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RECENT DEVELOPMENTS IN THE BATTLE AGAINST GRAY MARKET IMPORTS IN THE UNITED STATES

By

Charles E. Buffon
Laurie C. Self
Ronald G. Dove, Jr.[*/]

Covington & Burling
1201 Pennsylvania Avenue, N.W.
P.O. Box 7566
Washington, D.C. 20044-7566
(202) 662-6000

Owners of U.S. copyright, trademark and patent rights in goods made in Japan (and elsewhere outside the United States) continue to face competition from unauthorized importers and distributors of those goods in the United States. This article discusses several significant recent legal developments in the United States relating to attempts to combat this "gray market" problem. Part I addresses the March 9, 1998, decision by the United States Supreme Court involving the importation of copyrighted gray market goods; Part II addresses new regulations of the U.S. Customs Service aimed at enhancing border protection against infringing imports of trademarked and copyrighted goods.

[*/] The authors represent the Coalition to Preserve the Integrity of American Trademarks ("COPIAT") and Parfums Givenchy, Inc., a party to litigation discussed in this article.

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I. UNITED STATES SUPREME COURT DECIDES CASE INVOLVING COPYRIGHTED GRAY MARKET GOODS

On March 9, 1998, the United States Supreme Court issued an important decision in a case involving the unauthorized importation of copyrighted goods made in the United States, exported abroad, then imported back into the U.S. This decision, *Quality King Distributors, Inc. v. L'anza Research International, Inc.,* 118 S. Ct. 1125, marks the first time the U.S. Supreme Court has addressed the use of copyright law in combatting the importation of gray market goods, defined as genuine products protected by copyright, trademark or patent that are imported into the United States without the authority of the U.S. intellectual property rights owner. It is also the first time the Court has tackled any major issue involving the gray market since its 1987 decision in *Kmart v. Cartier,* 486 U.S. 281. In that case the Court held that the U.S. Tariff Act does not require the U.S. Customs Service to bar importation of trademarked goods marketed abroad by corporate affiliates of the U.S. trademark owner, and in the *L'anza* case the Court placed limitations on the ability of copyright owners to assert private actions to combat diversion of their products.

In a unanimous opinion, the Court in *L'anza* held that a U.S. copyright owner's right to prevent the unauthorized importation of a copyrighted good made in the United States is extinguished upon the first sale of that good. That is, once a U.S.-made good is sold, the copyright owner retains no right exercisable under U.S. copyright law to restrict subsequent distribution. Significantly, however, the Court refused to extend its holding to copyrighted goods manufactured outside the United States, leaving intact a line of

cases that provides substantial protection to U.S. copyright holders of foreign-made works facing the problem of gray market imports into the United States.

A. Background

The facts of the *Quality King* case are straightforward: In 1993, L'Anza, a U.S. manufacturer and distributor of hair care products, discovered that Quality King had been importing and reselling L'Anza's products in the United States without authorization. L'anza had originally sold these products at discount to a British distributor, who in turn sold them to a distributor in Malta. The Malta distributor sold the goods to Quality King, which imported them into the United States and resold them to various discount retailers who were not in L'anza's authorized chain of distribution. Each of the products was manufactured by L'anza in the United States and bore a copyrighted label.

L'anza saw Quality King's conduct as a threat to its carefully crafted distribution plan for the U.S., which involved heavy spending on advertising and promotion and the use of exclusive distributors to sell L'anza's products only to authorized retailers such as beauty salons and barber shops. By importing and reselling these "gray market" goods, Quality King was in L'anza's view violating L'anza's copyright and causing damage to L'anza by "free riding" on its hard-earned good will and preventing L'anza from realizing the "full value" of its exclusive right to market its products in the United States.

Quality King, on the other hand, argued that L'anza had received its reward when it sold its products to the foreign distributor and that there was no copyright violation. It claimed that L'anza was now just trying to unfairly exploit its copyright monopoly and prevent consumers from obtaining L'anza's products at a more reasonable price on the free and open market.

L'anza filed suit in federal district court in California. It prevailed in that court and before a federal appeals court. Because the appeals court opinion was in conflict with an earlier decision by another federal appeals court, the U.S. Supreme Court decided to hear the case.

B. The U.S. Supreme Court's Decision

In reaching its decision, the U.S. Supreme Court focused on the relationship between three sections of the U.S. Copyright Act:

- Section 602(a), which provides that "[i]mportation into the United States, without the authority of the owner of the copyright under this title, . . . is an infringement of the exclusive right to distribute copies . . . under Section 106";

- Section 106(3), which provides that "Subject to sections 107 through 120, the owner of copyright under this title has the exclusive rights . . . (3) to distribute copies . . . of the copyrighted work to the public by sale or other transfer of ownership . . ."; and

- Section 109(a), also known as the "first sale" exception, which provides that "[n]otwithstanding the provisions of Section 106(3), the owner of a particular copy . . . lawfully made under this title . . . is entitled, without the authority of the copyright owner, to sell or otherwise dispose . . . of that copy . . ."

L'anza argued that the importation right of § 602(a) is separate and distinct from the distribution right of § 106(3), and thus the § 109(a) "first sale" limitation to § 106(3) does not apply. The Supreme Court rejected this position, holding that the right against unauthorized importation granted by § 602(a) is indeed limited by § 109(a).

The Court reasoned that § 602(a) does not categorically prohibit the unauthorized importation of copyrighted materials, but instead provides that such

importation is an infringement of the exclusive right to distribute copies under § 106. Section 106, by its own terms, is limited by the provisions of §§ 107 through 120, including § 109(a). Section 109(a) permits the owner of a lawfully made copy to sell that copy "[n]otwithstanding the provisions of section 106(3)."

The Court held that after the first sale of a copyrighted item "lawfully made under this title," any purchaser, whether from a foreign or U.S. reseller, is an "owner" of that item entitled to dispose of that copy as it sees fit, even if the first sale occurred outside the United States. This holding applies equally to all copyrighted works, such as books and CDs, not just product labels or other works of more limited creative content.

The Court rejected as irrelevant the various policy arguments put forward by the parties as to the alleged evils and benefits of the gray market, focusing primarily on the text of the statute itself.

C. Two Important Limitations

There are two significant limitations to the U.S. Supreme Court's decision that should not be overlooked. First, the Court indicated that copyrighted goods "lawfully made under the law of another country" -- as opposed to under the U.S. Copyright Act -- are not subject to the first sale doctrine. Thus, a party that imports such foreign-made copyrighted goods (*e.g.*, Japanese-made computer software) without the permission of the U.S. copyright owner may be subject to liability under § 602(a) -- even if there has been a first sale outside the United States.

A second significant limitation to the Court's opinion is that, despite the urgings of Quality King and its supporters, the Court chose not to address the issue of whether retailers who purchase illegally-imported gray market goods without knowledge of

their source are liable under § 602(a). The Court avoided this issue by assuming that Quality King was the importer. Thus, as discussed below, the cases holding retailers liable remain good law in their respective jurisdictions.

D. The Survival of the *Givenchy* Decision

The U.S. Supreme Court's decision in *Quality King* left standing the important case of *Parfums Givenchy, Inc. v. Drug Emporium, Inc.,* 38 F.3d 477 (9th Cir. 1994), *cert. denied*, 115 S. Ct. 1315 (1995). In that case, the U.S. Court of Appeals for the Ninth Circuit upheld the use of copyright law to combat the importation and distribution of gray market goods manufactured and first sold outside the United States. Decisions of the U.S. Court of Appeals for the Ninth Circuit are binding on all U.S. district courts located in Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon and Washington. They may also be cited as persuasive authority in other jurisdictions. As do all federal courts in the United States, federal courts in the Ninth Circuit have authority to provide nationwide relief in the cases before them.

The *Givenchy* case involved the unauthorized sale of gray market perfume packaged in boxes bearing a copyrighted design. The perfume and packaging were manufactured in France and first sold outside the United States. The U.S. copyright holder in the box design was also the exclusive authorized distributor of the perfume in the United States and a wholly-owned subsidiary of the French manufacturer, Parfums Givenchy.

On these facts, the Ninth Circuit affirmed a nationwide permanent injunction against Drug Emporium, a discount retailer that had sold the gray market perfume imported without the authorization of the U.S. copyright holder. Drug Emporium had not imported the perfume itself, but had purchased it from unauthorized importers.

The Ninth Circuit held that, in the case of foreign-made goods, the "[i]mportation right [of § 602(a)] survives as to a particular copy unless and until there has been a `first sale' in the United States." The appeals court relied in part on its previous decision in *BMG Music v. Perez,* 952 F.2d 318 (9th Cir. 1991), *cert. denied,* 505 U.S. 1206 (1992). In that case the court held that "[t]he words `lawfully made under this title' in § 109(a) grant first sale protection only to copies legally made and sold in the United States." Consistent with that holding, the panel of the court assigned the *Givenchy* case concluded that "sales ***abroad*** of ***foreign manufactured*** United States copyrighted materials do not terminate the United States copyright holder's exclusive distribution rights in the United States under §§ 106 and 602(a)" (emphasis added). The first sale doctrine applies to foreign manufactured goods only if the U.S. copyright owner at some point authorizes their importation or sale in the United States.

Two other holdings in *Givenchy* are also significant. First, the court held that a "purchaser of illegally imported copies has no more authority to distribute copies than does the original importer." For that reason, a U.S. copyright owner may sue retailers of foreign-made gray market goods and is not confined to just suing importers (who are often difficult to locate). Second, the *Givenchy* court found that the U.S. copyright owner's status as a wholly-owned subsidiary of the foreign manufacturer was not relevant to the copyright infringement analysis: "There is nothing in the plain language of § 602, its legislative history, or case law that suggests that subsidiaries of foreign manufacturers should be treated any differently from other U.S. copyright holders."

Each of these holdings survives the Supreme Court's decision in *Quality King*.

E. Looking Ahead

The *Quality King* decision will have a significant impact on U.S. manufacturers of copyrighted works, who must now look to some means other than copyright law as a basis for combatting gray market imports. At the same time, companies owning the U.S. copyright in works manufactured in Japan or elsewhere outside the United States will continue to have a remedy available to them under U.S. copyright law. Assuming that the necessary conditions are met, such companies should, like Givenchy, be able to enforce their copyrights against unauthorized importers and resellers of foreign-manufactured goods sought to be marketed in the United States.

II. UNITED STATES CUSTOMS SERVICE ISSUES REGULATIONS PERTAINING TO GRAY MARKET GOODS

In March 1998, the U.S. Customs Service issued two rulings that purport to enhance border protection against infringing imports of trademarked and copyrighted goods. The first ruling, issued in final form, will increase the information made available to trademark and copyright owners when imports are detained or seized by the Customs Service. The ruling theoretically will allow trademark and copyright owners to play a more active and effective role in identifying infringing imports before they enter the stream of commerce.

The second ruling, issued in draft form for public comment, purports to implement the 1993 *Lever Brothers* decision, in which a federal appeals court ordered the Customs Service to seize "materially different" gray market imports, despite affiliation between the U.S. and foreign trademark owners. As discussed below, the proposed ruling relies on an unduly narrow interpretation of *Lever Brothers* and related cases. Thus, if

adopted in its present form, the ruling would have little impact on the flow of unauthorized gray market imports.

Notably, both rulings were issued after years of internal delays, reflecting the struggle of the U.S Customs Service to balance intellectual property enforcement against so-called "free trade" interests. This struggle, which typically pits intellectual property owners against pro-gray market groups, has seriously crippled efforts to obtain effective border protection against infringing gray market imports. These recent rulings demonstrate that the tension between intellectual property and gray market interests has not abated. It appears that the Customs Service will continue to take steps to facilitate identification of seized goods, but it will limit Customs' seizure to a very narrow category of gray market imports.

A. Final Disclosure Regulations

Approximately 4½ years after publishing its original proposal, the U.S. Customs Service on March 12, 1998 issued a final rule to amend its disclosure regulations (19 CFR Part 133). The amendments require the Customs Service to disclose to intellectual property owners important information concerning trademarked or copyrighted imports that are seized or detained. The amendments became effective April 13, 1998.

Previously, the Customs Service was obligated to provide U.S. copyright owners with sample merchandise of copyrighted goods that had been seized or detained. However, those disclosure requirements did not extend to trademarked imports. Thus, in order to obtain information concerning seized or detained trademarked imports, U.S. trademark owners were forced to submit a request under the Freedom of Information Act -- a cumbersome and time-consuming process.

1. **Seizure of Merchandise**

In order to remedy this disparity between copyright and trademark notification procedures and to enhance effective border enforcement, the U.S. Customs Service has amended its regulations to require disclosure of certain identifying information whenever trademarked or copyrighted merchandise is seized or detained. Under the revised regulations, whenever such merchandise is seized (because the merchandise is known to be infringing), the Customs Service ***must*** disclose to the intellectual property owner, within 30 business days, the following information (if available) --

1. the date of importation;
2. the port of entry;
3. a description of the merchandise;
4. the quantity involved;
5. the name and address of the manufacturer;
6. the country of origin of the merchandise;
7. the name and address of the exporter; and
8. the name and address of the importer.

2. **Detention of Merchandise**

Where merchandise is merely detained (because it is suspected of being infringing), the U.S. Customs Service must disclose to the intellectual property owner, within 30 business days, the date of importation, the port of entry, a description of the merchandise, the quantity involved, and the country of origin of the merchandise.

3. <u>Provision of Sample Merchandise</u>

Whenever merchandise is seized or detained, the U.S. Customs Service may provide a sample of the suspect merchandise to the intellectual property owner for examination or testing. However, in order to obtain the sample, the intellectual property owner must furnish a bond in the form and amount specified by the port director. This bond requirement (which was omitted from previous drafts of the amendments) is intended to indemnify the importer for any loss or damage that may result from the provision of the sample merchandise in the event such sample is determined to be non-infringing.

The proposed amendments will allow intellectual property owners to better assist the Customs Service in identifying infringing goods. In addition, intellectual property owners will have greater and more timely access to the kind of information necessary to bring private actions against infringers. In recognition of these benefits, the Coalition to Preserve the Integrity of American Trademarks ("COPIAT") and several other associations and corporations submitted written comments to the Customs Service in support of the proposed disclosure amendments. Of the 22 comments submitted, the Service received only one dissenting comment, which was submitted by the pro-gray market American Free Trade Association ("AFTA").

B. **Proposed Ruling to Implement *Lever Brothers* Decision**

After more than five years since the publication of the *Lever Brothers* decision, the Customs Service on March 26, 1998 issued a proposed rule that purports to implement the court's holding. Significantly, the ruling would limit "Lever-rule" protection to those U.S. products that differ both physically and materially from gray market imports intended for sale outside the United States. Thus, the ruling would completely ignore other trademark cases in which the standard of "material differences" has been broadly defined to encompass both physical and non-physical differences. In addition, "Lever-rule" protection would not apply to physically and materially different gray market imports that bear a specified label warning consumers of product differences.

1. **The 1993 *Lever Brothers* Case**

The *Lever Brothers* case involved the importation of gray market soap products, which were manufactured for sale in the United Kingdom using a different formulation from products manufactured for sale under the same trademark in the United States. The U.S. Customs Service had denied seizure of the gray market imports, citing Tariff Act regulations that permit entry of gray market goods whenever the U.S. and foreign trademark owners are the same or affiliated entities (the "affiliate company exception"). Lever Brothers brought suit against the Customs Service, claiming that the UK products violated Section 42 of the U.S. Lanham Act and thus were subject to seizure without regard to the affiliated company exception.

In 1993, the U.S. Court of Appeals for the D.C. Circuit found in favor of Lever Brothers and ordered the Customs Service to seize the gray market soap products. *Lever Brothers Co. v. United States,* 981 F.2d 1330 (D.C. Cir. 1993). The court ruled that

because the UK products were manufactured using a different formula, they were "materially" and "physically" different from similarly-trademarked products intended for sale in the United States. These "material differences" were sufficient to render the goods "non-genuine" from the perspective of a U.S. consumer and thus in violation of the Lanham Act.

Significantly, the court rejected the affiliated company exception as a bar to seizure, holding that the regulation does not apply to violations of the Lanham Act, even in cases involving gray market imports. Accordingly, the Customs Service was obligated to seize the infringing soap products regardless of whether the U.S. and foreign trademark owners were the same or affiliated entities.

2. Other Lanham Act Cases

Lever Brothers was the first case to address the relationship between Section 42 of the Lanham Act and the affiliate company exception of the Tariff Act. However, other federal cases, before and since *Lever Brothers,* have expanded the concept of "material differences" under the Lanham Act to encompass a variety of physical and non-physical differences that may distinguish a gray market import from a product intended for sale in the United States. Prior to *Lever Brothers*, the U.S. Court of Appeals for the First Circuit held that the unauthorized importation of gray market PERUGINA chocolates infringed the rights of the U.S. trademark owner under Sections 32, 42 and 43 of the Lanham Act. *Societe des Produits Nestle, S.A. v. Casa Helvetia, Inc.,* 982 F.2d 633 (1st Cir. 1992) ("*Nestle*"). The gray market PERUGINA chocolates, manufactured in Venezuela, differed in numerous respects from the Italian-made chocolates intended for sale in the United States: quality control procedures, ingredients, shape, packaging and price. The court held these differences to be "material" for purposes of the Lanham Act, stating that "any

difference . . . that consumers would likely consider to be relevant when purchasing a product" is presumptively material.

Significantly, the standard of "materiality" adopted in *Nestle* and subsequent cases makes clear that a broad range of physical and non-physical differences may render a gray market product infringing under the Lanham Act. For example, in *Helene Curtis v. Nat'l Wholesale Liquidators, Inc.,* 890 F. Supp. 152 (E.D.N.Y. 1995), a federal district court applied the *Nestle* standard to determine whether the unauthorized importation of gray market "Finesse" shampoo violated the Lanham Act. Based on this standard, the court found that differences in quality control standards, composition, labeling and packaging were sufficiently "material" to preliminarily enjoin U.S. distribution of the gray market Finesse products.

Most recently, the U.S. Court of Appeals for the Fifth Circuit applied the *Nestle* standard of "material differences" in a case involving the unauthorized importation of genuine Herend porcelain not offered for sale in the United States by Herend's exclusive U.S. distributor Martin's Herend Imports. Although the diverted Herend pieces were arguably of the same quality as pieces sold by Martin's, differences in pattern, color and other artistic features rendered them "materially different" from the authorized pieces and thus infringing. *Martin's Herend Imports, Inc. v. Diamond & Gem Trading USA, Co.,* 112 F.3d 1296 (5th Cir. 1997).

3. Proposed Customs Service Ruling

The proposed ruling contains two fundamental parts: (i) guidelines for determining whether gray market products are eligible for seizure (i.e., the "material

differences" standard); and (ii) an exemption for gray market imports that bear a specified label notifying consumers of material differences.

a. Material Differences Standard

Significantly, the Customs Service based its standard of "material differences" exclusively on the *Lever Brothers* case, ignoring completely the broader standard announced in *Nestle* and other cases. Accordingly, the ruling would permit seizure of gray market imports only if such goods bear "material" and *"physical"* differences from goods intended for sale in the United States. By limiting seizure to physically different imports, the ruling would significantly limit the type of trademarked goods eligible for protection.

b. Categories of Physical and Material Differences

Rather than adopting a definition of "physically and materially" different goods, the proposed ruling would provide categories of information that trademark owners may provide to the Customs Service to determine whether certain trademarks are eligible for "Lever-rule" protection. These categories are as follows:

> The composition of both the authorized and gray market product(s) (including chemical composition);
>
> Formulation, product construction, structure, or composite product components, of both the authorized and gray market product(s);
>
> The performance and operational characteristics of both the authorized and gray market product(s);
>
> Differences between the authorized and gray market products resulting from legal or regulatory requirements, certification, etc.;
>
> Other characteristics that can be described with particularity by the U.S. owner claiming gray market protection.

In order to merit "Lever-rule" protection, the trademark owner must provide "competent evidence," stated with "particularity", to demonstrate that one or more of the foregoing differences exist.

4. **Application for Protection**

Following final adoption of the rule, owners of U.S-registered trademarks, which are currently recorded with the Customs Service, may submit requests to Customs requesting "Lever-rule" protection. (Customs will not accept applications filed prior to adoption of the new Lever rule.) The application must include:

> a detailed description of any physical and material differences between the articles authorized for importation or sale in the United States and those not so authorized; and
>
> "competent evidence" to support claims of physical and material differences and a summary of such differences.

At approximately 30-day intervals, the Customs Service will publish for comment in the Federal Register a list of those trademarks for which gray market protection has been requested, together with the summaries of physical and material differences. At the end of the comment period, Customs will review the request and comments and issue a determination whether gray market protection is granted.

5. **Labeling Exemption**

If an application for "Lever-rule" protection is granted, subsequent imports of physically and materially different products will presumptively be detained under existing regulations. However, such detention will not occur, despite the existence of "material differences," if the product bears "a conspicuous and legible label designed to remain on the product until the first point of sale to a retail consumer in the United States stating that:

> 'This product is not the product authorized by the United States trademark owner for importation and is physically and materially different.'"

According to the Customs Service, the foregoing label would eliminate the likelihood of consumer confusion that forms the basis of trademark infringement under *Lever Brothers*. Moreover, the labeling exemption would preserve the integrity and commercial value of the U.S. trademark, without allowing the Lanham Act to be invoked "inappropriately as a barrier to trade." Thus, despite the existence of "material differences," and after the expense and delay of applying for border protection, the trademark owner will obtain no border protection if the gray market importer is willing to apply the specified label.

6. <u>Analysis of Proposed Ruling</u>

a. <u>Material and Physical Differences Test</u>

As noted above, the proposed ruling would protect only a narrow category of trademarked goods that differ both materially and physically from unauthorized gray market imports. Based on the U.S. Customs Service's criteria for establishing material and physical differences, even significant differences in packaging (*e.g.*, instructions in a foreign language) or quality control procedures could be deemed insufficient to merit protection.

Clearly, this narrow construction of trademark protection under the Lanham Act is not warranted under the *Lever Brothers* decision and related cases. Although the *Lever Brothers* case involved trademarked products that differed physically from the unauthorized gray market imports, nothing in the court's decision suggests that only physically different imports are subject to Customs seizure under the Lanham Act. Indeed, the *Lever Brothers* court made clear that the affiliate company exception does not limit the

manufacturer's right to trademark protection under the Lanham Act. Thus, in constructing a material differences test, the Custom Service should have looked to the full body of relevant precedent (including *Nestle, Helene Curtis,* and *Herend*), which clearly provides that physically identical products may nonetheless be infringing because of other material differences.

Because the U.S. Customs Service relied solely on the fact pattern of *Lever Brothers*, its proposed ruling would implement a far more stringent test of materiality than exists under the Lanham Act. Thus, if adopted, a significant category of infringing imports would nonetheless be permitted entry into the United States. Clearly, this result is not consistent with prevailing court construction of the Lanham Act. To rectify this problem, the Customs Service should revise its materiality test to encompass the full range of physical and non-physical differences deemed relevant under the applicable U.S. trademark law decisions.

b. Labeling Exemption

The proposed labeling exemption is intended to balance the potentially competing goals of trademark protection and free trade. In practice, however, the proposed label will provide little protection against infringing imports and may further undermine the U.S. trademark owner's reputation and goodwill.

Although the label must be "*designed* to remain on the product until the first point of sale to a retail consumer," there is nothing to prevent the distributor or retailer from removing the label after entry into the country. Gray market distributors typically show little respect for product packaging and often will obliterate product codes or remove packaging altogether to prevent identification of the product source. Thus, there is little

doubt that a significant portion of labeled imports will be "de-labeled" by the time they reach the consumer.

Even if the product reaches the consumer with the label intact, the trademark owner's reputation and goodwill are likely to suffer. For those manufacturers that invest heavily in product packaging and image, the conspicuous placement of a warning label is bound to detract from the appearance and prestige of the product. Also, the consumer is unlikely to disassociate the labeled import from the U.S. trademark owner. Thus, a disappointed consumer is likely to blame the U.S. trademark owner for product differences, despite the warning label.

Recognizing these deficiencies, the Coalition to Preserve the Integrity of American Trademarks ("COPIAT") has filed comments with the Customs Service, requesting that the proposed ruling be amended to provide greater protection to trademark owners.

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Despite the developments discussed in this article, owners of U.S. intellectual property rights in goods manufactured outside the United States continue to have a number of strategies and tools available to them for successfully combatting gray market imports. Nevertheless, these developments do highlight the fact that there remains considerable resistance within the U.S. to gray market enforcement. Particularly in dealing with the U.S. Customs Service, rights owners must be very careful to tailor their practices as closely as possible to those involved in successful past cases. It is also necessary to keep fully informed of current legal and regulatory developments.

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