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FIRST REPORT (FINAL) TO THE COMMITTEE ON INTERNATIONAL TRADE LAW OF THE INTERNATIONAL LAW ASSOCIATION ON THE SUBJECT OF PARALLEL IMPORTATION

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ABSTRACT

The First Report on Parallel Imports approaches the exhaustion/parallel imports question in broad economic terms, asking whether there may be an economic and social welfare benefit to permitting IPRs holders to block parallel imports that outweighs the potential harm to liberal trade. The Report addresses each major form of IPR (patent, trademark and copyright) separately. It concludes with respect to each form that the evidence of benefits that might flow from allowing parallel imports to be blocked is insufficient to justify the potential inhibition of trade. The Report observes that most objectives which IPRs holders seek to achieve by the allocation of geographic markets can be attained through less trade restrictive means, namely through the vertical allocation of distribution territories by contract. The interests of the developing countries are a focus of the Report. Some economists have suggested that allowing rules on parallel importation to enforce price discrimination in favor of developing countries may increase global economic welfare. The Report concludes that developing and developed countries are better served by open markets and the operation of comparative advantage. The Report recommends that the WTO adopt a rule precluding governments from blocking parallel imports save in certain exceptional cases, and it also suggests that further study of this issue would be desirable.

INTRODUCTION

On June 22, 1995 the International Trade Law Committee of the ILA (ITLC) met at the Headquarters of the World Intellectual Property

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Organization (WIPO) in Geneva to discuss issues relating to the implementation of the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement). Following presentation of a preliminary report by this Rapporteur, presentations by Professors Thomas Cottier and Mitsuo Matsushita, and discussion among Committee Members concerning the subject of parallel importation, it was agreed by the Committee that a study of the role of parallel imports in the international trading system would form part of the Committee's work program. A general discussion of legal issues relating to parallel importation was incorporated in the Second Report of the ITLC adopted at the August 1996 ILA Helsinki Conference. A preliminary draft of this First Report was presented and discussed at the working meeting of the ITLC in Helsinki. This Rapporteur undertook to prepare revisions to the preliminary draft based upon observations made orally and in writing by Members of the Committee, and to circulate the report for reaction by industry and other groups. Also in 1996, the preliminary draft was presented at a workshop at the Max-Planck Institute for Foreign and International Patent, Copyright and Competition Law in Munich. A number of useful observations were made at that workshop.[1] This Rapporteur has discussed the substance of the report with representatives of WTO Member governments, and with members of the WTO Secretariat. In preparation for the June 1997 meeting of the ITLC at the headquarters of the World Intellectual Property Organization, this Report has been circulated for reaction to industry groups in a number of countries and regions. The initial response of these groups will be reported on at the June 1997 meeting.

1. DEFINING THE PARALLEL IMPORTS QUESTION

The parallel imports *question* may be succinctly stated as follows:

> To what extent should intellectual property rights (IPRs) holders within particular national/regional territories be entitled to restrict the importation of goods and services into those territories on the basis of local IPRs ownership when the subject goods and services have been placed on the market outside the territory of importation with their consent?

In other words, should the authorized first sale of a good or service in any national or regional jurisdiction exhaust the right of the IPRs owner to control the subsequent movement across borders of that good or service on the basis of the IPR? This question is intricately connected both to the international trading system and its basic principles of operation, and to the international system for the protection of IPRs.

[1] The Rapporteur was invited to return for further discussion of the Committee's work on the subject of parallel importation as it proceeds.

The TRIPS Agreement formula and its extension to the Copyright and Performances Treaties

Article 6 (Exhaustion) of the TRIPS Agreement provides that:

> For the purposes of dispute settlement under this Agreement, subject to the provisions of Articles 3 and 4 [national and MFN treatment] nothing in this Agreement shall be used to address the issue of the exhaustion of intellectual property rights.

This formula was the result of a compromise among the interested GATT Contracting Parties in the Uruguay Round TRIPS negotiations: developing countries that largely favored a rule of international exhaustion,[2] the European Union that sought to assure preservation of the intra-Union exhaustion doctrine,[3] and the United States that largely favored rules restricting parallel imports based on existing US legislation and doctrine.[4] The formula conveys three messages: (1) the subject of exhaustion of IPRs and parallel imports was not inadvertently overlooked; (2) TRIPS negotiators failed to reach a consensus on the subject; and (3) having failed to reach a consensus on result, each WTO Member reserves the right to regulate parallel imports in the manner it considers appropriate.[5]

In December 1996 two new treaties with respect to intellectual property rights were adopted at WIPO: the Copyright Treaty and the Performances and Phonograms Treaty.[6] These two treaties include provisions with respect to the exhaustion of rights that are substantively equivalent to Article 6 of the TRIPs Agreement,[7] and reflect the continuing lack of

[2] See, e.g., J. S. Chard and C. J. Mellor, Intellectual Property Rights and Parallel Importation, 12 World Econ. 69 (1989).

[3] See F. M. Abbott, GATT and The European Community: A Formula for Peaceful Coexistence, 12 Mich. J. Int'l L. 1, 5 at n. 9 (1990), discussing the EU proposal for a TRIPS Agreement which included an MFN waiver for customs unions and free trade area IPRs measures. This perplexing EU proposal was subsequently explained as an attempt to preclude an attack on the intra-EU exhaustion rule.

In this report, the regional integration arrangement established by the Treaty of Rome will be referred to as the 'European Union' or 'EU' recognizing that in some instances a legal distinction might be drawn between the European Union, the European Communities and the European Community.

[4] Rapporteur's discussions with members of the US Trade Representative's Office with responsibility for TRIPS.

[5] T. Cottier suggests that Article 6 does not mean that the TRIPS Agreement is without effect on the subject of parallel imports in the field of trademarks. This suggestion is discussed further above at n. 87. See T. Cottier, Das Problem der Parallelimporte im Freihandelsabkommen Schweiz-EG und im Recht der WTO-GATT, Revue Suisse de la Propriété Intellectuelle, I/1995, 37, 53–56. See also, e.g., discussion of TRIPS Agreement Article 51, below.

[6] World Intellectual Property Organization: Copyright Treaty [adopted in Geneva, Dec. 20, 1996], 36 I.L.M. 65 (1997) and World Intellectual Property Organization: Performances and Phonograms Treaty [adopted in Geneva, 20 December 1996], 36 ILM 76 (1997).

[7] Article 6 of the Copyright Treaty provides:

(1) Authors of literary and artistic works shall enjoy the exclusive right of authorizing the making available to the public of the original and copies of their works through sale or other transfer of ownership.

agreement among governments on a unified approach to the parallel imports question.[8]

Existing legal solutions

The exhaustion/parallel imports question is by no means a new one.[9] The European Court of Justice has rendered an extensive body of decisions regarding the relationship between member state IPRs laws and the free movement of goods.[10] National courts have similarly addressed the parallel imports question with a variety of results.[11] The German Federal Supreme Court recently added to this body of case law by eliminating for Germany in the *Dyed Jeans* case the rule of international exhaustion of trademarks in light of the EU Trademarks Directive.[12]

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(2) Nothing in this Treaty shall affect the freedom of Contracting Parties to determine the conditions, if any, under which the exhaustion of the right in paragraph (1) applies after the first sale or other transfer of ownership of the original or a copy of the work with the authorization of the author [italics added].

Article 8 of the Performances and Phonograms Treaty provides:

(1) Performers shall enjoy the exclusive right of authorizing the making available to the public of the original and copies of their performances fixed in phonograms through sale or other transfer of ownership.

(2) Nothing in this Treaty shall affect the freedom of Contracting Parties to determine the conditions, if any, under which the exhaustion of the right in paragraph (1) applies after the first sale or other transfer of ownership of the original or a copy of the fixed performance with the authorization of the performer [italics added].

[8] The Committee of Experts that prepared proposals for the treaties offered two alternative draft provisions: one that would have excluded international exhaustion, and one that would have permitted each treaty party to adopt an international exhaustion rule. *See* Chairman of the Committee of Experts, Basic Proposal for the Substantive Provisions of the Treaty on Certain Questions Concerning the Protection of Literary and Artistic Works to be Considered by the Diplomatic Conference, WIPO Doc. CRNR/DC/4, 30 August 1996, at Article 8.

[9] Beier noted in the 25th anniversary issue of IIC his mistake in pronouncing some 23 years ago that the parallel imports question in the field of trademarks had been resolved. F.-K. Beier, The Development of Trademark Law in the Last Twenty-Five Years, 26 IIC 769, 777 (1995).

[10] This body of decisions is referred to in the IIC 25th anniversary volume. See Beier, id., and U. Loewenheim, Intellectual Property Before the European Court of Justice, 26 IIC 829 (1995). Regarding the European Community and Switzerland, see T. Cottier and M. Stucki, Parallelimporte im Patente-, Urheber- und Muster-und Modellrecht aus europarechtlicher und völkerrechtlicher Sicht, paper presented at a conference of the Association Suisse d'Étude de la Concurrence (ASEC), 23 February 1996.

[11] The case law of the United States and Japan is referred to in ILA International Trade Law Committee, Second Report of the Committee, Helsinki Conference, 12–17 August 1996 (E.-U. Petersmann and F. M. Abbott, Rapporteurs), at n. 6 and 7. See, e.g., F.-K. Beier, Industrial Property and the Free Movement of Goods in the Internal European Market, 21 IIC 131 (1990); G. Marenco and K. Banks, Intellectual Property and the Community Rules on Free Movement: Discrimination Unearthed, 15 Eur. L Rev. 224 (1990); W. A. Rothnie, Parallel Imports (1993); Beier, id., and; Loewenheim, id.

[12] BGH, Urt. v. 14 December 1995 – 1 ZR 210/93 (Stuttgart), NJW 1996, Heft 15, 994–97 (*Dyed Jeans*). See also MarkenG Section 24 Abs. 1 – 'GT ALL TERRA', OLG München, Urt. v. 12 October 1995 – 29 U 4086/95, GRUR 1996, Heft 2, at 137–9.

Legal solutions to the parallel imports question that legislatures, courts and commentators have laid out include:[13]

1. A rule of international exhaustion of a particular IPR, which in some cases will depend on the relationship between the holder of the IPR and the party that places the good on a foreign market. Whether or not the right is exhausted may depend on whether the party placing the good on the market is: (a) the IPR holder in the country of import; (b) another entity in the same corporate group; or (c) a manufacturing licensee.[14]
2. International exhaustion as under (1) unless the original marketer has given sufficient notice that the goods are not licensed for import into the country in question.[15]
3. No international exhaustion of a right.[16]

Basic underlying principles of trade and IPRs protection

The rules of the World Trade Organization (WTO) proceed from one very basic idea: that the elimination of barriers to the movement of goods and services across and within national boundaries is beneficial to global economic welfare because this encourages specialization and efficiency in production and distribution, and results in an increased output of goods and services. To use the terminology of Samuelson and Nordhaus, liberal international trade rules move the global economy closer to its production

[13] See fax from W. R. Cornish to F. M. Abbott of 7 August 1996.

[14] The US Supreme Court has interpreted legislation prohibiting the importation of goods bearing a trademark registered in the United States not to prohibit importation of goods placed on a foreign market by an entity under the common control of the US trademark holder. *K Mart Corp.* v *Cartier*, 486 US 281 (1987). In the same decision, the Court rejected a long-standing Treasury Department interpretation of the same legislation that had permitted importation of goods placed on a foreign market by a licensee of the US trademark holder.

A common control doctrine is established by the courts of the United Kingdom with respect to trademarked goods. *Revlon* v *Cripps & Lee*, Court of Appeal (Civil Division), [1980] FSR 85, 22 November 1979 (United Kingdom).

The European Union's intra-union exhaustion doctrine generally allows the importation of goods placed on the EU market by trademark holders, commonly controlled entities and licensees. See above at n. 10. Though the matter remains to be definitively resolved by the ECJ, the intra-Union exhaustion doctrine apparently does not extend to goods placed on markets outside the EU with the consent of the EU trademark owner.

[15] In other words, it has been suggested that when a rights holder, commonly controlled entity or licensee has notified a purchaser that goods are restricted as to their territory of use or resale, this notice should effectively restrict the rights of the purchaser to transport or resell the goods in the restricted area. See, e.g., in the field of patents, *Sanofi* v *Med-Tech Veterinarian Products*, 565 F. Supp. 931, 937–38 (DNJ 1983), in which the federal district court distinguishes US court rulings that permit and prohibit parallel importation of patented products depending on whether the US patent holder placed contractual restrictions on future dispositions of the subject products.

[16] When there is no international exhaustion of IPRs, rights holders may block importation of goods placed on foreign markets with their consent.

possibility frontier.[17] In a world that confronts a scarcity of goods and services, the enhancement of productivity is essential.

Flowing from this basic idea is an extraordinarily complex set of formal and informal rules designed to reduce and eliminate tariff and non-tariff barriers to trade in goods and services.

The policy bases for the protection of IPRs vary in relation to the field.[18] The grant of the patent is justified in the main by an expectation of promoting innovation, and thereby enhancing economic growth and social welfare. Copyright protection in the main is intended to provide economic and moral support for authors and artists and, through their efforts, to enhance human well-being. Trademark protection is intended to protect the interests of consumers by assuring accurate identification of the origin of goods, and it may also be intended to protect the goodwill investments of producers.

As a consequence of the historical evolution of international society, IPRs have been granted and regulated by national, and now regional, authorities. The ownership rights of IPRs holders have been divided along national/regional lines. The international system for the protection of IPRs that has evolved over the past several centuries acts to assure that IPRs holders receive remuneration in countries other than those where their creative activity may have taken place, and to assure that information concerning the origin of goods is not obscured as the goods cross national/regional borders. The international IPRs system aims at global rights of exploitation and remuneration. The international IPRs system is gradually evolving into an integrated system through the operation of mechanisms such as the Patent Cooperation Treaty. Rules restricting parallel importation take advantage of the territorial nature of the international IPRs system, segregating markets, and enhancing the potential remuneration of IP owners.

The economics of parallel importation

The regulation of parallel imports involves a balancing of the interests of producers and consumers, and is an *economic* question in the broad sense of that term. In cases in which the interests of producers and consumers diverge, choices must be made as to which interest will be given priority. The interests of consumers relating to the parallel imports question are broader than only an interest in low prices. Consumers also have interests in the quality of products, the availability of variety (i.e., the opportunity to express subjective preferences), and in support for the use of products (instruction, servicing, etc.) The primary interest of producers is to maximize return on investment. The artist or author may also seek to maximize the distribution

[17] P. A. Samuelson and W. D. Nordhaus, Economics 897–910 (13th edn 1989).

[18] See also Th. Oppermann, 'Geistiges Eigentum – Ein 'Basic Human Right' des Allgemeinen Völkerrechts', in Währung und Wirtschaft 447 (A. Weber ed., 1997), discussing the deliberations of this Committee with respect to the ILA German Branch proposals regarding general international law principles with respect to intellectual property.

of a good as a value somewhat disassociated from maximizing economic return, though for the most part it seems fair to assume that artists and authors also seek to maximize return on investment in creativity. Innovation is a 'social welfare good' that has a value both for producers and consumers, allowing producers to achieve higher rates of return, and consumers to expand their choices and improve their general well-being (e.g., through improvements in health care).

It is tempting to suppose that the question of an international welfare-maximizing policy regarding parallel importation could be derived by reference to empirical research on patterns of trade and pricing, effects on innovation, and so forth. This is not at least for the time being a realistic approach. First, empirical studies on parallel importation in the international context are sparse, and in many cases quasi-anecdotal.[19] Assuming *arguendo* that a more extensive information base concerning parallel importation and its effect on consumers and producers existed, there would nevertheless remain an information gap grounded in the existing international intellectual property environment.

Because many major economic powers, including the United States and European Union, do not follow a rule of international exhaustion, existing patterns of trade reflect the assumption that there is not a free international market in IPRs-dependent goods. Today parallel import goods may not reflect a significant proportion of world trade.[20] Yet existing patterns of trade are distorted by existing governmental rules. While one can look to economic models, one cannot construct an alternative universe in which trade and domestic pricing patterns have developed under an international exhaustion rule. There may well be a large 'dormant market' in parallel import goods that would be unleashed if a doctrine of international exhaustion were adopted. International trade in goods continues to accelerate, and the market in parallel import goods might be more fluid today than even five years ago.

In addition to the sparse empirical and quasi-empirical literature on parallel imports, there is a body of economics literature that seeks to model the outcome of various approaches to the parallel imports question.[21] The results of these studies reflect the use of numerous simplifying assumptions concerning economic behaviors that may or may not adequately reflect real world conditions. Though these studies are useful for identifying variables that

[19] Accord, see, e.g., Chard and Mellor, above at n. 2, at 71; Rothnie, above at n. 11, at 567, and D. A. Malueg and M. Schwartz, Parallel imports, demand dispersion, and international price discrimination, 37 J Int'l Econ. 167, 168–9 (1994) [hereinafter Malueg and Schwartz].

[20] Importers do not report 'parallel imports' as such, and customs authorities do not collect data on the phenomenon. Name brand consumer goods producers assert that as much as 30 per cent of world trade in such goods is 'gray market' trade, and in the 1980s parallel imports trade was estimated to constitute 2–3 per cent of US imports. Malueg and Schwartz, id.

[21] See, e.g., id.

should be accounted for in policy-making, their utility as tools for decision-making appears limited.

Existing studies of the parallel imports question are mainly directed to trademarked goods – the so-called 'gray-market goods' question – with considerably less attention paid to patents and copyrights. The underlying purpose of each form of IPR is substantially different, and it should not be assumed that data and conclusions with respect to one form of IPR will be equally valid with respect to the other forms.

This report considers in turn the rule applicable to parallel imports in the fields of patent, copyright and trademark. The policy foundation for each form of IPR is different, and there is good reason to treat each field separately. However, economic argumentation is not repeated for each field, but is rather distinguished as appropriate.

2. PARALLEL IMPORTATION IN THE FIELD OF PATENTS

The European Union and United States internal markets and parallel importation in the field of patents

Under domestic US antitrust law, a vertical territorial restraint in connection with the licensing of a patent is permitted, absent some special competitive abuse.[22] Within the context of EU competition law, the European Commission similarly permits EU patent holders to grant patent licenses which restrict the sales territory of licensees within the territory of the Union.[23] Competition law specialists have accepted that there may be a positive value to the vertical geographical division of sales territories in the field of patents because this may encourage the transfer of technology, investment in innovation and in the production, distribution and servicing of products. This may strengthen inter-brand competition and have a beneficial effect for the consumer. In both the US and EU domestic/regional context, however, the vertical market is 'policed' by the first sale doctrine.[24] So, in the EU context, parallel importation of patented products may not be subject to restraint by the member states. In the US domestic context, the first sale of a patented product removes any resale restraint based upon the patent itself.[25]

Policy foundations for permitting the vertical allocation of primary distribution territories among patent licensees are succinctly stated in the recitals of Commission Regulation 2349/84 of 23 July 1984, the prior block exemption

[22] See US Department of Justice and Federal Trade Commission, Antitrust Guidelines for the Licensing of Intellectual Property, 6 April 1995, 34 ILM 1116 (1995); and OECD, Competition Policy and Intellectual Property Rights 59–65 (1989).

[23] See OECD, id. at 61–65, and Commission Regulation (EC) No 240/96 of 31 January 1996 on the application of Article 85 (3) of the Treaty to certain categories of technology transfer agreements, 1996 OJ L 31.

[24] OECD, id. at 42–45 and 61–65, and cases cited in Second Report of the ITLC, above at n. 11.

[25] Though this does not mean that vertical territorial restraints based on contract may not be used within a manufacturer's distribution chain. See discussion above with accompanying n. 29 and 74–5 regarding US rules respecting vertical price restraints and vertical non-price restraints.

for certain categories of patent licensing agreements.[26] This block exemption was combined on 1 January 1996 with a joint block exemption that also covers non-patented technical know-how,[27] and in which the basic rules are extended. In a recital to the 1984 block exemption, the Commission said:

> (12) the obligations listed in article 1 [including primary territorial sales restraints within the Community] generally contribute to *improving the production of goods and to promoting technical progress; they make patentees more willing to grant licenses and licensees more inclined to undertake the investment required to manufacture, use and put on the market a new product or to use a new process, so that undertakings other than the patentee acquire the possibility of manufacturing their products with the aid of the latest techniques and of developing those techniques further. The result is that the number of production facilities and the quantity and quality of goods produced in the common market are increased*[28] [emphasis added].

The Commission thus sees significant benefits to the producer flowing from the ability to segregate primary production and distribution activities. However, the Commission demands that the interest of the consumer is safeguarded. How is this accomplished? Specifically, by the guarantee of parallel importation. Thus the Commission continued:

> (13) consumers will as a rule be allowed a fair share of the benefit resulting from this improvement in the supply of goods on the market. *To safeguard this effect, however, it is right to exclude from the application of article 1 cases where the parties agree to refuse to meet demand from users or resellers within their respective territories who would resell for export, or to take other steps to impede parallel imports, or where the licensee is obliged to refuse to meet unsolicited demand from the territory of other licensees (passive sales).* The same applies where such action is the result of a concerted practice between the licensor and the licensee [emphasis added].

European Union policies encouraging parallel importation are specifically designed to attack governmental and private party economic distortions by assuring a competitive supply of goods and services from a variety of internal EU sources. Parallel imports exert a pressure on member state governments to assure that domestic manufacturers can produce and distribute at competitive prices *vis-à-vis* other member states. European Union parallel importation policies in the field of patents are designed to assure that the grant of monopoly that characterizes the patent is not used to impose the kind of internal market segregation and distortion that other EU policies are designed to eliminate. Thus, while it might be the case that EU patent holders could increase their rates of return by segregating the product

[26] Patent Block Exemption, OJ No. L 219/15 (16 August 1984).

[27] Commission Regulation (EC) No 240/96 of 31 January 1996, above at n. 23.

[28] Block Exemption, recital 12, continued:

> This is true, in particular, of obligations on the licensor and on the licensee not to exploit the licensed invention in, and in particular not to export the licensed product into, the licensed territory in the case of the licensor and the 'territories reserved for the licensor', that is to say, territories within the common market in which the licensor has patent protection and has not granted any licences, in the case of the licensee. . . .

market in a more concrete way, and that increased rates of return for these producers might permit increased investments in innovation, neither the interest of the consumer nor the interest in the goal of completing an undistorted internal market supports concrete segregation.

Though vertical territorial restraints are permitted by US competition rules (subject to rule of reason control), vertical agreements regarding resale prices are *per se* illegal in US competition law. An IPR licensor (including a patent licensor) may not fix a licensee's prices for its products.[29] In the European Union, the prior EU block exemption for patent licensing agreements and the new block exemption for technology agreements exclude from the scope of allowed restrictions terms by which 'one party is restricted in the determination of prices, components of prices or discounts for the licensed products.'[30]

In the highly industrialized US and EU, where advances in patented technology are believed to play a major role in economic progress and global competitiveness, the conclusion has been reached (a) that there may well be an economic benefit that flows from permitting producers to segregate primary markets on the basis of patent licenses (in the US context this refers to internal segregation), and (b) that the interests of the consumer are protected by application of the first sale doctrine on the internal/intra-Union level. Both the United States and the European Union have seen their internal patent policies subject to extensive analysis.[31] The EU patent block exemption has been in place for more than a decade, and its underlying policies are reaffirmed in the 1996 block exemption on technology transfer.[32]

[29] In *Business Electronics* v *Sharp Electronics*, 485 US 717, 724 (1988), the Court observed 'that vertical agreements on resale prices have been illegal *per se*' since 1911. The Court suggests that vertical price restraints may reduce inter-brand price competition by facilitating cartels. Id. at 725–6. The Justice Department's Licensing Guidelines, above at n. 22, note that '[i]t has been held *per se* illegal for a licensor of an intellectual property right in a product to fix a licensee's resale price of that product...' and that 'the Agencies will enforce the *per se* rule against resale price maintenance in the intellectual property context' (at para. 5.2).

[30] Patent Block Exemption, above at n. 26, at art. 3(6). Technology Transfer Block Exemption, above at n. 23, at art. 3(1). See also OECD, above at n. 22, at 56.

The Munich Draft International Antitrust Code recommends that '[d]istribution strategies fixing a resale price or price level' be 'conclusively presumed to prevent, restrict or distort competition.' Draft International Antitrust Code (DIAC), at Article 5, Section 2. Reprinted in F. M. Abbott and D. J. Gerber (eds) Public Policy and Global Technological Integration, Appendix 2 (1997). Commentary to this DIAC section says that:

> Consistent with GATT objectives, this section is based on the principle that vertical restraints should not be used to inhibit cross-border transactions.
>
> Additional objectives are: (1) to prevent the use of restraints to enhance market power, and (2) to keep markets free and open, with a right of sellers to set their own price and a right of competing firms to have access to markets on the merits [of their products].

[31] See, e.g., F. M. Scherer and D. Ross, Industrial Market Structure and Economic Performance, (3d. ed 1990) ch. 17 and extensive references therein, and Richard M. Buxbaum, Restrictions Inherent in the Patent Monopoly: A Comparative Critique, 113 Uni. Penn. LR 633 (1965).

[32] The Block Exemption regarding Technology Transfer contains similar language to the 1984 Patent Block Exemption with respect to consumer protection through parallel importation:

The international market and parallel importation in the field of patents

What policies may distinguish the international market from the internal/regional market for purposes of parallel importation analysis in the field of patents? One could start with the terminology of the EC Treaty, and the phrase commonly used by the EU organs to explain much of EU economic and social policy. Namely, that EU regional policy is directed to 'completing the internal market,'[33] that is 'an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this Treaty.'[34] One could look to the ambitious goals of the Maastricht Treaty on European Union and the related social framework that envisages a progressively closer drawing together of Union interests. One could then say, as the European Court of Justice has from time to time said, that the policies which underlie the European Union do not necessarily extend to relations with third countries.[35]

The European Union seeks to create an internal economic zone free from distortions based upon member states government policies and, insofar as possible, to create a reasonably high minimum standard of living for all Union citizens. As evidenced by 45 years of EU history, the elimination of economic distortions and the creation of a high minimum standard of living are not so easily achieved. Member state governments do not lightly part with the power to provide local preferences. The governments of the member states in high wage/benefit areas of the Union, and their workers, do not always appreciate competition with other members of the Union whose wage rate/benefit structures are significantly lower.[36] Differing government policies in the field of health care establish non-market driven pricing in the field of pharmaceuticals and other health care supplies.

Differentiation in the goals and mechanisms of integration

The goal of the WTO is to lower barriers to trade in goods and services in the international market, and thereby to enhance global economic productivity. The WTO pays special attention to the needs of developing countries, and to sustainable development. There are many parallels between the WTO Agreements,

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> [Recital para.] (17) . . . Consumers will, as a rule, be allowed a fair share of the benefit resulting from the improvement in the supply of goods on the market. To safeguard this effect, however, it is right to exclude from the application of Article 1 cases where the parties agree to refuse to meet demand from users or resellers within their respective territories who would resell for export, or to take other steps to impede parallel imports. Above at n. 23.

[33] See, e.g., the title of the Commission's 1992 Plan White Paper, The White Paper Completing the Internal Market, COM (85) 310 (June 1985).

[34] EC Treaty, art. 7a, para. 2.

[35] See, e.g., *Hauptzollamt Mainz* v *C.A. Kupferberg & Cie.*, Case 104/81, [1982] ECR 3641.

[36] See, e.g., the conflict arising from Renault's announced plans to close production facilities in Belgium in favor of increasing production in Spain. EU Ministers to Discuss Vilvoorde Closure Plans, Reuter EC Rept., 16 April 1997 (Lexis CURNWS) and Renault Workers Clash with Police, Vow to Go On, Reuter Eur. Bus. Rept., 4 April 1997 (Lexis CURNWS).

including the GATT 1994, and the EC Treaty insofar as eliminating national barriers to trade in goods and services are concerned. For example, Articles 30 and 36 of the EC Treaty perform largely the same functions as GATT Articles XI and XX in regulating quantitative restrictions. Nevertheless, it is quite clear that the WTO does not share the overall structural and regulatory ambition of the European Union (or the federal union of the United States). The WTO does not envision free movement of persons or capital, it does not at the moment have an express competition policy, it does not pursue an industrial policy in the field of research and development, it does not attempt to harmonize the rights of workers, and so forth. It certainly does not envision the high political goals of the Maastricht Treaty, nor is a WTO monetary union in the offing. The WTO does not include governmental organs with the power to eliminate trade distortions based upon variations in the social policies of its Members, except in a few limited contexts through the application of negative rules such as the national treatment standard. The TRIPS Agreement was a breakthrough in the WTO structure in that it represents the first effort at positive harmonization of national legislation within the broad multilateral WTO system.

To the extent that Union organs refer to completion of the internal market as something more than the removal of impediments to trade in goods and services, the WTO does not, for the time being at least, share in the EU vision. We could here refer to the very language of the ECJ in the *Polydor* case[37] (i.e., that the provisions of a free trade agreement with Portugal 'do not have the same purpose as the EEC Treaty, inasmuch as the latter . . . seeks to create a single market reproducing as closely as possible the conditions of a domestic market'). The WTO does not share in the federal vision of the United States of America.

Despite the lack of federal or quasi-federal organs and powers, the WTO nevertheless strives to open national markets to competition from goods and services produced anywhere in the system. There are high wage Members and low wage Members, there are Members richly endowed with natural resources and Members with few natural resources, there are heavily populated Members and sparsely populated Members, there are Members with elaborate and expensive social welfare schemes and Members with minimal social welfare schemes. The WTO takes into account some of these differences by according special and differential treatment to developing countries in certain fairly limited contexts. However, by and large, the goods and services produced by private enterprises within the Members of the WTO system are expected to compete in each other's markets on a head-to-head basis, without any adjustment or 'handicap' (other than bound tariffs). Internal government policies of the Members distort the international 'free market' looked at in an absolute sense.

[37] *Polydor* v *Harlequin Record Shops*, Case 270/80, [1982] ECR 329, [1982] 1 CMLR 677, Feb. 9, 1982. Though this was a copyright case, the Court broadly referred to 'industrial and commercial property rights' in its judgment.

The TRIPS Agreement has sought to assure that private enterprises will be able to obtain a roughly equivalent level of patent protection in each of the WTO Members where they will do business. There should therefore not be a major distortion in the international market for patented products arising from different government policies with respect to the granting of patents, or the duration of patent terms. Prior to the TRIPS Agreement, a producer might have argued that prices would necessarily be lower in markets in which it lacked patent protection, and that therefore the global market for patented products was distorted as a result of differing national patent policies. The TRIPS Agreement operates to nullify this claim.

Disparities in level of economic development

One substantial difference between the European Union and the WTO system has to do with homogeneities in level of economic development. Malueg and Schwartz have noted that there are substantial variations in the levels of economic homogeneity as among the states of the United States, the EU member states, and the world as a whole. They observe:

> The following figures illustrate these differences in 1990. The quintile of the US population represented by the states with the greatest per capita incomes had a per capita income approximately 1.5 times as great as did the quintile of the population in the poorest states. . . In contrast, for the EC countries, instead of the states in the United States, the comparable ratio is about 2.3. . . Worldwide these income differences were significantly greater. Among World Bank member countries, the richest quintile (based on world population) had a per capita GNP approximately 75–85 times as great as in the poorest quintile. . . Even after adjusting for purchasing power parity, as done in the United Nations' International Comparison Program, this ratio lay in the range of 15–20.[38]

Malueg and Schwartz, among others, have suggested that rules permitting parallel importation may adversely affect developing countries as manufacturers/licensors based in developed countries lose the capacity to discriminate in price. Rather than suffer the erosion of high prices in developed country markets as a consequence of low priced parallel imports from developing countries, these manufacturers/licensors may elect to raise prices in the developing countries, or they may cease to sell in these countries.[39] Based on mathematical modeling, Malueg and Schwartz have suggested that as a result of this phenomenon, rules permitting parallel importation may decrease global economic welfare.[40]

[38] Malueg and Schwartz, above at n. 19, at 170, n. 4 [references omitted].

[39] This phenomenon is said to affect the internal EC market in relation to low and high-price pharmaceutical countries, though this appears to be the result of price controls coupled with rules permitting parallel importation. Id. at 190, n. 4. See above regarding the effects of price controls on pharmaceuticals, including discussion of Rothnie, this report, n. 49.

[40] They also suggest one possible solution – the division of the world market into regions based on income levels, in which discriminatory pricing might be allowed as between (but not within) regions. They are aware that there are many practical obstacles to implementing such a solution. Malueg and Schwartz, at 184–92.

The foregoing hypothesis runs counter to the assumption of many developing country governments, i.e., that rules permitting parallel importation work in their favor by assuring that lower-priced goods produced within their borders are not excluded from developed country markets on the basis of claims to IPRs protection. Developing country governments are concerned that IPRs protection will be used as a non-tariff barrier to imports as their producer-exporters become increasingly competitive with developed country producers.

The goal of the WTO is to encourage economic growth and expand the production of trade in goods and services in accordance with the objective of sustainable development.[41] This goal is to be accomplished through 'arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international trade relations.'[42] The means (i.e., lowering of trade barriers) chosen to accomplish the goal (i.e., economic growth) reflects the collective determination of governments that international economic growth is best encouraged through the efficient allocation of productive resources resulting from the exchange of goods on an open market.

Decisions of market actors with respect to the allocation of productive resources depend upon information concerning consumer demand and producer supply.[43] Information regarding demand and supply is conveyed through the mechanism of price. When equilibrium prices are established among trading nations their productive resources are most efficiently allocated to address real global demand and supply.[44]

Malueg and Schwartz posit that IPRs-holding producers in highly developed markets should not face price competition from authorized sellers/licensees in developing country markets. Prices in developing country markets should not rise in response to demand from developed country markets. This, according to Malueg and Schwartz, will result in increased global economic welfare.

Malueg and Schwartz's research is limited to the particular question whether a monopolist (such as the producer of a patented pharmaceutical) under certain assumptions might contribute more to the welfare of developing countries in respect to its product if it is permitted to engage in international price discrimination – because the monopolist would be less likely to cease supplying the poorer markets. Malueg and Schwartz do not consider the impact of an international price discrimination system on developing country producers and consumers acting outside the field of the monopolist's product. Most importantly, they do not consider the broader effects of an international price discrimination system on the international allocation of resources.

[41] See Agreement Establishing the World Trade Organization (WTO Agreement), preamble.

[42] Id.

[43] See Samuelson and Nordhaus, above at n. 17, 903–918.

[44] This efficient allocation is generally attributed to operation of the principle of comparative advantage. See, e.g., Samuelson and Nordhaus, above at n. 17.

If developed country producers are not pressured to become more efficient as a consequence of price competition, this will distort the efficient allocation of resources in the developed countries. If developing country producers/licensees are limited in the profitability of their operations, this will limit developing country investments in future production. If the profit-making potential of capital investments in developing countries is limited, this will encourage the developing countries to continue to rely on capital intensive developed country exports. These are some of the broader foreseeable consequences of the international price discrimination system advocated by Malueg and Schwartz.

A substantial part of international trade is in goods that are not protected by IPRs, particularly in the commodities and unfinished goods sectors.[45] Developing country markets are not unserved with these products. Developing country buyers may be served with lower-priced IPRs-protected goods through product differentiation.[46] If producers refuse to supply some developing markets, consumers should not literally go unserved with respect to necessary products such as pharmaceuticals. If a developed country producer does not supply a market with an important pharmaceutical product either by production or importing, whether or not patent protection has been secured for that product, a developing country government may be justified in issuing a compulsory license to a local producer to satisfy local demand.[47]

The limited mathematical case that international price discrimination based on IPRs may serve the interests of developing countries does not adequately support rules restricting parallel importation.

Private market restraints

Katrin Cutbush-Sabine cautions against undue optimism concerning the beneficial effects on global pricing practices that would result from permitting

[45] It should be observed that regions like the EU have sought to protect themselves against the flow of inexpensive imported agricultural products though mechanisms such the Common Agricultural Policy, and that textile quotas have been ubiquitous. WTO Members have agreed to phase out textile quotas over ten years, and the Agreement on Agriculture seeks to dismantle barriers to the flow of agricultural products.

[46] Manufacturers of IPRs-protected goods such as automobiles may develop lower cost/price versions of their products for lower-income developing country buyers. These products are not necessarily attractive to higher income developed country buyers.

[47] See TRIPS Agreement, Article 31. [Author's note: in his contribution to this *Journal of International Economic Law* special issue, Harvey Bale suggests that pharmaceutical producers desiring to aid less developed countries with low cost pharmaceuticals might be prevented from doing so by rules permitting parallel imports. H. Bale, 'The Conflicts Between Parallel Trade and Product Access and Innovation: The Case of Pharmaceuticals', 1 JIEL at Section 8. Pharmaceutical producers selling at below world market prices or donating pharmaceuticals in developing countries might reach agreement with recipient nations that such pharmaceuticals cannot be exported on grounds of protecting public health. Article XX(b) of the GATT and the public interest safeguards of the TRIPS Agreement (e.g., Article 8:1) could be used by developing country governments to justify export restrictions on public health grounds that may otherwise be precluded by GATT Article XI.]

parallel importation.[48] She suggests that increased levels of collusive horizontal pricing among private market participants may result if producers are unable to maintain discriminatory prices on the basis of IPRs.[49]

Though a risk of increased collusive behavior may be present, it does not justify a rule restricting parallel imports. Instead, it may justify a more effective multilateral system for addressing private market restraints.

Conclusion regarding patents

In the view of US and EU competition authorities, vertical territorial contract restraints on intra-brand competition in patented products may have positive welfare effects, by encouraging transfers of technology and investments in plant and equipment. This may lead to higher rates of return for innovators, and may encourage further innovation. There is no apparent justification for suggesting that this basic economic view should not be carried to the multilateral level. It is logical that patent holders will be more inclined to license their technology to foreign producers if they can be assured that the licensees will not directly sell the products manufactured under license into the licensors' markets. Technology transfer and local capital formation should be stimulated, assuming that the EU and US models hold.[50]

Equally so, there is no apparent reason on the multilateral plane to dispense with the policing function served by parallel imports of patented products. Parallel imports will serve to assure that an adequate level of price competition is maintained in international markets. Price competition is essential to the effective operation of comparative advantage, and to achieving efficiency gains throughout the international trading system. There are without doubt different competitive environments in different WTO Member markets. However, such differences have never been accepted as a basis for the imposition of quotas or measures with equivalent effect under GATT-WTO rules. There is no apparent policy reason why Members should be entitled to prohibit the importation of products lawfully produced and sold

[48] Remarks of Prof. K. Cutbush-Sabine at the working meeting of the ITLC at Helsinki, August 1996.

[49] Rothnie observes that despite the intra-Union exhaustion rule, substantial variations in the price of patented pharmaceutical products remain among the EU member states. Rothnie attributes these price variations largely to differences in national medical cultures and to differences in national government regulatory policies with respect to approvals, and direct and indirect efforts at price control (for example, via health care reimbursement policies). Rothnie, above at n. 11, at 471–94. Rothnie acknowledges that variations in price among the member states may result from strategic behaviors by pharmaceutical firms, id. at 507, but discounts this as the primary factor, id. at 508. Rothnie's inquiry into private strategic behaviors is limited (at least in part because the pharmaceutical industry did not cooperate in furnishing information to him, id. at 473, n. 6), and his conclusions must be considered in this light.

[50] That is, a patent holder should, as a private law matter, be entitled to grant a license to a foreign producer to make a product covered by a patent and impose upon the foreign licensee a restriction that the patented product may only be sold in the country of manufacture (or in some other limited territory). Similarly, a patent holder should be entitled to sell the patented product to a foreign distributor with a restriction that such product may only be first sold within a limited geographic territory. This is presently not precluded by WTO rules.

under patents, any more than there is a policy reason why governments should be entitled to erect quotas to protect their markets from imports from lower wage regions.

1. The case of controlled prices

One claim made by patent holders deserves special attention. This is a claim, largely made by pharmaceutical manufacturers, based upon government price controls in national markets. Pharmaceutical Manufacturer A sells Drug X in the US wholesale market for $1. There are no government price controls over pharmaceuticals in the US market. Manufacturer A sells Drug X in the Xanadu market for $.60 as a consequence of Xanadu price controls. Wholesalers in Xanadu buy Drug X for $.60 and ship it to the United States, where they resell it for $.95. Manufacturer A loses a high margin sale in the United States to a low margin sale in Xanadu. Should government controls on the prices of patented products affect the parallel importation analysis?

The private market answer is that Manufacturer A should produce or sell only enough of Drug X in Xanadu to satisfy the local market. If a shortage in Drug X arises because of the actions of wholesalers in that country, and that shortage is contrary to public health policy, then the government of Xanadu may have to reconsider the structure of its health care market, perhaps to eliminate wholesale buyers from the system.[51]

The WTO polices against certain kinds of national policies considered to create 'unfair' trade distortions. Articles VI and XVI of the GATT 1994 and the Subsidies Agreement operate to prevent governments from granting export subsidies.[52] Prohibited subsidies are defined, *inter alia*, by their degree of 'specificity'.[53] The 'specificity' test is designed to distinguish between government policies addressing general social welfare concerns, and government policies directed at distorting competition in trade. General social welfare subsidies are permitted, even though governments may differ considerably concerning the policies they pursue. Export subsidies (including specific subsidies) are prohibited as they constitute an attack on the competitive playing field.

One can envisage an exception to an open international parallel importation rule based upon government price controls directed at a specific industry, for example, the pharmaceutical industry. By setting a non-market price, the government subsidizes exports at the expense of the manufacturer. Parallel imports of products 'specifically' subsidized in this manner might be regulated in light of long-standing WTO policy regarding export subsidies.[54]

[51] The government in such a case should not be entitled to grant a compulsory license for increased production since the shortage is the consequence of its own policies.

[52] Agriculture is governed by a separate regime.

[53] WTO Agreement on Subsidies, Articles 1 and 2.

[54] This situation is similar to the one which market economy governments have faced with respect to products imported from non-market economy countries. The problem of non-market pricing has been addressed in the GATT/WTO system without the wholesale adoption of prohibitions on imports.

Wealth allocation effects

A rule of international exhaustion in the field of patents may have the effect of transferring wealth from more highly developed countries to less highly developed countries. If industrialized country patent licensors cannot restrict parallel imports, and if substantial secondary or resale markets develop for products produced under license in developing countries (e.g., because wage differentials translate into lower prices), developing country licensees may benefit from patent licenses at the expense of industrialized country licensors. There are unknowns connected with this hypothesis. However, *assuming arguendo* that a rule of international exhaustion in the field of patents would benefit the developing countries at some expense to the industrialized countries, is this a reason to oppose such a rule?

The answer to this question is necessarily a subjective one. Some will place priority on local interests. Some will place priority on global community interests. While it may be that in an interconnected world it is essential to look out for the interests of the whole, it is also important to recall the time-worn aphorism that 'all politics is local.' It may therefore be that advocates of a rule of international exhaustion in patents will not face a receptive audience in OECD industry, or in OECD government.

3. PARALLEL IMPORTATION IN THE FIELD OF COPYRIGHT AND NEIGHBORING RIGHTS

The copyright industry is extremely complex and encompasses significant submarkets. The historical distinction between patent and trademark as industrial property right, and copyright as authors' and artists' right, has broken down as a consequence of the development of the software industry and the continuing digitization of information. Broadcast rights present certain unique characteristics in terms of the retransmittable quality of the broadcast product. The unique characteristics of the broadcast industry as they relate to parallel importation were addressed by the ECJ in its *Coditel* decision.[55]

The single best case study of a parallel imports question is directed to the book industry, a highly traditional copyright domain. In its Inquiry Into Book Prices,[56] the Australian Prices Surveillance Authority lays out a clear explanation of the parallel imports question in legal and economic terms.[57] It explains the problems of market definition, substitutability of competing

[55] *Coditel SA* v *Cine-Vog Films*, Case 62/79, [1980] ECR 881, [1981] CMLR 362, decision of Mar. 18, 1980 (*Coditel I*); see *also Coditel SA* v *Cine-Vog Films*, Case 262/81, [1982] ECR 3381, [1983] 1 CMLR 49, decision of 6 October 1982 (*Coditel II*) regarding the potential applicability of Article 85 EC Treaty to the same facts.

[56] Australian Prices Surveillance Authority, Inquiry Into Book Prices, Interim Report of 31 August 1989, Matter No. PI/89/3, Rept. No. 24 and; Inquiry Into Book Prices, Final Report of 19 December 1989, Matter No. PI/89/3, Rept. No. 25.

[57] For a critical view of the study see Rothnie, above at n. 11, at 525–51.

products, determination of comparative prices, potential effects on existing channels of distribution, and potential social gains and losses from eliminating restrictions on parallel importation in the Australian market for books. In the case of the Australian book market, restrictions on parallel importation were taken advantage of by foreign book publishers to establish significantly higher prices for books exported to the Australian market as compared with books sold in other markets. The Prices Surveillance Authority determined that the price discrimination was not justified by market factors, and resulted in significant economic distortions in the Australian book market. In its Interim Report, the Authority recommended the elimination of existing legislation that blocked parallel importation of books copyrighted in Australia. In the face of a concerted attack by the book publishing industry, it reiterated its justifications and conclusions in its Final Report.

The ECJ faced an interesting copyright-related parallel importation question in the *Warner Brothers* v *Christiansen* case.[58] In this case the owner of a copyright in a film in two member state markets sought to preclude the buyer of a video cassette 'free and clear' for rental in one market from renting out the cassette in the second market when, in the second market, video rental rights were not included in the selling price of similar cassettes. The ECJ held that in the absence of harmonization of rental rights policy at the Union level, the copyright law of the member state into which the copyrighted cassette was imported would govern the rights of the cassette owner.

In *Coditel*,[59] the ECJ faced the situation in which a party without authorization retransmitted (broadcast) in a second member state a film publicly broadcast in a first member state by a licensee with the consent of the copyright holder. The rights to exhibit and broadcast the film in the second member state were held by an exclusive licensee of the copyright holder different from the licensee in the first member state. The ECJ confronted the question whether exclusive film exhibition and broadcast rights could be geographically allocated within the Union such that public exhibition or broadcast in one member state (with the consent of the rights holder) would not interfere with exclusive exhibition or broadcast rights granted for another member state. The Court alluded to the special nature of the film and broadcast industry, which depends for its economic viability on earning revenues from repeated showings of the same copyrighted subject matter. It distinguished public performances from subject matter such as books and phonograms the earnings from which depend upon circulation to the public in material form. The Court held that in view of the characteristics of the film exhibition and broadcast industry, the exclusive geographic allocation of exhibition and broadcast rights among member states did not interfere with the freedom to provide services prescribed by the EC Treaty, and that the public exhibition

[58] Case 158/86, [1988] ECR 2605, [1990] 3 CMLR 684.

[59] Above at n. 55.

or broadcast of a film in one member state would not interfere with exclusive rights to exhibit or broadcast the film held in a second member state.

The *Warner Brothers* and *Coditel* cases illustrate that there may be some characteristics of copyrighted subject matter that affect analysis of the parallel imports question in specific cases. In particular, a certain harmonization of national policies on questions such as video rental rights may need to be reached before a uniform 'first sale' rule can be recognized with respect to video cassettes.[60] The *Coditel* case suggests that the licensing of performance or broadcast rights for a particular national or regional territory should not imply a parallel performance or rebroadcast right in another national territory or region. The territorial divisibility of performance and broadcast rights appears to be an accepted principle of neighboring rights doctrine, owing itself to the particular nature of this subject matter.[61] Performance and broadcast licensing may constitute a 'special case' for parallel importation analysis.

By contrast, although the software industry sometimes makes claim to the territorial divisibility of the international market for parallel imports purposes,[62] there is no apparent justification for this claim beyond the potential for price discrimination. While a software sale/license may under ordinary copyright principles be restricted to a single copy/use, i.e., the buyer of a disk may not make and distribute copies for other users, the single authorized copy should nevertheless be subject to traditional first sale principles. This result, according to Lehrmann, is recognized under both German and European law.[63] The US Copyright Act of 1976 achieves the same result.[64]

US copyright legislation and Supreme Court doctrine in the field of copyright affirms the first sale doctrine, which acts to assure internal parallel importation within the territory of the United States.[65] The ECJ has

[60] There may be reason to question the ECJ's decision in *Warner Brothers*, since the producer and first seller of the subject video cassette obtained a market return on its sale that included permission to rent out, and in essence sought a second return in another member state market for the rental right.

[61] See, e.g., *Suisa* v *Rediffusion AG* (Swiss Federal Supreme Court – Bundesgericht), [1982] ECC 481, 20 January 1981; *Re Cross-Border Copyright in Television Works* (Austrian Supreme Court – Oberster Gerichtshof), [1992] ECC 456, May 1991.

[62] This claim is often asserted on commercial software labeling, e.g., 'this product is for sale and distribution only in North America, export prohibited', etc.

[63] See Michael Lehrmann, The New Software Contract Under European and German Copyright Law – Sale and Licensing of Computer Programs, 25 IIC 39, 46–48 (1994).

[64] See Section 109 of the Copyright Act of 1976, which affirms the first sale doctrine (sec. 109(a), below n. 65), and excludes the right to rent out a computer program based on ownership of a single copy (sec. 109(b)). By implication, the single copy of the computer program may be resold by its owner.

[65] Section 109(a) of the Copyright Act of 1976 states, *inter alia*, that:

> . . .the owner of a particular copy or phonorecord lawfully made under this title, or any person authorized by such owner, is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy or phonorecord.

Section 109(b) precludes the rental of a software program based upon ownership of a particular copy of that program.

repeatedly held that the member states of the Union may not allocate the internal market on the basis of member state copyright legislation.[66] Discussion of the block exemptions on distribution which illuminate the position of the European Commission in respect to parallel importation in the field of copyright and neighboring rights, will be reserved for the discussion of parallel imports in the field of trademarks.

The main economic argument that the copyright industries make in favor of restricting parallel imports on the international plane is an argument that favors more traditional vertical distribution restraints, i.e., that the vertical territorial allocation of markets encourages advertising, investment in distribution facilities, higher quality services, and so forth. As in respect to the field of patents, while this argumentation may indeed support contractual vertical territorial restraints on the international plane, it does not make the case against the market policing function of parallel imports in the field of copyright. As the Australian Price Surveillance Authority has demonstrated, rules restricting parallel importation in the field of copyright are susceptible to use as a cover for unjustifiable price discrimination.

The ECJ, in allowing member state restrictions on non-EU originating parallel imports in the field of copyrights, has briefly alluded to the special task of completing the EU internal market.[67] That the goal of completing the EU internal market differs from the goal of the WTO system, as noted previously, cannot be doubted. Whether this justifies an international prohibition on parallel imports in the field of copyright is another matter.

It seems most doubtful that rules restricting parallel importation in the field of copyright are necessary to assure that developing country markets are served. The price of a copyrighted video cassette or book may be higher in relation to the income of a developing country national than a developed country national. However, a developing country national who owns a television set and a video cassette player should not find the rental price of a cassette unduly burdensome. If purchasing video cassettes is too expensive in some countries because of the threat of parallel exportation, then perhaps money will be better saved, and video cassettes rented instead. Software developers may argue that they will not serve developing country markets because they cannot charge as much for software there as they charge in developed country markets. It remains to be explained why software developers should not be required to face price competition in international markets as other producers, and to charge a price that allows them a reasonable rate of return across all markets, even if this means reducing prices in developed country markets.

[66] See, e.g., *Deutsche Grammophon* v *Metro*, Case 78/70, [1971] ECR 487, 8 June 1971; *Musik–Vertrieb membran* v *GEMA*, Cases 55, 57/80, [1981] ECR 147, [1981] 2 CMLR 44.

[67] See *Polydor* v *Harlequin*, above at n. 37.

4. PARALLEL IMPORTATION IN THE FIELD OF TRADEMARKS

The parallel imports question in trademarked goods appears to have received the most attention in legal and economic literature.[68] The various economic and social rationale for and against parallel importation have been enumerated with some precision.

Hilke offers the following list of possible explanations of parallel importation of trademarked goods:

1. To take advantage of differences in handling and promotion costs between authorized resellers and parallel importers (the so-called 'free rider' effect);
2. To take advantage of manufacturers' discriminatory pricing among geographic markets;
3. To take advantage of differences in the quality of products between markets (having the theoretical consequence of leading to consumer deception by parallel importers that offer lower quality goods);
4. The disciplining of authorized distributors by manufacturers (i.e., manufacturers may encourage open parallel importation to price-constrain their own distribution chains);
5. To take advantage of exchange rate adjustment lags (i.e., product arbitrage analogous to currency arbitrage), and;
6. Transference by manufacturers of distributional functions to low-regulatory-cost distributors (i.e., manufacturers may prefer to forgo high regulatory-compliance cost distributors in favor of low cost 'unauthorized' distributors).[69]

Hilke concludes as follows:

> Although a theoretical case can be made that gray market imports are motivated by free-riding on the promotional and service efforts of authorized importers, the available empirical evidence is inconsistent with the strong form of this hypothesis that links all gray market activity to free-riding. The hypothesis that gray market imports are connected with lags in exchange rate adjustments is generally more consistent with the evidence in more industries. More definitive conclusions than these are not possible because of the limitations of the data.[70]

[68] See, e.g., Beier, above at n. 9 and 11, Chard and Mellor, above at n. 2 (largely devoted to trademarks issues); Rothnie, above at n. 11, at 10–185, 562–79; J. C. Hilke, Free Trading or Free-Riding: An Examination of the Theories and Available Empirical Evidence on Gray Market Imports, 32 World Comp. 75 (1988); Robert J. Staff, The Law and Economics of the International Grey Market: Quality Assurance, Free-Riding and Passing Off, 4 IPJ 191 (1989). Several articles, e.g., Hilke, refer to data in a mimeo, Economic Effects of Parallel Import: A Preliminary Analysis, Patent and Trademark Office of the US Department of Commerce (23 January 1985). Regrettably the US PTO and Department of Commerce were not able to locate a copy of this report for the Rapporteur.

[69] Hilke, id.

[70] Id. at 91.

Chard and Mellor offer the following possible explanations for 'attempts to prevent parallel importation':

(a) quality consistency in the eyes of consumers,
(b) maintenance of pre-sales and after-sales services,
(c) efficient collection of information and investment decisions,
(d) collection of lump-sum fees,
(e) detection of illicit copies,
(f) creation and maintenance of monopoly power and
(g) price discrimination.'[71]

With respect to the 'typical developed country', Chard and Mellor offer the following observations:

> Our research in the United Kingdom supports the hypothesis that parallel imports often undermine the attempts of rights owners to guarantee consistent qualities of products and to maintain pre-sales and after-sales services. The adverse effect on domestic consumers is impossible to quantify, but is nevertheless real. The degree of protection against parallel imports provided by trademark law is of particular importance here (although copyright is also relevant). *This was emphasized in our discussions with industry associations with particular interests in trademark rights.*

. . .

> There may be some benefits to consumers of parallel trading, especially when foreign-based rights owners are discriminating on price against domestic consumers. Given, though, that the net benefits of parallel trading in undermining price discrimination are as likely to be negative as they are to be positive, we conclude that the overall balance of the effects of parallel trading is probably adverse[72] [emphasis added].

Regarding Chard and Mellor's emphasis on effects on consumers, the following extract from Hilke is revealing:

> Systematic nondisclosure of material facts has not been found by the FTC staff in any of its investigations of gray market goods initiated in the 1980s. Although authorized importers have provided anecdotal evidence of consumer injury, allegedly associated with the sale of gray market goods, there was insufficient evidence of a systematic problem to warrant bringing a complaint. In addition, investigations of importers of gray market products conducted by the FTC's Division of Marketing Practices in 1983 and 1984 failed to substantiate claims of consumer injury resulting from the warranting practices of gray market importers.[73]

Under US legislation and Supreme Court doctrine, the vertical territorial allocation of distribution markets in trademarked products is permitted, subject to rule of reason analysis in the competition law context.[74] At the retail

[71] Chard and Mellor, above at n. 2, at 72. This list is put forward as generally applicable to the copyright, patent and trademark fields.

[72] Id. at 79.

[73] Hilke, at 86.

[74] See, e.g., *Continental T.V.* v *GTE Sylvania*, 433 US 36 (1977); *Business Electronics* v *Sharp Electronics*, 485 US 717 (1988).

level, the US internal market in trademarked products is policed by the first sale doctrine. The first buyer of a trademarked good outside the manufacturer's vertical distribution chain may resell that good throughout the United States. It should be noted, however, that intrabrand competition may be restrained at the wholesale distribution level, in favor of enhancing interbrand competition.[75]

The European Union treatment of vertical territorial restraints in trademarked products proceeds most notably from the ECJ's benchmark 1966 decision in *Consten and Grundig,*[76] to the rules adopted by the Commission in the Block Exemptions on Distribution and Exclusive Purchasing Agreements in 1983.[77] In the view of the Commission, vertical territorial restraints on the distribution of trademarked products are permitted as between two undertakings, subject to certain conditions. However, this permission is not granted when:

> Article 3
>
> . . .
>
> (c) users can obtain the contract goods in the contract territory only from the exclusive distributor and have no alternative source of supply outside the contract territory; [or]
>
> (d) one or both of the parties makes it difficult for intermediaries or users to obtain the contract goods from other dealers inside the common market or, in so far as no alternative source of supply is available there, from outside the common market, in particular where one or both of them:
>
> 1. Exercises industrial property rights so as to prevent dealers or users from obtaining outside, or from selling in, the contract territory properly marked or otherwise properly marketed contract goods;
>
> 2. Exercises other rights or takes other measures so as to prevent dealers or users from obtaining outside, or from selling in, the contract territory contract goods.

Parallel imports are the European Union's internal mechanism for policing against potential abuses of vertical territorial restraints by trademark holders.

In the United States, parallel importation of trademarked goods may be

[75] The *GTE Sylvania* decision, id., did not restrict the permissible scope of the territorial allocation of resale markets to the first wholesale buyer from the manufacturer, but in essence permitted a manufacturer to exercise 'non-price' control over its distribution chain up to the retail level, subject always to rule of reason constraints. The later *Sharp Electronics*, id., decision emphasizes interbrand competition as a constraint on pernicious intra-brand behavior, and suggests that manufacturers have a strong interest in promoting low prices.

[76] *Consten and Grundig* v *Commission*, Cases 56, 58/64, [1966] ECR 299.

[77] Commission Regulation 1983/83 on the application of Article 85(3) to categories of exclusive distribution agreements, OJ L 173/1, 30 June 1983; and Commission Regulation 1984/83 on the application of Article 85(3) to categories of exclusive purchasing agreements, OJ L 173/5, 30 June 1983.

blocked pursuant to statutory authority,[78] except when the imported goods are manufactured by an entity under the common control of the US trademark holder.[79]

According at least to the German Federal Supreme Court, the EU Trademarks Directive is to be understood as having eliminated the possibility of international exhaustion in the field of trademarks for the European Union.[80] Although 'common control' was not an issue in this German case, a common control exception has previously been recognized in the United Kingdom at least.[81] There is no policy explanation in the EU Trademarks Directive for eliminating international exhaustion for the Union, if this was the intent of the Directive. However, for the sake of argument, it may be assumed that the Community once again has established a dividing line between 'completion of the internal market' and multilateral trade policy.

In the case of trademarks, no persuasive argument or data has been presented for treating the EC market and the WTO market differently. Vertical allocation of distribution markets by manufacturers may have a positive effect on consumers by strengthening inter-brand competition. In both contexts, parallel imports will police against price discrimination. The argument of Malueg and Schwartz favoring price discrimination to protect developing country interests should be rejected for the field of trademark for the same reasons it should be rejected for the fields of patent and copyright. International price discrimination distorts comparative advantage, and there is no persuasive evidence that it is necessary (or would be helpful) for promoting the interests of developing countries. In the final analysis, no persuasive economic or social case has been made in favor of a rule restricting international parallel importation in the field of trademarks.

5. THE PUBLIC ENFORCEMENT OF PRIVATE RESTRAINTS

An argument made by those favoring a rule restricting parallel imports across the copyright, patent and trademark fields is that the private enforcement of vertical territorial restraints by manufacturers is difficult in the international context. An unambiguous rule prohibiting parallel imports is a cheap (i.e.,

[78] 19 USCA Section 1526(a) and Treasury Regulation 19 CFR Section 133.21(b) (1987).

[79] *K Mart Corp.* v *Cartier*, 486 US 281 (1987). The concurring opinion of US Supreme Court Justice Brennan in the *K Mart* case elucidated a theoretical basis for eliminating restrictions on parallel imports in the field of trademarks. However, he was unable to persuade a majority of the Supreme Court. Id. at 295.

[80] BGH, Urt. v. 14.12.1995 – 1 ZR 210/93 (Stuttgart), NJW 1996, Heft 15, 994-97 (*Dyed Jeans*). First Council Directive of 21 December 1988 to approximate the laws of the member states relating to trade marks (89/104/EEC), 1989 OJ L 40. Article 7(1) of the Directive provides: 'The trade mark shall not entitle the proprietor to prohibit its use in relation to goods which have been put on the market in the Community under that trade mark by the proprietor or with his consent.'

[81] *Revlon* v *Cripps and Lee*, Court of Appeal (Civil Division), [1980] FSR 85, 22 November 1979 (United Kingdom).

efficient) way to implement such restraints.[82] That is, a public law replaces the private sector in enforcing a desirable set of contract restraints. Depending as it does on the assumption that vertical territorial restraints on resellers are desirable in all international contexts involving IPRs, both in the primary and secondary resale markets, this suggestion lacks an adequate empirical foundation.

6. THE RESULT FOR THE WTO AND THE TRIPS AGREEMENT

The existing legal framework

Rules restricting parallel importation are non-tariff barriers to trade that are inconsistent with the general terms, structure and spirit of the WTO and GATT 1994. Specifically Article XI:1 of GATT 1994 provides:

> No prohibitions or restrictions other than duties, taxes or other charges, whether made effective through quotas, import or export licenses or *other measures*, shall be instituted or maintained by any contracting party on the importation of any product of the territory of any other contracting party. . . [emphasis added]

The safeguard in Article XX(d) that permits Members to maintain otherwise inconsistent measures 'necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement, including those relating to . . . the protection of patents, trade marks and copyrights, and the prevention of deceptive practices' does not relieve rules restricting parallel imports from inconsistency with Article XI, because rules restricting parallel imports are not necessary to protect national IPRs. By definition, parallel import goods are placed on markets with the consent of rights holders. Rights holders ultimately control the conditions of intra-brand competition, i.e., to what extent they will compete with their own authorized sales. Rules restricting parallel imports permit and enforce price discrimination. They are not required to protect interests which rights holders may themselves protect by contract and intra-corporate control. This analysis is entirely consistent with the case law of the ECJ, which has refused to permit Article 36 of the EC Treaty to be used as a defense against an Article 30 violation otherwise established by a member state prohibition on parallel importation.[83]

It has also been suggested that restrictions on parallel imports may violate the GATT Article III prohibition on discrimination in favor of domestically produced goods.[84] If imported goods are prohibited from entering a national market on the basis of local ownership of an IPR, this effectively favors locally

[82] See, e.g., Chard and Mellor, above at n. 2, at 71–2.

[83] See *Centrafarm BV* v *Winthrop BV*, Case 16.74, [1974] 1974] ECR 1183.

[84] This argumentation was suggested to the Rapporteur by a member of the WTO Secretariat.

produced goods.[85] If rules restricting parallel imports are considered to violate the national treatment principle, an escape under the Article XX(d) safeguard would not be justified because such discrimination is not 'necessary' to protect the interests of rights holders.

TRIPS Agreement Article 6 says only that nothing in 'this Agreement', i.e., the TRIPS Agreement, can be used to address the question of exhaustion of rights in the dispute settlement context. It can therefore be suggested that no modification of TRIPS Article 6 is needed in order to address the parallel imports question. Cottier and Stucki have suggested that GATT Articles XI and XX(d) provide the general basis for eliminating rules against parallel imports in the WTO context and that, in the case of particular markets that are distorted by government intervention (such as the pharmaceuticals market), Article XX(d) may be employed to justify an exception.[86]

Nevertheless, some may argue that GATT Article XX(d) permits restriction of parallel imports because such restrictions are the customary practice of WTO Members. To the extent that TRIPS Article 6 suggests an 'agreement not to agree' on the question of a parallel imports rule, this may bolster an argument that WTO Members did not intend GATT Article XI:1 or III to prohibit such national or regional restrictions.

Within the confines of the TRIPS Agreement, elimination of Article 6 would not resolve the parallel imports question. Take the case of patents, for example. TRIPS Agreement Article 28 grants to the patent owner 'the following exclusive rights':

> (a) where the subject matter of a patent is a product, to prevent third parties not having the owner's consent from the acts of : making, using, offering for sale, selling or importing [footnote 6] for these purposes that product; . . .

Footnote 6 says: 'This right, like all other rights conferred under this Agreement in respect of the use, sale, importation or other distribution of goods, is subject to the provisions of Article 6'.

Consider the elimination of Article 6 in the patent context. Does a third party's 'having the owner's consent' to manufacture and sell a product in one Member State imply a right to parallel export that product to another market? The drafters of Article 28 were sufficiently concerned about this interpretative question that they referred the matter back to Article 6.

Cottier has pointed out that TRIPS Agreement Article 16 does not grant to trademark holders a specific right to prevent importation.[87] Rather, it provides that third parties 'not having the owner's consent' may not use

[85] It can be argued to the contrary that local producers other than those authorized by the IPRs holder are no more able to place goods on the local market than foreign producers, and that the situation is therefore non-discriminatory.

[86] Thomas Cottier and Marc Stucki, Parallelimporte im Patente-, Urheber- und Muster-und Modellrecht aus europarechtlicher und völkerrechtlicher Sicht, paper presented at a conference of the Association Suisse d'Étude de la Concurrence (ASEC), 23 February 1996.

[87] Cottier, above at n. 5.

identical or similar signs in the course of trade 'where such use would result in a likelihood of confusion,' and it provides that '[i]n the case of the use of an identical sign for identical goods or services, a likelihood of confusion shall be presumed.' Cottier suggests that the presumption of confusion might be rebutted in the case of the trademark holder's consent to use of the mark.

The copyright provisions of the TRIPS Agreement do not expressly contain a right to prevent importation, nor does the Berne Convention to which the TRIPS Agreement refers. The new Copyright and Performances and Phonograms Treaties do not include a right to prevent importation.

Section 2 of the TRIPS Agreement concerning Civil and Administrative Procedures and Remedies may shed some light on the matter. For example, Article 51 relating to suspension of release by customs authorities, says that Members should 'adopt procedures [footnote 13] to enable a right holder, who has valid grounds for suspecting that the importation of counterfeit trademark or pirated copyright goods [footnote 14] may take place,' to lodge an application to suspend release into free circulation, etc. Footnote 13 states:

> It is understood that there shall be no obligation to apply such procedures to imports of goods put on a market in another country by or with the consent of the right holder, or to goods in transit.

Footnote 14 defines 'counterfeit trademark' and 'pirated copyright' goods in terms of the absence of consent to use or copy.[88]

The elimination of TRIPS Article 6 would lead to substantial uncertainty with respect to the proper interpretation of the TRIPS Agreement. Arguably, the effect would be that Members would be entitled to determine their own parallel import policies, with reference to the guiding principles of the TRIPS Agreement outlined above. However, the realpolitik of the TRIPS Agreement does not suggest such a result. The real possibility exists that OECD industries will pressure their governments to demand that WTO Members take steps to prevent parallel importation, on the grounds that parallel imports deprive them of the expected return on their IPRs investments. Moreover, this may not be solely a North-South trade problem. Japan, for example, has followed a more open policy with respect to parallel imports in trademarked goods than has the United States, and a decision by Japan's Supreme Court with respect to parallel imports in patented products is pending. The US government has already signaled that it may react adversely to a decision by Japan that permits parallel importation of patented products. It may be recalled that Section 301 of the US Trade Act of 1974 was amended during the Uruguay Round implementation process to authorize the US Trade Representative to impose sanctions on countries that fail to adequately protect IPRs, notwithstanding that such countries are in compliance with the TRIPS Agreement.[89]

[88] Article 44 regarding injunctions refers to prevention of infringement of IPRs after customs clearance, and Article 45 regarding damages refers to infringing activities.

[89] Section 301(d)(3)(B) of the Trade Act of 1974, as amended; 19 USC Section 2411.

The rule of law in the WTO would not be well served by the invitation to dispute that would be created solely by elimination of TRIPS Agreement Article 6.

Towards a parallel imports rule

As a preliminary conclusion, it is suggested that rules prohibiting parallel importation are non-tariff barriers to trade that are inconsistent with basic WTO principles. They should be prohibited, absent a showing that they serve a social welfare purpose that outweighs their trade-restricting effect. The vertical territorial allocation of distribution markets by IPRs owners can be accomplished by significantly less trade restrictive means, i.e., by private contract establishing exclusive sales territories for authorized sellers.

The following proposal is put forward for a set of rules with respect to parallel importation that might be incorporated in the TRIPS Agreement. This proposal addresses both goods and services. A more limited rule affecting only goods might alternatively be considered.[90]

1. Draft rules

The basic rule. A basic rule with respect to parallel imports might state:

> A Member shall not restrict the importation of a good or service on the basis of an intellectual property right if such good or service was first sold, or ownership of it was otherwise transferred, on the market of any Member with the consent of the intellectual property rights holder.

The price control exception. One possible approach to the problem of government price controls on patented 'public health' goods would rely on patent holders to limit production in markets in which price controls are imposed. Private limitations on production may not be effective, however, if wholesalers' potential profits from exports substantially exceed potential profits in the local market. Members might therefore be required in adopting 'public health' price controls to place limitations on the export activities of wholesalers, such as by requiring that all sales in price-controlled health care markets be undertaken by the patent holder or its authorized representative. In addition, Article 31(f) of the TRIPS Agreement might be clarified to provide that compulsory license holders in price controlled health care markets may not manufacture for export.

An export control-based approach could also be considered. For example, a safeguard with respect to government price controls might read as follows:

> Members may establish price limits for patented products, or products produced by patented processes, on public health grounds when such regulations are applied in an equivalent manner to all producers, domestic and foreign. However, such price controls shall be presumed to nullify or impair the rights of patent holders in export markets. Patent holders in Members that impose price controls on public health grounds shall be entitled to affix or cause to

[90] See fax from W. R. Cornish to the Rapporteur, above at n. 13, suggesting that rules respecting products and services might be considered separately.

> be affixed a label to affected products stating: 'This product subject to government price control: not for export'. Customs authorities in the Member of export shall prohibit the export of such products absent the express consent of the patent holder; and administrative procedures shall be established which permit patent holders to enforce such prohibitions.

The audio–visual exception. Finally, it may be useful to address the specific situation confronted by the European Court of Justice in the *Coditel* case. The public broadcast or performance of an audio-visual work in a Member State, or the licensing for public broadcast or performance in a Member State, should not constitute selling or transferring the copyrighted subject matter in a parallel imports sense because of the unique characteristics of the broadcast and performance market. Copyright holders in broadcasts and performances depend upon earnings from repeated communications of the same work to the public. Moreover, it is commercially impracticable for producers of broadcasts and performances to communicate to the public simultaneously throughout the global market. A parallel imports exception for public performances might therefore provide:

> The public broadcast or performance of an audio-visual work shall not constitute the first sale or transfer of ownership of such work in a Member for purposes of paragraph *basic rule* above.

2. Transparent adoption procedures

Governmental rule-making is most intelligently accomplished when the best information concerning the potential consequences of rules is used. It has been suggested here that parallel imports will police the pricing structure of the international market in IPRs protected goods. It has also been suggested that insufficient evidence of a social welfare benefit generated by rules restricting parallel imports exists to justify such rules.

The possibility cannot be excluded that more data on the parallel imports phenomenon in the international environment might shed new light on the question. Several different approaches might be followed with respect to assembling more data, and analyzing it. One such approach would be for the TRIPS Council to request WIPO or some other international body to undertake a program of research and prepare a report. Another approach would be to follow the kind of administrative procedure used by various national and regional administrative authorities, and to invite interested parties to make submissions to the TRIPS Council. Because industrialized country industry groups are generally better able to finance such submissions than other affected groups, such a procedure may give rise to an imbalance in perspectives. It is for this reason that the work of an independent international body would be an important component of such an undertaking.

Ultimately the TRIPS Council will act on the basis of the expressed interests of its Members. Nevertheless, this may be an appropriate occasion to increase the transparency of WTO rule-making.