESS CONSIDERATIONS AND STRATEGIES WHEN CONSIDERING GRAY MARKET ISSUES.

Using IP to Control Gray Goods

Gray goods, also known as parallel imports, are the bane of many manufacturers.

Goods intended for foreign markets are diverted outside the authorized distribution chain and then rerouted to other, more expensive markets, often the United States. The first line of defense is controlling distributors, both through contractual restrictions and tracing goods, in an effort to "plug the holes" and keep the distribution system as intended.

But when such efforts fail, manufacturers turn to other legal methods to try to stop the sale and distribution of those goods in the United States. The obvious problem is that these are, at least at their origin, genuine goods – the company, or its affiliates, did manufacture them, albeit for a foreign market. Although the distributor may have breached a contract in selling them outside its territory, that by itself does not make the goods false or infringing, and secondary market dealers may be free to sell them.

Intellectual property law can be employed to control gray goods – but that requires both an understanding of the details of those laws, and strategic choices as to how to exploit them.

Patent and Copyright Law

In the past, it was possible to use both patent and copyright laws to control gray goods – if the product was covered by one of these rights, many courts allowed a claim of copyright or patent infringement, even though the same company had sold the goods abroad. But the Supreme Court ended that option in two cases, *John Wiley & Sons v. Kirtsaeng* (2013) and *Impression Products v. Lexmark International* (2017), which dealt with copyrights and patents, respectively.

Both patent and copyright law have versions of the "first sale doctrine", which states that the IP owner's rights end as to any unit of the product once the IP owner makes the first sale of that unit. A publisher that sells a copyrighted book, for example, has no more copyright interest in that particular book – the purchaser is free to resell it.

The Supreme Court in the *John Wiley* and *Lexmark* cases decided that a sale by the copyright or patent owner *anywhere in the world* invokes the first sale doctrine. If a company sells a unit of product abroad, then all of its patent and copyright interests in that unit come to an end.

One possible workaround for these decisions is to segregate the IP ownership – and the sale – among different corporations. The corporation selling the product abroad would be different from that owning the IP in the United States. It is not yet clear whether such a strategy would work.

In *Lexmark*, the Supreme Court distinguished an 1890 case where the patented item had been sold in Germany by a different company holding the patent there. But in that case, the German company was completely independent of the U.S. patent holder. Whether courts will tolerate division of patent/copyright ownership among different corporate affiliates in an effort to avoid the first sale doctrine remains to be seen.

Trademark Law

Trademark law is the one area of IP law that still may be and is used to control gray goods. Trademark law also has a first sale doctrine; a sale by the trademark owner, anywhere in the world, triggers the first sale doctrine. And that applies even as to corporate affiliates. The Trademark Act explicitly states that use of a trademark by "related companies" is considered to be use by the trademark owner. 15 U.S.C. 1055. (This has advantages to trademark owners in establishing trademark rights in the first instance, but it also means that a sale by any affiliate corporation is considered a sale by the trademark owner.)

Of course, if the goods sold abroad were sold by a completely independent company, then the first sale doctrine does not apply. Trademark rights are territorial, if there are different trademark owners in different countries then the first sale doctrine will not apply. The Supreme Court so held in *A. Bourjois & Co. v. Katzel* (1923). A good illustration is *Sterling Drug v. Bayer AG* (2d Cir. 1994), where a federal court of appeals dealt with an unusual situation involving the mark BAYER. Bayer was originally a German company founded in 1863. During World War I, its trademarks were seized by the U.S. government as enemy property and sold to a competitor. In 1994 the German company reacquired the trademark through a corporate purchase. So, from 1918 to 1994, there were different, independent owners of the BAYER mark – one in the U.S. and Germany. Sale of German products bearing the mark into the U.S. was an infringement of the U.S. company's mark. But, as discussed, this does not apply to related companies. A sale by one corporate affiliate anywhere in the world invokes the first sale doctrine as to the U.S. trademark owner.

Material Differences

But the story does not end there. A long series of federal court decisions has recognized one major exception to the first sale doctrine in trademark law – known as material differences. Sometimes the same product sold abroad is different in some way from the product sold in the U.S. If that difference has significance to a consumer – if it is "material" to their purchase decision, then the product intended for sale abroad is not genuine in the United States. Selling it in the U.S. would constitute trademark infringement.

One of the earliest and most cited cases on this point is *Societe des Produits Nestle v. Casa Helvetia* (1st Cir. 1992). The case involved chocolates made under the PERUGINA mark. Most of the world had distribution of chocolates manufactured in Italy. But a licensee in Venezuela used the same mark on locally manufactured chocolates. The chocolates had a different formulation to suit local tastes, as well as different packaging. The court held that because they were materially different, the importation and sale of the Venezuelan chocolates into the U.S. market infringed the PERUGINA mark in the U.S., even though the same company had licensed its mark to the Venezuelan manufacturer.

That difference, of course, was quite blatant – a different formulation of chocolate is obviously "material" to consumers' purchase decisions.

But what the *Nestle* case is important for is its discussion of materiality. The linchpin of any trademark case is consumer confusion – the test for infringement is likelihood of confusion. For that reason, the *Nestle* court emphasized that the threshold of materiality must be kept low enough to take into account potentially confusing differences – differences that are not blatant enough to make it obvious to the average consumer that the origin of the product differs from their expectations. Thus, even subtle differences count "for it is by subtle differences that consumers are most easily confused." As we discuss, this can be very useful in formulating a gray goods strategy.

Another important point is that the "product" in which there are material differences may include more than what is usually thought of as the product being sold. Another classic gray goods case, *Original Appalachian Artworks, Inc. v. Granada Electronics, Inc.* (2d Cir. 1987) illustrates the point. The case involved "Cabbage Patch Dolls." Dolls manufactured for the Spanish market were diverted to the U.S. The dolls themselves were identical, but the "birth certificate" and "adoption papers" that accompanied the dolls were in Spanish, while the U.S. version had English papers.

And, the manufacturer had set up a system whereby purchases could send in the adoption papers to process the "adoption" and also an option to "change the name" of the doll. The U.S. distributor only provided these services to U.S. sold dolls, not those intended for the Spanish market. There were enough to render the differences material, and hence the product infringed the U.S. trademark.

Thus, even where the core "product" – the dolls – was the same, differences in paperwork and related aftermarket services created "material differences" sufficient to render the sale a trademark infringement. The reason for this is that when a consumer purchases a "product," he or she is acquiring more than the core item. Part of the purchase includes accompanying paperwork (manuals that guide use, for example), warranties and after-market services. All of these can form part of the total "product" the consumer expects to be purchasing for their money. That, in turn, makes any differences "material."

Material Differences Strategies

There are several strategies that can be used to leverage the "material differences" standard in trademark law. As we have seen, these differences need not be directed to the core product, such as a different formulation for the Perugina chocolates, but can exist in associated materials or services.

Differences in accompanying manuals and paperwork can be material, and hence render the foreign product infringing. *Hyundai Const. Equip. USA v. Chris Johnson Equip.* (N.D. Ill. 2008), was a gray goods case involving, remarkably, expensive construction equipment, like excavators and wheel loaders, sold under the HYNUDAI mark.

Some of the units had safety, operation, and maintenance instructions and safety decals in Korean rather than in English, since they had been manufactured for the Korean market. This rendered them “materially different,” since the customers and their employees obviously needed English-language instructions and decals.

Differences in after-market services – customer assistance, repairs, *etc.* can also create material differences. In *Dentsply Sirona v. Net32* (M.D.Pa. 2018), the plaintiff manufactured and sold dental supplies and equipment. The U.S. version was more expensive and Dentsply generally provided less customer support outside the U.S. (Customer service apparently had to be supplied by the region where the products were intended to be sold.) These differences rendered the foreign goods materially different.

In another case, in which the author was counsel, a manufacturer of consumer medical devices provided a phone number for consumers to call with questions and instructions about use. The U.S. product had a toll-free 800 number directed to a U.S. service center, while foreign destined goods had foreign numbers directed to foreign service centers. The court held that this was among several “material differences” in the product, since a U.S. consumer receiving the foreign product would be faced with a phone number to a foreign center.

Another possible difference we have discussed with clients is to require that post-sale services (such as repair and warranty service) be directed to the country or region where the goods were intended.   Thus a U.S. consumer buying a product originally intended for the Asian market, for example, would have to ship the product to the Asian service center to obtain service, while the same consumer buying the U.S. product could obtain service from the U.S. service center.

The goal in all these cases is to create some material difference between the product sold abroad and that sold in the U.S., even if that difference is not in the core product. But, of course, this requires a willingness to implement and stick with this territorial difference in the product.

Serial Numbers Strategy

A related, although somewhat different strategy, involves serial numbers. Serial numbers identifying each unit (or at least each batch of units) stamped or printed on the product are a powerful tool to control gray goods. They can be used on several levels. The manufacturer can maintain a database of serial numbers and which distributors and territories were sold which numbers. When large numbers of gray goods appear on the market, these can be used to trace the sources of the leaks, and then attempt to stop it through negotiation with the distributors.

But what happens if the secondary market removes or defaces the serial numbers? That can render the goods “materially different” and hence infringing, if certain policies related to the serial numbers are adopted.

In *Beltronics USA v. Midwest Inventory Distribution* (10th Cir. 2009), the plaintiff manufactured radar detectors and sold them under its trademark, BELTRONICS.   The defendants sold

Beltronics radar detectors with the original serial number label replaced with either a phony label or altogether removed. The altered radar detectors were then resold on eBay as “new.” It was Beltronics’ policy that only those persons who purchased detectors bearing an original serial number label were eligible to receive warranty services. Consumers that bought such altered detectors became irate when they learned their detectors were not covered by Beltronics’ warranty, and thus Beltronics deemed it extremely harmful to its reputation and goodwill.

The court held that the defacement of serial numbers which impacted the product warranty associated with Beltronics’ radar detectors was a material difference, and thus infringing.

In *Zino Davidoff v. CVS* (2d Cir. 2009), the plaintiff sold fragrance products under its house trademark. The defendant drugstore chain was found to be selling Davidoff products with the UPC codes having been ground off the bottle bottom and removed from the packaging by cutting out a portion of the box package. Davidoff asserted that the UPC codes supported its quality control in two ways: the codes facilitated the detection of counterfeits and they improved its ability to identify defective products, effectuate recalls, and remedy production defects.

The court held that this interference with quality control efforts rendered the goods materially different, and hence infringing. Later courts have generally upheld this standard, so long as it is not pretextual and there is a genuine system in place that relies on serial numbers for this purpose.

Serial numbers, when combined with appropriate policies, can thus be a powerful tool to control gray goods. Such policies might include (1) requiring a valid serial, undefaced serial number to honor the warranty or provide aftermarket services or (2) using serial numbers to control quality and conduct recalls and deal with defects.

It is important to keep in mind, however, that until and unless the serial number is defaced, the product is genuine and can legally be resold under the first sale doctrine. Prior to defacement, the gray goods control function of a serial number lies not trademark law, but the ability to trace the source and plug leaks in the distribution system. It is only if the serial number is defaced or altered can the lack of serial number be used to stop such sales as infringing.

Business Considerations in Choosing a Strategy

Each of the two strategies, implementing material differences, and serial numbers, have their advantages and disadvantages. The material differences strategy renders all foreign-intended product infringing in the U.S. While that can be a powerful tool to control gray goods, there are often countervailing considerations not to do this. For one thing, differentiation by intended market adds to costs, by requiring use of different products, packaging, manuals or associated services for different markets. Second, the customer base must be willing to tolerate these differences. Being able to obtain post-sale services worldwide is an advantage to many consumers, and in some product lines, limiting their services to certain regions might detract from the product’s value.

The serial number strategy has certain advantages in that no differences among goods intended for different territories is required. On the other hand, as we discussed, the goods are genuine unless the serial numbers are altered or defaced, and there are costs involved in applying the serial numbers, maintaining a serial number database with distributors, and maintaining policies related to the numbers (for example, no warranty service without a valid, intact serial number).

Ultimately, this is a business decision – are the costs of implementing a gray goods strategy outweighed by the enhanced ability to control gray goods? Businesses should assess the extent of the gray goods problems they have, and its financial harm, and then weigh those against the costs of implementing any such a strategy.