Parallel imports are genuine products imported without the authorization of the trademark or copyright owner in a country. Authorized dealers have employed trademark and copyright law to exclude parallel imports using claims of infringement. Our assertion is that trademark and copyright laws are inappropriate for enforcing restrictions against parallel imports for two reasons. First, trademark exclusion of parallel imports indiscriminately eliminates intrabrand competition and should be scrutinized from an antitrust perspective. Second, trademark laws inefficiently constrain the feasible set of distribution systems. We propose a policy combining contract, tort, and antitrust law to regulate parallel imports. © 1999 by Elsevier Science Inc.

I. Introduction

Parallel imports, also known as gray goods, are genuine products imported without the authorization of the trademark (TM) or copyright owner in a country. Owners of intellectual property such as TMs and copyrights complain that these sales infringe on their exclusive rights, whereas gray marketers counter that the goods are genuine and that consumers benefit from the additional competition. These opposing points of view have been debated in courts around the world for over 100 years.¹ We revisit the debate in this paper, using a contractual approach from modern economic theory. Our claim in this paper is that TM and copyright laws are not the appropriate instruments for

¹For a thorough historical review and analysis of the current confused state of the law relating to gray market goods, see Lipner (1990).
enforcing restrictions against gray goods for two reasons. First, these laws fail to discriminate between efficient restrictions on gray goods and those that are anticompetitive. Because the exclusion of gray goods eliminates intrabrand competition, it should be scrutinized from an antitrust perspective. Second, TM enforcement against gray goods constrains and distorts the feasible set of arrangements for organizing an efficient distribution system. We argue that a policy that combines contract, tort, and antitrust law is superior to trademark laws in both of these dimensions. This paper focuses on the laws in the United States, but the policies prescribed are universally applicable.

We adopt a framework that resembles a typical gray market situation: A manufacturer supplies a product to an authorized distributor in each of several countries. In most countries including the United States, the TM owner has the exclusive right to use (or to delegate the use of) a particular symbol or attribute that is attached to a good. For example, a product obtains special protection from its TM or from the copyrighted design of its box.) This property right may be undermined by gray markets, which arise when the retail price in a country is higher than the wholesale price in a second country plus shipping costs. The gray good is typically sold in direct competition with the authorized distributor through a discount store without warranties or other services. Authorized distributors worldwide have sought to use various mechanisms for restricting parallel imports, including, most commonly, claims of TM infringement. This is not a trivial issue, because gray markets are sizable, especially in countries with appreciating currencies. For example, a 1988 estimate of the size of the gray market in the United States was $7 to $10 billion per year. Some 60,000 gray market cars were imported from Europe in 1985. Gray market car sales in Germany in 1996 are estimated at over 300,000, implying a minimum of $6 billion in sales.

A manufacturer’s private incentives to prevent gray goods are equivalent to those for segmenting markets by granting distributors an exclusive territory (ET), a common market restriction that constrains distributors from selling directly or indirectly (through third parties) into each others’ territories. The economics of territorial restrictions is well understood and can be applied directly to the analysis of restrictions

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2It was Dam (1966) who first noted the connection between TM and antitrust law, observing that any attempt by a TM owner to prevent the selling of gray goods through exclusive territory contracts reduces intrabrand competition and raises antitrust concerns.

3Usually, there is a single authorized firm in each country, responsible for distribution of the product in its country. Developing an organization where the responsibility of these tasks is left largely with a single independent distributor or subsidiary within each country can be efficient in the presence of large set-up costs and in economies of scale in distribution, and in collecting information on local tastes. For example, many multinational corporations are organized around subsidiaries or head offices in each country that have substantial decision-making power for the local market; this is the efficient means of organization.

4The incentive to engage in the gray market is more pronounced when exchange rates change rapidly but nominal prices in different markets are not sufficiently responsive. Prices may not respond to exchange rate fluctuations because of informational problems or adjustment costs. For example, two camera companies reported to Customs that they preferred to fix their prices for a reasonable period of time to avoid “yo-yoing” their distribution network. Cited in Tarr (1985, p. 25). This aspect seems to be empirically important: Gray markets seem to flourish at times of currency appreciation. For example, the U.S. gray market in luxury automobiles grew 2000% between 1981 and 1986 on the tail of considerable dollar appreciation [Lowe and McCrohan (1989)]. And as the Japanese yen appreciated at the end of the 1980s, gray imports achieved greater penetration in Japan. (See Armstrong L., W. Holstein, and A. Cuneo, “Now, Japan Is Feeling the Heat from the Gray Market,” Business Week, March 14, 1988, pp. 50–51.).

5Cespedes et al. (1988), p. 75. Other countries also face large gray markets; see, for example, Weigand (1989).


on gray goods. The main focus of our paper is then: When ET (or equivalently, gray
good exclusion) is socially efficient, what is the appropriate legal mechanism for
enforcing this restriction? In many countries including the United States, a TM
owner can prevent competition from gray goods by invoking its rights under TM
laws. Opponents of such a policy argue that it grants powers to TM owners that
extend well beyond protection from counterfeits and unauthorized copies to ex-
clude even genuine products. Proponents of such protection, on the other hand,
warn that gray goods may create consumer confusion and harm the goodwill of the
TM owner, resulting in a reduction in product quality, special services, information,
and product availability.

This issue is representative of the interface between intellectual property and anti-
trust policy. In general, TM rights are “exhausted” after the first sale of a product, in the
sense that the purchaser of a trademarked product may do with it as he wishes,
including reselling it. Thus, gray marketers claim that the manufacturer or authorized
distributor in the United States has no right to prevent them from reselling their goods
in the United States. However, when the TM is “territorial” (rather than universal), TM
law sometimes suspends this notion of exhaustion for the special case of cross-border
sales, and the gray marketer is prevented from resale of the product in the United
States, on the basis that the TM in one country is different from the same TM in another
country. The effect of this policy is to enforce a vertical restraint, typically the domain
of antitrust law. To the extent that this vertical restraint would not be supported in an
antitrust court, the two sets of laws are in conflict. We argue that they should actually be
complementary in coordinating the policy toward gray goods so that the optimal policy
allows for both ET and exhaustion.

The paper is organized as follows. In Section II, we analyze the private incentives for
designing a distribution system around ET (or gray market exclusion), as identified in the
economic literature, and the social implications of such a design. After establishing that
gray good restrictions may be socially efficient in some cases, we address the issue of how
these territorial restrictions might be best enforced. In Section III we review the use of
TM laws to exclude gray goods and to show that enforcement based on it will be
inefficient. A policy toward gray market imports, recommended in Section IV, relies on
the laws that are used to regulate other types of territorial distribution systems. Section
V concludes the paper.

II. Restricting Intrabrand Competition

*Private Incentives for Exclusive Territories (or Gray Market Exclusion)*

The economic literature on the theory of the firm identifies a fundamental conflict that
prevails in most organizations: The collective interest of an organization may diverge
from the individual interests of its parts.8 This conflict is exacerbated in international
distribution networks, where the manufacturer attempts to maximize profits of the
entire organization but each distributor cares only about the profits that it generates
within its own market. Vertical controls may be necessary to attain local behavior that is
aligned with the interests of the organization. In this section, we identify four predom-
inant motivations for establishing ET.

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8See, for example, Williamson (1985) and Hart (1983).
Price Discrimination. Manufacturers may establish ET to facilitate price discrimination: If the price elasticities of demand for a product vary across countries, then a manufacturer may attempt to exploit those elasticity differences to increase its profits by charging different prices in different countries. Conditions that must exist for firms to practice successful price discrimination are well known.9 First, the firm must have some market power. Second, customers must be sorted according to different demand elasticities. Third, resale from one country to another must be prevented. The first and second conditions are often satisfied in markets for goods protected by TM rights because product differentiation, typical of such goods, grants some market power to the TM owner, and because the price elasticity of demand generally varies across countries in relation to per capita income. The third condition is satisfied when gray market goods are excluded from countries with high prices.

Facilitating Collusions. Rey and Stiglitz (1995) show that territorial restrictions may be used to dampen competition between manufacturers of differentiated products.10 Through ET, retailers enjoy market power, which results in markups over the wholesale price. In contrast to the situation with competitive distributors in which an increase in the wholesale price is passed on entirely in the form of higher retail prices, an increase in the wholesale price to exclusive retailers will be only partially passed on because imperfectly competitive retailers will maximize profits by absorbing part of the price increase. This makes the demand facing the manufacturers less elastic than for competitive retailers, hence softening competition between the manufacturers. Such collusion will be attenuated by gray goods unless distributors can be prevented from selling outside of their designated territories.

Preventing Free-Riding. Manufacturers often impose territorial restrictions to encourage the exclusive distributor to make specific investments in goodwill or intangible assets. This goodwill includes a reputation for delivering a certain quality of product and service, brand awareness, presale information, and post-sale services (such as warranties), and is created by investment in marketing, customer service, quality control, and protection from counterfeits. TM owners may invest in product control in ways that cannot be verified when the product is purchased.11 These investments may represent a substantial fixed cost for the authorized distributor. Rival distributors, or gray marketers, may not need to incur the expense of these investments and so can price above marginal cost but below the price set by the authorized distributor. An extreme example of this is the fragrance industry, which has been the constant target of gray marketers. The cost of marketing perfumes is frequently over 30% of the selling price, whereas transportation costs are very small, certainly less than 10%. Thus gray marketers, who spend very little on marketing, will typically be able to undercut the authorized distributors.12 Unless authorized distributors are restricted from selling (directly or indirectly) in another distributor’s country, each may have the incentive to divert some of its production to a firm (gray importer) outside of the distribution

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9See Varian (1989) for a comprehensive review of price discrimination.
11For example, the life of batteries may be shortened if the temperature is not properly controlled when the goods are being shipped.
Even with identical retail prices, gray goods may persist as long as there is a difference between the wholesale price in one country and the retail price in another. A price-marginal cost wedge for a good may give an authorized distributor the incentive to extract another distributor’s quasi-rents by diverting some products to a gray marketer in the latter’s country.

**Preventing Consumer Confusion.** ET may be used to prevent consumer confusion when the product differs between countries. Many goods with identical TMs are produced in different locations under different specifications, vary according to local tastes, have different packaging and instructions, and comply with different safety standards. A common TM may be used because of economies of scale in brand development, or because information flows easily between countries through newspapers, television, and travel. However, if a common TM is used and prices differ between countries, then gray markets may emerge as unauthorized importers try to pass off one product for another. This undoubtedly will cause confusion and may cause distributors to reduce their investment. Hence, market segmentation is needed to ensure that their efforts will not be undermined by gray marketers.

**The Social Efficiency of Exclusive Territories**

Opponents of restrictions on gray good argue that exclusive territories are most often established to facilitate price discrimination and collusion, so that gray goods increase consumer welfare. Those who favor gray good exclusion tend to rely on free riding and product differences. If the former motivations for ET are relevant, then private efficiency of such a market arrangement may not coincide with social efficiency. The clearest case of this is ET established for collusive purposes; the efficiency implications of price discrimination are less transparent. The welfare of the country accepting gray goods is unambiguously harmed by enforcing ET if the exclusive territories are supporting a scheme of international price discrimination, because allowing gray goods would not eliminate the availability of the good in the country but would reduce the price. However, because such a policy may jeopardize the availability of the product in markets with high price elasticity (low-income countries), price discrimination may be globally welfare enhancing. Private efficiency coincides unambiguously with social efficiency when ET prevents free riding and consumer confusion. If gray markets arise in such cases, authorized distributors will be inclined to cut back on their investment in goodwill or in product development at a loss to consumers’ welfare.

**Toward a Policy on Gray Goods**

We have examined the private and social incentives for eliminating intrabrand competition between distributors (and gray marketers). Attempts to identify empirically which motivations are most pervasive for excluding gray goods reveal that all motivations are...
important and suggest that more than one explanation may apply in many cases. Malueg and Schwartz (1994) find that both price discrimination and free riding seem to be responsible for gray market imports, but they observe that an important additional factor in stimulating the gray market is sudden changes in exchange rates.\textsuperscript{16} Currency revaluations are particularly important because setting up a network to arbitrage price differences across countries usually takes some time and expense, allowing a firm to price discriminate opportunistically until gray marketers organize. It seems implausible that the increases in gray market activity observed in countries whose currencies are being revalued upward indicate a sudden increase in free riding. Hilke finds that a combination of factors may have stimulated the growth in gray market imports in the United States in the early 1980s, but argues that price discrimination was most powerful.\textsuperscript{17} Tarr (1985) concludes that free riding was an important factor in some industries, such as fragrances, but that price discrimination was the key factor in other industries, such as automobiles, Japanese cameras, ski equipment, outboard motors, and champagne. \textsuperscript{18} For example, in Osawa v. B&H Photo, the defendants (gray marketers) argued that Osawa-Japan was price discriminating to such an extent that the gray market retail price was lower than the official U.S. wholesale price.\textsuperscript{19}

Quality differences are often alleged to be the motivating factor for eliminating gray goods; however, courts in the United States have been reluctant to protect distributors against gray goods on the basis of product differences.\textsuperscript{20} In several cases in which the warranty was the primary difference, the court recommended a resolution by centralizing warranties through the manufacturer rather than by gray market restrictions.\textsuperscript{21}

The paucity of cases brought under the allegation of collusion suggests that it may not be common, perhaps because it requires a restrictive set of conditions: Rival firms must have market power, and they must coordinate exclusive territories across countries. Alternatively, coordination may be common but difficult to identify, because firms are unlikely to publicize it. Although issues of antitrust have been raised in gray market cases,\textsuperscript{22} a violation against the Sherman Act was found in only one U.S. case, Guerlain,
by a lower court.\textsuperscript{23} However, the judge’s reasoning behind his conclusion that a number of perfume companies were engaged in collusion was considered erroneous, eventually leading to a dismissal of the case.\textsuperscript{24}

The empirical evidence indicates that all the four motivations for restricting competition between distributors may be important. Keeping in mind that disentangling the motivations may not always be straightforward, as a first step toward a policy on gray goods, we make the following recommendation:

**RECOMMENDATION 1:** The exclusion of gray goods should be allowed, except when it is used to facilitate collusion or to enforce anticompetitive price discrimination.

Recommendation 1 establishes the notion that although the exclusion of gray goods may be socially efficient, an optimal policy should allow the exclusion of gray goods in some cases, essentially setting up the same standard as that laid down by the Supreme Court in *Continental T.V. v. GTE Sylvania*. Note that this recommendation is only a preliminary step toward a policy on gray goods, simply stating what to do if policymakers are omniscient. It begs two important questions: first, which laws should be used to enforce or prevent the exclusion of gray goods? And, second, how might policymakers identify which motivation is relevant in a particular case? Both of these issues are addressed in Section IV where a complete policy toward gray goods is developed. Before developing the policy, we examine in Section III the legal mechanisms that are actually invoked in U.S. gray market cases and identify the inefficiencies of those policies.

### III. TM and Copyright Law as Instruments for Preventing Gray Market Imports

The previous review of the incentives for excluding gray goods summarizes the accepted message from the vertical restraints literature: Restrictions on intrabrand competition may be efficient both from private and social points of view. In this section, we examine the current approach for enforcing such restrictions under TM and copyright laws. The first part of Section III reviews the U.S. law governing gray goods. In the second part of Section III we show that these laws may inefficiently distort manufacturer distribution systems.

#### Gray Market Policy in the United States

Three key TM statutes affect the importation of gray goods in the United States: (1) §42 of the Lanham Act, which prohibits the import of an article "which shall copy or who opposes the enforcement of a TM on the ground that its use violates antitrust law has a heavy burden. The natural monopoly that a TM owner has over its product does not violate antitrust law unless it is used to gain control of the relevant market.” This view is consistent with current jurisprudence on competition policy towards vertical restraints, under which exclusive territories are subject to rule of reason. In *Disenos v. Work*, 676 F. Supp. 1344 (SDNY 1984), Judge Glasser found that the allegation leveled against the distributor of misusing the trademark for the sole purpose of stifling competition was a triable issue, but required that the gray marketer show that the product had sufficient market share to constitute a threat to competition. Gray marketers received a more hostile reception in *Original Appalachian Artworks v. Granada Electronics* (816 F.2d 68 at 74 (2d Cir. 1987)), in which their argument that the “wide disparity in price” between domestic and foreign Cabbage Patch dolls reflected a violation of antitrust law was dismissed on the grounds that the gray marketers had suffered no “antitrust injury that would give [them] standing to challenge” the pricing.

\textsuperscript{23}In this case, three U.S. exclusive distributors of high-priced perfumes and colognes, together with foreign manufacturers of the product, were named as parties to a collusive agreement that “monopolized the trade in these products by attempting to exclude gray market imports.” [See Lipner (1990), note 1, p. 21.]

simulate the name of any manufacturer or trader registered in the United States or abroad; (2) the Tariff Act (19 U.S.C. §526), which prohibits the importation of "any merchandise of foreign manufacture if such merchandise . . . bears a trademark owned by a citizen of, or by a corporation or association created or organized within, the United States" without consent; and (3) Customs Regulation 19 C.F.R. 133.21, which forbids the importation of "foreign-made articles bearing a trademark identical to one owned and recorded" by a U.S. citizen or corporation. The latter regulation also contains the "common control exception," which exempts imports of goods where the foreign and U.S. TM owners are "parent and subsidiary companies or are otherwise subject to common ownership or control." The validity of the common control exception has been widely discussed in the U.S. courts, culminating in a 1988 Supreme Court ruling supporting the exception. The conclusions reached by the Supreme Court can be summarized in the following rules:

**Rule 1:** If the authorized and gray goods differ materially, the goods may be excluded under §526.

**Rule 2:** Regardless of product similarity, if the U.S. mark holder is independent of the foreign manufacturer, or if it authorizes production of the TM goods by an independent firm abroad, then the gray goods may be excluded under §526; otherwise, Customs may choose not to exclude the gray goods.

The first rule is intended to prevent consumer confusion. The rationale for the second rule is to protect the American TM owner’s goodwill, but only applies when the U.S. distributor is not under common control with the manufacturer. This is based on the assumption that an integrated firm can use “self-help” methods to prevent gray goods by ensuring that its distributors minimize sales to gray marketers.

Additionally, the Copyright Act (17 U.S.C.A. §§101-914) protects copyright owners against both unauthorized importation and subsequent unauthorized distribution of copies of copyrighted materials. This statute has been used in several recent cases to exclude gray market imports. In *Parfums Givenchy*, the authorized U.S. distributor successfully blocked gray market imports on the basis of copyright infringement of the box design. This case was of particular interest because the authorized distributor was the wholly owned subsidiary of the manufacturer, so that the appeal to the Copyright Act has somewhat eviscerated the common control exception of the Customs Regulation. It remains to be seen whether other authorized distributors will successfully use the Copyright Act to minimize the gray market. To the extent that copyright is used in the same way as TMs to exclude gray goods, then the discussion in this paper also applies to it.

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25 Other relevant statutes are §337 of the Tariff Act (1930), and various state laws, including legislation requiring vendors of gray market goods to give conspicuous notice to the consumer of differences in their product from the product sold through authorized distributors.


Distortions Created by TM Enforcement in Gray Goods Cases

The previous section reveals that TM owners have considerable scope to prevent gray good imports and, therefore, to support a system of international exclusive territories. Two features stand out: (1) distributors can successfully protect exclusive territories if they appeal to TM law; and (2) distributors that are not affiliated with the original mark owner (manufacturer) obtain more protection. We argue that these two features of current policy toward gray markets may lead to distortions in the distribution of the product. To see this, we define the “first-best” privately optimal organization of distribution as the organization that maximizes profits when the manufacturer is unconstrained to contract as it wishes with its distributors. We show that current policies may constrain the manufacturer from reaching this optimal organization or may distort the manufacturer’s incentives.

Assume that the manufacturer chooses to distribute its product through an independent firm, rather than to integrate into distribution. Four organizational structures for distributing a product are possible:

1. Assign only national TM rights to each national distributor.
2. Assign only exclusive territories (ET) to each national distributor; under this restriction, distributors are constrained from selling, either directly or indirectly, through third parties, in another distributor’s territory.
3. Assign both TM and ET rights.
4. Assign neither TM nor ET rights.

**Distortion 1: A Bias Against Competition.** When TM owners are automatically protected from gray goods by TM laws, arrangement (1) will not be feasible. If TM rights include the ability to block gray goods, then assignment of those rights to the distributor effectively eliminates any possibility of competition from other distributors or gray marketers. That is, if the manufacturer assigns the TM, the distributor is incidentally given an ET and might seek to prevent intrabrand competition in situations where complete market segmentation is neither privately (from the organization’s point of view) nor socially efficient. Hence, a bias in organizational design may be created if the manufacturer wants to transfer the TM rights to the distributor without segmenting markets. To determine the scope of that bias we must identify under what conditions it would be privately efficient to maintain competition among distributors, while assigning TM rights to some (or all) distributors.

TMds distinguish one brand from another, thus achieving two goals simultaneously: the prevention of consumer confusion and protection of a firm’s goodwill. (A copyright may be used in the same way when the product includes some distinct copyrighted characteristic, as in Parfums Givenchy.) In practice, investment in developing a TM may involve monitoring for counterfeiters who attempt to pass off their product as the genuine one, controlling product quality to ensure consistency in product characteristics, and developing the consumers’ image of the brand through, for example, advertising and product promotions. These are ways in which goodwill is fostered in a brand.

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28Economides (1989) notes that “tradenames may indirectly signal a quality standard extending to multiple products within a category... Firms may use tradenames to help the consumer identify the quality level of products... Choosing a high quality standard in the category of electronic products, a manufacturer can use his tradename to transmit information on quality through the direct previous experience of consumers.”
We discuss below the reasons for assigning a TM, which may differ from the reasons for granting ET.

The first reason for assigning a TM is that the assignee may have some advantage in promoting the mark because of informational or cost advantages; at the same time, the assignee must also be capable of supporting the mark, that is to say, of exercising some degree of quality control over products bearing the TM. Assignment of a TM confers “residual rights of control,” the rights to determine how that asset will be used under contingencies not specified in the contract. An exclusive dealing contract, by definition, cannot do this. Grossman and Hart (1986) show that these residual rights should be given to the party whose investment in the value of the asset (brand name capital) is more important; that party may very well be the distributor. For example, a TM may be assigned when the distributor has a better knowledge of the local market that cannot be easily conveyed to the foreign manufacturer and thus has a competitive advantage in developing the TM.

TMs may be assigned to reduce the possibility of manufacturer opportunism. For example, if the manufacturer retains TM ownership, it may have an incentive to introduce substitute products under the same (or a similar) brand name through a different distributorship after the first distributor has made specific investments in developing it. Recognizing the potential for opportunism, the distributor will either reduce its payment to the manufacturer or invest less in marketing the product. By assigning the TM, the manufacturer commits itself not to behave opportunistically in this respect. To the extent that contracts are incomplete, especially regarding future products, the transfer of the TM may be efficient.

Assigning a TM—but not an exclusive territory—will also allow limited international competition. Eliminating competition between distributors may not always be best from the organization’s point of view. At least two motivations for encouraging competition (and therefore gray goods) have been given in the literature: (1) to mitigate the double-marginalization problem; and (2) to provide insurance to risk-averse distributors.

Double-marginalization occurs when both the manufacturer and distributor have monopoly power that permits them to set the wholesale and retail prices, respectively, above their marginal costs. That is, the manufacturer marks up its wholesale price over its marginal cost, and the distributor marks up the retail price over the wholesale price (plus other marginal costs it may incur). Consequently, the retail price will exceed that which would be set by a vertically integrated monopolist, implying lower total profits and lower consumer welfare.29 Competition among distributors (either directly or through gray marketers) can eliminate or at least reduce this problem, so that retail prices approach those that would be set by a vertically integrated firm. Consequently, the manufacturer may desire competition between distributors (either direct or

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29If the foreign TM owner is constrained to charge a per unit wholesale price for the goods transferred to the distributors, and if firms are allocated ET, there will be a double mark-up; that is, both the foreign TM owner and the distributor will set the wholesale and retail prices, respectively, above their marginal costs. Fixed fees may be imperfect instruments for extracting rents either because of unknown demand (the manufacturer cannot estimate the correct fee to charge), or possibly because of risk aversion on the part of the distributor. Alternatively, incentives for the manufacturer to advertise or upgrade the product’s quality may require that the manufacturer retain a claim on the profits earned, so that it will have the incentive to improve the product. See Tirole (1988) for a more detailed explanation of the double mark up.
through gray goods). Because retail prices are lower, a reduction in the double mark up will also be socially desirable.

Competition also has the advantage of providing good insurance for distributors, as shown by Rey and Tirole (1986). Competing retailers are fully insured in the sense that their profit margin is equal to zero for any realization of the cost uncertainty. When a distributor’s cost increases, so do the costs of its competitors, so that the competitive price fully reflects the cost uncertainty. A manufacturer can also obtain the vertically integrated profits by granting exclusive territories to its distributors, setting the wholesale price equal to marginal cost, and then extracting the distributors’ profits through a fixed fee. However, in this case, distributors bear all the risk of any change in their distribution costs. Thus, ET has poor insurance properties, and so the manufacturer may want to allow for competition between its distributors when they are risk averse.

If competition between distributors is desirable for either of these reasons, one might ask why the TM owner does not simply license a second distributor in a particular country if it wants to discipline the exclusive distributor. One possible answer is that competition from a foreign distributor may be more efficient because it has already incurred the fixed distribution/production costs to serve another market. Alternatively, the TM owner may want to limit (but not eliminate) the competition (so as to maintain incentives for providing services); transportation costs provide a natural constraint.

To summarize, a manufacturer may want to sell or assign its TM while simultaneously promoting limited international competition between distributors, but current laws make that arrangement infeasible, so that arrangement (1) is distorted to arrangement (3). Thus, the distribution of products may be (privately) inefficient. Even if the manufacturer intended to segment markets, and providing for the TM facilitated this, excluding gray goods through TM law could be inefficient from a social point of view. As discussed earlier, there may be instances in which territorial restrictions are anti-competitive, but if they can be enforced under TM law, such arrangements will escape the appropriate antitrust scrutiny that is given to such restrictions when contractually specified. In fact, the manufacturer may simply rely on the TM assignment to enforce ET, rather than specify the restriction contractually, so as to circumvent antitrust investigation. Hence, even when the privately efficient organization involves both TM and ET (Choice 3 above), allowing TM assignees the right to exclude gray goods may be socially undesirable.

Distortion 2: A Bias in Corporate Structure. Because distributors can appeal to TM law to segment markets, and because they will be more successful when corporately independent from the manufacturer, two organizational biases may occur as a result of the laws relating to gray goods. First, the manufacturer may assign the TM to its exclusive distributors (Arrangement 3) even when this is not efficient because, for example, it has a relative advantage in TM development (i.e., it should choose Arrangement 2). Second, it may distribute its product through an independent distributor when vertical integration is more efficient. That is, the manufacturer may choose to assign the TM to an independent distributor because of the stronger protection obtained against intra-brand competition.

This distortion of choosing TM to segment markets arises directly from extending TM protection to cover gray goods and from the fact that the protection is limited to
independent distributors under U.S. laws.\textsuperscript{30} As discussed in the previous section, the Tariff Act, as interpreted by Customs regulations, does not permit the establishment of national exclusive territories when the U.S. TM owner is corporately affiliated to the foreign manufacturer (the “common control exception”). This gives an incentive for the manufacturer, wanting to segment the markets for its products, to assign the American TM not to a subsidiary but to an independent distributor.

At least two cases have come before the courts in which a would-be gray marketer has claimed that a TM assignment to an independent distributor was an assignment in gross (that is to say, invalid) because the principal purpose of the assignment was to obtain the exclusion of gray goods.\textsuperscript{31} Although these cases were unsuccessful, in one of them the trial judge agreed that the assignment might have been motivated by the ability to qualify for customs exclusion, which in itself was not a triable issue. Normally, a TM would be assigned because the distributor has greater efficiency or lower cost in promoting and developing the TM. However, these cases suggest that, given the many private advantages from gray good exclusion, international manufacturers may choose to assign the TM to the U.S. distributor not because of efficiency or cost considerations but despite them.\textsuperscript{32}

The rationale behind the “common control exception” is that preventing gray goods is easier to implement privately when a distributor is company owned. If an integrated firm cannot prevent gray goods, the argument goes, it has not tried hard enough or it is simply engaged in international price discrimination. An independent domestic distributor, on the other hand, is less able to stem the supply of gray goods. Moreover, the courts may have difficulty identifying independent, local goodwill when the two firms are vertically integrated. Hence, although a contract with ET rights on the sale of a trademarked good might be supported in court, the distributor would not benefit from customs exclusion if it were a subsidiary of the foreign manufacturer.\textsuperscript{33}

The reasoning for this rule is misguided.\textsuperscript{34} First, there are many instances in which parent companies efficiently decentralize distribution and production decisions with their subsidiaries, which then invest in local goodwill. Another distributor or unauthorized importer may have the incentive to free-ride on that goodwill. Many of the “self-help” measures, such as centralizing advertising, warranties, and other services, may be more expensive than decentralization, and in any case, this solution of decentralization should apply equally to organizations developed around independent firms.

Second, the argument that international price discrimination is easier to achieve with

\textsuperscript{30}Although only U.S. laws are explicit, it is likely that even in other countries assignees that are subsidiaries of the foreign manufacturer will receive a less favorable treatment than independent assignees.

\textsuperscript{31}\textit{Premier Dental Products Co. v. Darby Dental Supply Inc.}, No. 85-1468, slip opinion (E.D.PA. 1986); and \textit{J. Atkins Holdings Ltd. v. English Discounts Inc.}, 14 USPQ2d 1301.

\textsuperscript{32}It is worth remarking that assigning a TM cannot be a hollow transaction and still benefit from the Customs exclusion under Section 526. If the assignment is not accompanied by an independent development of goodwill on the part of the U.S. mark holder, then the assignment is said to be an assignment in gross and is invalid.

\textsuperscript{33}Comparison of this rule with the antitrust treatment of vertical integration is interesting. Under antitrust law, a vertically integrated firm is usually less constrained by law in achieving the optimal organization than is a nonintegrated manufacturer entering into vertical contracts with distributors. For example, vertically integrated firms are not restricted in their internal pricing, advertising, and servicing arrangements, whereas a nonintegrated manufacturer is constrained from setting resale price maintenance and other vertical restraints.

\textsuperscript{34}There has been much criticism of the common control exception: Judge Leval, writing on a gray market case, observed that “Antitrust questions are far too complex to be reasonably decided by reference to a short questionnaire on corporate ownership,” and concluded that the Customs regulation was “unsound as antitrust policy and as trademark law.” (\textit{Osawa v. B & H Photo}, 589 F. Supp. at 1178.)
subsidiaries than independent firms when markets are segmented is not convincing. If contracts are enforceable, then any diverting distributor could be punished, whether it is a subsidiary or an independent firm. If these contracts are not enforceable, because arbitrage between distributors is difficult to control, then the manufacturer can vertically integrate into distribution in the country with the more elastic demand and can distribute through an independent firm in the inelastic-demand country. Integration may prevent resale of the low-price good into the high-price country by the subsidiary, but this putative advantage of integration would be constrained by unauthorized importers of the goods.

With these two distortions emerging from the current treatment of gray market goods, we turn now to an alternative policy recommendation for gray goods.

IV. A Policy on Gray Markets

The essence of the previous section is that TM law as a tool in supporting exclusive territories may be privately distortionary, relative to the choices that would be made if the manufacturer were unconstrained in its decisions. In this section, we show that the current laws in the United States are also socially inefficient, and we offer an alternative.

The Policy Recommendation

The policy of protecting distributors from gray goods that we recommend does not invoke TM law:

**RECOMMENDATION 2:** TM rights should include protection from counterfeit goods and the right to develop the TM, but not the right to exclude genuine goods imported from foreign distributors within the international distribution system.

This view that TM protection should not be extended to include gray goods is not based on the conventional “more competition is better” reasoning in the literature but follows from two principles: (1) Manufacturers should have the widest—and most efficient—selection of contractual arrangements, allowing firms the flexibility to contract separately for exclusive territories and assignment of trademarks, but subject to (2) the law preventing welfare-reducing restrictions in contracts.

The policy prescription that we recommend involves the coordination of three areas of the law: contracts, torts, and antitrust. This combination of laws for enforcing ET (restrictions on gray goods) is superior to the current policy according to both criteria laid out above because it is more effective in preventing anticompetitive uses of ET and it is less distortionary to the manufacturer’s design of its distribution system. Under this view, TM laws form only one component of the set of laws that govern distributational relationships. If the manufacturer wishes to segment markets, then territorial restrictions should be included explicitly in the contract. That is, the policy we propose “unties” TM from ET and from corporate structure so that the various contractual arrangements can be chosen separately.

The three laws that comprise this policy would be implemented in the following way:

First, a distributor granted an exclusive territory in its contract could appeal to contract law to enforce it in the event that an authorized distributor or the manufacturer sells the good outside of its territory. However, because contract law does not permit a distributor to file a suit against a party outside the contract, manufacturers could police the distribution system to prevent supplies to gray marketers or could appeal to the common law tort of unfair competition to prevent gray marketers who are free riding. Finally, the
competition law of the country into which gray goods are imported would evaluate anticompetitive implications of gray market exclusion. Consistent with the treatment of exclusive territories in competition policy cases, the burden of proof that gray goods exclusion is socially harmful should reside with the gray marketer or violator of the ET contract.

For the case in which the manufacturer chooses competition among its distributors over territorial segmentation, it should be presumed that because competition among distributors is privately efficient, it is also efficient for consumers. That is, if ET had been necessary to encourage investment in the product, the TM owner would have offered it or the distributor would have insisted on it. In contrast to the current policy, this recommendation would not interfere with the private decision to encourage competition.

Some courts have tended to take a paternalistic view toward the local distributor who has purchased a TM from an “opportunistic” manufacturer, starting in the United States with *Bourjois v. Katzel*.\(^{35}\) We argue that protecting individuals from entering into unprofitable contracts is not the mandate of the law. The policy toward gray goods should generally not constrain intrabrand competition more than is desired by the original TM owner (as revealed through the decision to segment territories); such government intervention would simply raise prices. If protection from differentiated products bearing the same TM were necessary, then one would expect the original owner to have provided for this through ET.\(^{36}\)

ET is not a difficult clause to contract for, and the private incentives for establishing ET, outlined in Section II, should be reasonably evident to the original TM owner. If ET has not been specified, but perhaps should have been (for example, if the gray goods differ significantly from the domestic TM good), rather than banning the importation of the gray goods, possible solutions include the mandatory labeling of product differences, as under some state laws.\(^{37}\) This approach mitigates consumer confusion without eliminating the (possibly efficient) competition between distributors. The message here is that the law should not presume to rewrite private contracts, except in blatant cases of deception or misrepresentation.

### The Identification Problem

Our “freedom-to-contract” policy outlined above turns on the perspective that the law should attempt to maximize the set of feasible contracts for the privately efficient design

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\(^{36}\) An exception to this rule might occur when contracts are incomplete, in which case courts may want to intervene to exclude gray goods, even when this protection has not been privately contracted. The “freedom-to-contract” perspective of the law assumes that the ability of TM owners to set up efficient contracts is perfect (and therefore that the role played by law should be minimal). An alternative perspective to the “freedom-to-contract” is that the law should complete contracts, when necessary. For example, suppose that the original TM owner, had it anticipated the situation, would have guaranteed ET because it is part of the privately efficient complete contract that would have been written in the absence of contracting costs. If gray goods are permitted, consumers may become confused. Because the foreign TM owner did not anticipate some change (e.g., a currency fluctuation), it may not have taken the necessary precautions (e.g., different TMs on the products or ET) to protect its TM product from consumer confusion. Although a case could be made for providing protection from gray goods may be justified even when the distributor has not been given ET status, the court should be circumspect in exercising this interventionist rule; for example, it should be restricted to cases in which the gray products are considerably different, thus causing confusion and harm to the distributor’s goodwill.

of organizations when they are also socially efficient; at the same time, the law should not provide extra advantages for certain contractual forms in a way that distorts organizational incentives. However, there are at least two problems of implementation that must be considered. As noted in Recommendation 1, ET (or gray market exclusion) is not always socially efficient; in such cases, our policy recommends that competition be permitted through the free flow of gray goods. The problem facing competition authorities is to identify the motivation behind the inclusion of territorial restrictions in the contract.

In gray goods cases, the courts have attempted to identify when the motivation behind territorial division is a welfare-improving one by determining the existence and value of local goodwill. The judgments made by courts as to the value of goodwill seem to have depended on the complexity of the product; for example, electronics require local special services, whereas exclusive distributors of simpler goods such as clothing, toothpaste, soap, batteries, toys, and perfume need more evidence to convince the court of their local contributions.

Attempting to measure local goodwill is difficult, at best, and may be misleading. The presence of local goodwill is neither necessary nor sufficient for ET to be an efficient arrangement. Rather than attempting to identify whether ET is established for socially efficient reasons, courts should try to establish whether it is contracted for socially inefficient reasons. In particular, a necessary condition for successful price discrimination or collusive behavior is significant market power.\textsuperscript{38} Competition between manufacturers in the relevant market should alleviate concerns over restrictions in intrabrand competition.

A correlation seems to exist between products that are sold in noncompetitive markets (where price discrimination or collusion could be a threat) and those that require local goodwill. Conversely, products in highly competitive markets do not seem to require investment in specific assets. For example, markets for razors, soap, lotion, dolls, and toothpaste are competitive, and free riding on local goodwill hardly seems to be relevant in these cases. Hence, exclusive territories, if observed, would be hard to justify from a social perspective. Investment in specific assets and local services is necessary for products in more concentrated markets such as electronics, computers, and watches. High market concentration does not imply significant market power if potential entry limits the price that the monopolist can charge. Even if the TM owner/manufacturer has significant market power, exclusive territories may be welfare increasing if consumers benefit from the added services and information under ET that this restriction encourages.

Some argue that courts should be particularly lenient when trademarked goods differ in some characteristics because protecting consumers from misrepresentation is the primary intent of TM law. However, caution is required in allowing gray market exclusion for this reason. If a ban on gray goods were allowed whenever products differed, it could pay the manufacturer to differentiate its product only slightly across

\textsuperscript{38}Market power is the power to control prices or exclude rivals. However, short-run market power is not exclusionary in itself; its practice often attracts firms into the market. To maintain market power in the long run, the firm must be able to exclude rivals. Market share is often used as a proxy for market power, but the accuracy of this measure depends on defining correctly the relevant market. This requires a careful account of goods that are substitutes in consumption, substitutes in production, the excess capacity of firms in the market, and the potential for entry of new competitors.
countries to disguise a more anticompetitive motive for eliminating competition between its distributors.\footnote{Several gray goods have been excluded under TM law based on what seemed to be minimal differences. For example, Venezuelan Pepsi was excluded from Puerto Rico because of can size and product promotion; Spanish Cabbage Patch dolls were excluded from the United States because of language; various products were excluded from Canada because of English-only instructions; Heinz ketchup was barred from Canada because of a slightly different U.S. formula.}

The problem of identifying the motivation for ET is not an easy task; however, it is a challenge that courts have to face commonly in domestic competition cases. The economic analysis of territorial restrictions in which the benefits of providing the right incentives are balanced against the costs of facilitating anticompetitive behavior is equivalent to the task faced by courts in vertical competition policy cases.\footnote{We do not provide an analysis of the trade-offs here; rather, we refer to a prolific literature in this area and the references therein: Mathewson and Winter (1984, 1986, 1994); Posner (1981); Rey and Stiglitz (1995); Rey and Tirole (1986); and White (1991).} In contrast, courts that adjudicate cases based on TM laws fail to undertake this balancing act.

\textit{Problems of Enforcement}

Our policy recommends that contractual solutions be used, instead of TM law, to enforce ET (or the exclusion of gray goods). Contracts that specify territorial restrictions are intended to prevent exclusive distributors from selling in each others' territories. A problem of private enforcement of these contracts may arise when the original TM owner has sold the TM to two different firms in the two countries and it no longer has much interest in policing the contractual guarantees originally offered.

To be effective, the exclusive contract must prevent authorized distributors from selling to would-be gray marketers. However, because it may be difficult to identify gray marketers \textit{ex ante}, such restrictions on sales are difficult to enforce. Although remedies under contract law may protect authorized distributors with territorial rights from infringing parties to the contract, it is virtually powerless against third-parties outside of the contract (importers of gray goods). One possible solution is for the authorized distributor to make a case of common law tort of unfair competition against the gray marketer. Two approaches have been tried (unsuccessfully) in courts by authorized distributors facing gray market competition. One plaintiff argued that the gray marketer had intentionally interfered with contractual relations between it and the manufacturer.\footnote{\textit{DEP Corporation v. Interstate Cigar Company Inc.}, 622 F.2d 621 (1980).} Because this tort requires malicious intention on the part of the gray marketer, it seems an unlikely offensive against such competition.

The second approach focuses on the free riding on services provided by the authorized distributor. For example, in \textit{H.L. Hayden v. Siemens Medical Systems}, a distributor claimed that the parallel importer did not need to invest in showrooms because consumers were able to visit authorized dealers. Having ascertained which model they wanted to buy based on the explanations and demonstrations of the authorized dealers, consumers would then buy from the cheaper gray marketer.\footnote{\textit{H.L. Hayden of N.Y. v. Siemens Medical Systems}, 672 F. Supp. 724 (1987) at 752.} In this case, the trial judge noted that the services of the authorized distributor were not being “misappropriated in any legal sense,” and so dismissed the claim, on the basis of the decision in \textit{Societe Comptoir}, according to which “common law unfair competition must be grounded
in either deception or appropriation of the exclusive property of the plaintiff." But because, according to Societe Comptoir, it is appropriation of services, and not misappropriation, that forms the basis for the claim, this defense against gray marketers may yet be possible in cases in which there is blatant free riding on the services provided by the authorized distributor—exactly the class of cases in which gray goods are undesirable. However, although the common law tort of unfair competition may provide some protection to distributors, aside from the difficulty of showing "unfair competition," this legal remedy is indirect: Only the individual perpetrator is stopped, rather than gray goods in general. As Schwartz (1991) notes, "challenging individual distributors of infringing imported products, often in different parts of the U.S., has been likened to 'stamping out brushfires'."

Another possible approach to stopping gray marketers is through the claim of "unjust enrichment," when a gray marketer has profited "unjustly" at the expense of the authorized distributor who has invested in marketing the product. This argument was attempted (unsuccessfully) in the Israeli Supreme Court and may, perhaps, be applicable in the United States. However, no gray market cases in the United States have so far heard the "unjust enrichment" argument, so it is uncertain whether it would meet with any success.

Many opponents of gray goods call for an unconditional ban on all gray goods because nonprivate means may be inadequate to preserve efficient organizations. According to such arguments, Customs exclusion of gray goods is merely a sensible and cost-effective way of protecting vertical restraints, because other legal remedies (such as the tort of unfair competition) may not be sufficiently powerful to deter "harmful" gray goods. Even if one were to accept this argument, three problems echoing the biases discussed above arise. First, TM laws fail to take into consideration possible anticompetitive motivations for the exclusive territory they are enforcing, thus encouraging excessive TM assignment. Second, they promote inefficient distribution systems when competition between distributors is desirable because of the rights conferred to assignees of the mark, and because of the "common control exception" of TM law. Finally, if tort and contract law and internal policing of the distribution system are inadequate to control gray market imports from other countries, then they must be equally deficient for protecting domestic exclusive territories. It is not clear why international ET should be favored with a greater level of protection than domestic arrangements are able to obtain.

If the ease of enforcement under the current law is essential, then a more moderate private alternative to the unconditional ban would be to contract around the TM rights assigned to a distributor so as to constrain it from excluding gray goods. This contractual restriction, if feasible, could mitigate the first bias outlined in the second part of Section III while facilitating exclusive territories when they are efficient. As we argue below, such a restriction is not likely to be feasible under the current law.

Whether or not a contractual restriction on the exercise of an assignees' right to exclude gray goods would jeopardize the validity of a TM has not been tested by the courts. A few cases indicate that certain "limitations in an otherwise valid assignment do

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not invalidate it.” In *Premier Dental*, the assignor reserved the right to cancel the distributorship, in which case the TM and goodwill would be reassigned to it. In *Atkins*, the limitation obligated the assignee to license the assignor for the use of the marks in the United States. The latter case is of particular relevance here because the restriction could be interpreted as a constraint on the assignee’s right to exclude gray goods in the case of a single importer—the assignor. Whether such a restriction could be extended to apply to all potential gray market importers has not been tested, although, under the current law, such a clause could be viewed as vitiating the essence of TM protection and therefore the rights of the assignee to control the quality of the product sold under the TM. If the TM no longer identifies the source of the product effectively, it is apt to be vulnerable to infringers who could argue that the assignment explicitly disables the assignee from controlling the TM.

From a practical point of view, such a restriction that prevents the assignee from eliminating gray goods while being vigilant toward counterfeit goods may not be effective if the assignee has asymmetric information on the imported products. That is, the assignee will have the incentive to declare all goods bearing the TM as counterfeit and infringing, and, if monitoring by the manufacturer is costly, potential gray marketers may be discouraged by the expectation of ensuing legal battles. Notwithstanding these complicated legal and practical issues, even if such contractual restrictions were feasible, the other biases under the current policy—using TM to enforce anticompetitive market segmentation and the organizational biases toward TM assignment, against competition and against vertical integration—would remain problematic.

Consequently, in light of legitimate enforcement concerns, we recommend that when ET is contractually specified, courts should be sympathetic to plaintiffs in complaints of contractual violation or unfair competition by gray marketers, subject to an examination of the economic justification for the ET. Protection might be strengthened under these laws if contractual obligations were more closely scrutinized. For example, if the distributor’s contract specified some obligation such as quality control, the court might be more inclined to find misrepresentation by the gray marketer under tort law.

This combination of contract, competition, and tort law is more consistent and more flexible than extending TM rights to protect exclusive territories. The latter approach will encourage the inefficient assignment of TMs to achieve the desired ET protection, with the resulting vertical restraints being immune from antitrust scrutiny. In contrast, if ETs are treated as distinct from TM assignment under the law, the manufacturer can provide its distributors with control over the TM without having to create exclusive territories.

V. Conclusions

The policy prescription involves the coordination of three areas of the law—contract, tort, and antitrust—while being consistent with the fundamental objectives of TM laws: preventing consumer confusion and protecting firms’ goodwill. At the same time, the use of contract and tort law for enforcing exclusive territories respects the message of

45Premier Dental Products v. Darby Dental Supply, 794 F.2d.

46In Canada, courts have shown sympathy to authorized distributors who had a specified obligation that the gray marketer could and did not meet: for example, the distributor for Commodore products was required to undertake quality control measures, whereas the distributor for Mattel had a minimum sales requirement. See *Commodore Business Machines v. 116772 Canada Inc.*, 1985 C.S. (Que.) 1186 and *Mattel Canada Inc. v. GTS Acquisitions and Nintendo of America Inc.*, 27 CPR 3d 358 (Federal Court, 1989).
modern competition policy, that inter- and intrabrand competition should be balanced to maximize welfare.

Our policy toward gray goods rests on several principles. The first principle is that laws should operate so as to provide flexibility for the manufacturer to organize the distribution of its product in the most efficient manner. Second, when contracts are complete, they should generally be enforced. If the manufacturer/TM owner sees a role for impeding gray goods, then it should segment markets through contractual assignment of exclusive territories. These contracts would be enforced under the law of contracts and torts; in particular, contracts protect exclusive distributors from an opportunistic manufacturer or an authorized distributor that may or may not conspire with a third party, and common law gives some protection to exclusive distributors from unfair competition by importers. Of course, anticompetitive vertical arrangements should receive no such support.

If competition between TM owners across borders is privately efficient, then the presumption should be that is also socially efficient. In most cases, intrabrand competition should not be constrained by more than is desired by the original owner. Because the objectives of agents (distributors) may diverge from those of the organization, a distributor given TM ownership/user rights might attempt to protect its territory, if given the legal right, in situations where intrabrand competition is efficient from the perspective of the entire organization. Our recommendation based on the principle of “flexibility and freedom in contracting” has the joint effect of lessening inefficient distortions in organizational structures and subjecting ET arrangements explicitly to antitrust scrutiny.

Our proposed policy addresses many of the issues that have been raised during the extant international policy debates. Although the policies in most countries have been determined unilaterally, that is, with domestic interests in mind, recent multilateral discussions (such as those on the North American Free Trade Agreement (NAFTA), the General Agreement on Tariffs and Trade, and the European Union) have made import control rights and market segmentation important international issues. For example, the approach in Canada and the United States that favors granting import control rights to TM owners, has influenced other countries such as Mexico, where protection has historically been weak. The European Union, however, remains cautious about granting these rights: Article 36 of the European Economic Community (EEC) treaty states that intellectual property can be protected as long as it is not “a means of arbitrary price discrimination or a disguised restriction on trade between Member States.”

The policy we propose toward gray goods is consistent with free trade in recommending that genuine goods not be restricted by TM laws. We echo the European Union message on gray goods: Protectionism should not be concealed behind a convenient

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47Intellectual property laws have been reformed as part of the Salinas program for economic reform. In January 1990, Mexico relaxed regulations regarding licensing agreements. Some of the important changes include: (1) licensors may require that materials be purchased from specific suppliers and sources; (2) licensees may be required to keep proprietary information confidential after the agreement has expired; (3) licensee and licensor are free to determine the level of royalty fees; and (4) licensor may exercise more control over the operations of the licensee to maintain quality. On June 27, 1991, the Mexican Congress enacted a new law on patents and TMs. Compulsory licenses were eliminated, and the term of registration was extended from 5 to 10 years. These reforms may have a significant impact on trade and investment in Mexico. Enforcement, however, still remains an issue. During the NAFTA negotiations, the United States has pushed for greater enforcement of intellectual property laws in Mexico and higher penalties for counterfeit goods.

48Article 85(1) of the EEC Treaty (Treaty of Rome).
interpretation of TM laws. However, this policy may support international market segmentation in some instances. To the extent that the reduction of intrabrand competition encourages interbrand competition internationally, free trade is not jeopardized under the policy. As Anderson et al. (1990) point out, ET differs from barriers to trade in a fundamental way: Firms can choose the best distribution system for their products under the recommended policy. That is, the manufacturer can choose whether or not to invoke exclusive territory protection; it is not forced to use it. Our policy recommends that the manufacturer be given the flexibility to choose competition between its distributors. Under a tariff, it would not have that choice. Moreover, under this approach, the foreign firm can choose to locate production in the lowest-cost countries and can sell the product through local distributors. A tariff would inefficiently bias the organization toward decentralized production. Laws that allow TM owners to design the distribution system efficiently yield market outcomes that may look very different from policies that create trade barriers.

References


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49See Anderson et al. (1990) for a discussion of the relationship between intellectual property rights and international trade barriers.


