



# Toy and Game Licensing

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## The Graying of the Internet: The Gray Market's Effect on Intellectual Property Owners

Have you ever felt that the instructions to your new camera were in Japanese? They may very well indeed have been in Japanese if your camera came from the gray market. Gray market goods, also known as parallel imports, are typically products that are meant to be sold outside of the United States but which appear on US shelves and Web sites. Unlike black market goods—which might be smuggled, stolen, or counterfeit products—gray market goods were generally authorized for foreign markets but imported into the United States without the consent of the US copyright and/or trademark owner.

The gray market covers a host of products, from toys and electronics to pharmaceuticals, cosmetics, clothing, and jewelry. With the rise of the global economy and the increasing popularity of Internet shopping, the gray market has become a \$20 billion dollar segment of the economy. The Internet has fueled this gray market because it gives gray marketeers an inexpensive and readily available arena for their goods, and because increasing numbers of bargain hunters

search the Web for the lowest prices on almost every product imaginable. Of course, not all online stores carry gray market goods, and not all gray market goods are online. But the combination of underpriced, diverted goods, and the wide reach and relative anonymity of the Internet makes the World Wide Web the perfect place for the gray market to flourish.

Copyright and trademark owners may have several objections to the importation of gray market goods. First, these goods could hurt the value of a brand if the goods fail to perform as a US buyer expects. For example, several years ago the makers of the popular Cabbage Patch Kid dolls manufactured a version of the dolls for the Mexican market. The packaging, including the "adoption certificates" for the dolls (an integral part of the product's marketing), was printed in Spanish. The owner of the trademark challenged the importation of those dolls into the United States because it was concerned that local consumers would be disappointed. That challenge was successful. [See *Original Appalachian Artworks, Inc. v. Granada Electronics, Inc.*, 816 F.2d 68 (2d Cir. 1987).]

Second, the intellectual property owner may have established a network of authorized dealers to distribute its products. An authorized dealer network may object to gray

market goods entering the United States because they will reduce demand for products through the dealer network. In some instances, the dealers might be unable to service a product designed for a foreign market for such reasons as the specifications are different, the replacement parts are different, or the touch-up paints were a different color. Again, consumers may be disappointed, potentially hurting the value of the brand. Along the same lines, legitimate distributors might print brochures and catalogues, sponsor tradeshow displays and seminars, and then lose sales to a gray marketeer. A weakening of the distribution chain that the intellectual property owner has worked hard and paid well to establish could jeopardize the intellectual property owner's access to the public. From a contractual point of view, an intellectual property owner could end up on either side of expensive litigation if an exclusive distribution agreement were reached and yet gray-market goods ended up on a discount Web site outside of that exclusive distribution chain.

Third, the mere fact that the products are on a discount Web site could be bad for the image and value of the brand, especially one for which production is purposely limited to increase cachet and demand. Intellectual property owners typically want to choose carefully where, how, and to whom their products will be marketed.

Fourth, gray market goods may not be usable in the United States; electronics with European wiring may have incompatible ports or

catch fire in a US outlet, potentially resulting in a lawsuit.

Finally, gray market goods can harm intellectual property owners through direct financial loss. The intellectual property owner may have a less favorable financial arrangement for goods sold in foreign markets. The intellectual property owner also may be required to provide (and pay for) warranty work and other service in the United States, but not in foreign markets.

The logical question, therefore, is whether an intellectual property owner can prevent the importation or sale of gray market products. The most direct method is to impose contractual limitations on the buyers of the intellectual property owner's goods. But frequently it is difficult to trace the source of gray market products, making enforcement problematic. When the intellectual property owner determines that a specific distributor has breached its obligations and the foreign product is being imported into the United States, the owner can stop selling to that distributor and seek damages. The contract provisions, however, generally cannot provide an effective remedy for product that is already in the gray market. Indeed, contractual remedies generally are unavailable against second and third-hand buyers.

Intellectual property owners have attempted to use the intellectual property laws to protect exclusive distribution channels, which has met with mixed success. The US Supreme Court has held that under the Lanham Trademark Act, when the owner of a US trademark also owns the foreign trademark, that owner normally cannot prevent the foreign goods from being imported into the United States. [See *Kmart Corporation v. Cartier, Inc.*, 486 U.S. 281, 108 S. Ct. 1811, 100 L.Ed.2d 313 (1988).] Similarly, if the owner of the US trademark is under "common control" with the owner of the foreign trademark, gray market imports are also generally legal. [*Id.*]

The Supreme Court has held that a copyright owner cannot use the Copyright Act to prevent the re-importation of goods that had been exported to a foreign market. [*Quality King Distributors, Inc. v. L'Anza Research International, Inc.*, 523 U.S. 135, 118 S. Ct. 1125 (1998).] In other words, under the first sale doctrine the owner of copyrighted material such as a video game may, without the permission of the owner of the actual copyright, resell the video game to another party. [*Bobbs-Merrill Company v. Isidor Straus*, 210 U.S. 339, 28 S. Ct. 722 (1908).]

*Quality King* involved a California manufacturer of hair care products who believed that consumers would pay more for hair care products that were available only through high-end stores such as salons. The manufacturer sold its products only to distributors who agreed that they would maintain the proper sales channels. The manufacturer also, however, exported the products to foreign distributors for non-US consumers. A distributor in Malta resold the goods, which found their way to unauthorized US retailers at discounted prices. The Supreme Court decided that once the manufacturer put its hair care products into the stream of commerce, it no longer had the right to control how the products were distributed.

There are exceptions. For example, a trademark holder can stop imports of foreign goods that are materially different from the similarly trademarked goods sold in the United States. [*Lever Brothers Co. v. United States*, 877 F.2d 101, 278 U.S. App. D.C. 166 (1989).] The importer can attempt to avoid this exception by informing consumers that the product was not authorized for importation by the trademark owner and is different from the authorized product.

In light of these holdings, what can intellectual property owners do to avoid the perils of losing customers and control to the gray market? A key strategy is to monitor the distribution chain; diverted

shipments are often an inside job. Specialized companies exist to help intellectual property owners investigate and uncover gray marketeering and product diversion. Cooperation of distributors is essential.

Further, owners of trademarks can create a corporate structure that will provide protection against gray market goods, such as transferring the foreign trademark to a company that is not under common control with the US owner (this strategy, of course, implicates a host of other considerations as well).

Intellectual property owners can also educate consumers of the importance of buying through authorized dealers. People who shop at folding tables on street corners typically know that they are purchasing counterfeit or gray market goods. When people shop on the Internet though, they may not be aware that they can stumble into the gray market or why such a stumble could be problematic. In addition, an intellectual property owner might consider having a Web site that will allow customers to buy directly or that will lead them to authorized dealers.

One risky strategy is to insure that the product intended for foreign markets is materially different than the US version. While providing a tool for attacking gray market imports, however, this strategy may also make those imports more damaging when they do take place.

Gray market activities continue to build a strong niche, especially in the online world. Intellectual property owners, however, can take steps to avoid having their brands fall into the gray corners of the marketplace.

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