# Combating Gray Market Goods

## USING THE LANHAM ACT TO PROTECT YOUR CLIENTS

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Gray market goods include products with legitimate trademarks that are intended for sale and use outside the United States, but which are imported and sold in the United States without the consent of the U.S. distributor of like domestic goods. While estimates of gray goods vary by industry, the value is substantial. A 2003 KPMG report estimated the gray market for IT products alone to be $40 billion in sales, with $5 billion in lost profits annually for U.S. distributors. Unlike counterfeit (black market) goods, however, gray goods may be lawfully sold in the United States if they are identical to their U.S. cousins. Gray goods that are materially different, however, may violate § 32, 42, or 43 of the Lanham Act, and, thus, cannot be sold in the United States.

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In a down economy, the importation of gray goods increases because they are sold at a substantial discount. Gray marketers are able to purchase gray goods abroad well below the wholesale cost of their U.S. counterparts. Manufacturers, particularly of expensive goods (i.e., high-end watches or construction equipment), often sell like products cheaper overseas because the gray goods (1) do not come with the standard U.S. warranty; (2) contain cheaper components; and/or (3) do not meet U.S. safety and/or environmental standards. The domestic price also includes marketing/advertising and warranty/service costs, which the gray marketer does not have to pay for, but benefits from. Price differentials also can occur as the result of currency fluctuations (i.e., the value of the dollar to the Japanese yen).

Gray goods pose serious threats to U.S. distributors, which spend substantial sums to develop their goodwill and build loyal distribution and service networks. Gray sellers reap the benefits of this goodwill without the costs. Gray marketers use low prices to undersell U.S. distributors, resulting in lost sales and unhappy dealers. Likewise, because gray goods often materially differ from domestic goods, including quality control, product characteristics, labeling, and other key elements, U.S. consumers may be disappointed by the gray goods, resulting in a loss of the U.S. distributor's goodwill.

**Tips for Monitoring the Gray Market**

U.S. distributors have several routes to monitor the gray market. Because most gray market sellers use the Internet, U.S. distributors should closely monitor the Internet. While some Internet sites blatantly advertise materially different gray goods, most gray marketers are careful to hide this fact. A couple of signs, however, can identify a broker selling gray goods. To hide the fact that they are selling gray goods at well below retail prices, gray marketers often do not list prices but request potential purchasers to telephone or e-mail for the price. When asked about product serial numbers, gray sellers often claim that they do not know this information because the good is "on a boat" or "on the water." Such answers are a sure sign of gray goods that are most likely materially different.

In addition, because many reports

about gray goods come from customer or dealer complaints, U.S. distributors should educate the public and their dealer/service networks by putting a notice on their websites (1) defining the gray market; (2) alerting dealers, potential purchasers, and current owners of the existence of gray market products; (3) detailing the differences between the gray and domestic goods; (4) clearly stating that gray goods imported into the United States are done without the U.S. distributor's consent or knowledge; (5) indicating that gray goods do not fall under warranty and will not be serviced by authorized dealers; and (6) providing a toll-free telephone number to report gray market goods. U.S. distributors also should issue special alerts to dealers and/or service providers with respect to any specific gray good threat and provide continuing education.

**Options Under the Lanham Act**

Once a U.S. distributor discovers that it has a gray market problem, the Lanham Act (title 15 of the U.S. Code) provides several options to combat gray goods. A trademark owner, including a foreign owner of a U.S. mark, can seek an order of exclusion under § 42 of the Lanham Act. Domestic distributors may obtain monetary relief, including disgorgement of profits, under § 32 or § 43 of the Lanham Act. Section 32 is available to both foreign and domestic owners of registered trademarks. Section 43, which does not require a registered mark, may be used by a U.S. distributor, even if it is not an exclusive distributor, as long as it has "some cognizable interest" in the mark.

**The Material Difference Test**

Regardless of which route the U.S. distributor chooses, it must prove the gray goods are "materially different" from their domestic counterparts. In the most often cited gray market case, *Société des Produits Nestlé S.A. v. Casa Helvetia*, 982 F.2d 633 (1st Cir. 1992), the federal court of appeals held that a single material difference creates a *presumption* that the gray goods have a "potential to mislead or confuse consumers about the nature or quality of the product." Actual confusion is not required. "[A]ny difference . . . that consumers would likely consider to be relevant when purchasing a product" constitutes a material difference. Material differences include "subtle differences" that are "not blatant enough to make it obvious to the average consumer that the origin of the product differs from his or her expectations," and, thus, are likely to confuse and/or disappoint the average consumer.

**The distributor must prove the gray goods are "materially different" from their domestic counterparts.**

Counsel advising U.S. distributors facing a gray market threat should look to differences that could affect the distributor's ability to control the quality of the goods, impugn its goodwill, negatively affect its relationship with authorized U.S. dealers, and/or potentially lead to consumer confusion. Courts have found the following differences in gray goods material: (1) altered or obliterated serial numbers; (2) non-English language instructions, manuals, or labels; (3) a significantly reduced price from that of the U.S. exclusive distributor and/or sold without the standard, comprehensive U.S. warranty; and (4) physical differences, including packaging and/or product composition.

**Altered or Obliterated Serial Numbers**

A good example of altered serial numbers constituting a material difference is found in *Davidoff & Cie, S.A. v. PLD International Corp.*, No. 00-2635-CIV, 2000 WL 1901542 (S.D. Fla. Sept. 25, 2000), where the gray marketer sold gray goods with the batch codes removed and replaced with numbers that did not correspond to any actual products—gray or domestic. Holding this was a material difference, the district court found that obliterated manufacturer's codes (1) "degrade[] the appearance of the product," creating an appearance that "the product had in some way been tampered with," resulting in "a likelihood of confusion"; and (2) "deprive Plaintiffs of their exclusive right to control the quality of their products." "[B]atch codes are vital to plaintiff's quality control effort in that those codes are the only means for the plaintiff to identify and recall defective products." It did not matter that the manufacturer "never recalled any of its products . . . it is the right to control the quality—as well as the actual quality—that is afforded . . . protection."

Likewise, *John Paul Mitchell System v. Pete-N-Larry's, Inc.*, 862 F. Supp. 1020 (W.D.N.Y. 1994), involved the sale of gray goods with obliterated batch codes, which were the "only effective way [for plaintiff] to identify specific products for quality control purposes in the event that recall of products is necessary." The court held that the obliterated batch codes constituted a material difference because they were vital to the plaintiff's quality control efforts. The fact plaintiff never had a product recall was irrelevant because "it is the right to control quality—as well as the actual quality—that is afforded one of the most important protections under the Lanham Act." The court also noted that the "crudity" of the obliteration of the batch codes left noticeable scars that made the gray goods physically inferior to the domestic product and could tarnish the domestic distributor's goodwill because consumers "will likely attribute [the obliteration] to the plaintiff."

Similarly, in *Montblanc-Simplo GMBH v. Staples, Inc.*, 172 F. Supp. 2d 231 (D. Mass. 2001), the U.S. distributor of high-quality and highly priced pens sought to enjoin importation of

pens with altered serial numbers without the standard manufacturer's warranty. Finding material difference, the court held that "serial numbers are a vital part of [plaintiff's] quality control efforts" and their removal prevented the manufacturer from being able to recall, track, or identify lost or stolen pens. It did not matter that plaintiff did not identify any actual quality control problems because it is the ability of plaintiff to maintain quality control, not actual quality, that is protected.

**Foreign Language Decals and Manuals**

Likewise, gray goods with foreign language decals and manuals violate the Lanham Act. In *Bourdeau Brothers, Inc. v. International Trade Commission*, 444 F.3d 1317 (Fed. Cir. 2006), John Deere sought to prevent the sale in the United States of harvesters that Deere "manufactured solely for sale in Europe." The Federal Circuit held that each of the following constituted a material difference:

- The "North American harvesters" have "warning labels and safety decals" with "pictures and English writing," while the "European forage harvesters carry only pictures";
- "The operator's manuals of the European version forage harvesters are in the language of the target country, while the American forage harvesters are in English"; and
- "[T]he warranty services provided by Deere differ for the North American and European version[s]."

Similarly, in *Gamut Trading Co. v. International Trade Commission*, 200 F.3d 775 (Fed. Cir. 1999), the gray marketer sold Kubota tractors in the United States that were manufactured in and intended for sale and use in Japan. Kubota-US, a subsidiary of Kubota-Japan, the Japanese manufacturer of the tractors, was the exclusive distributor of Kubota tractors in the United States. The court found that Kubota-Japan manufactured tractors for specific use in the United States and that

- The U.S. machines "bear English-language controls and warnings, and have English-language dealers and users manuals";
- Kobota-US imported the U.S. machines "and sold [them] through a nationwide dealership network which provides full maintenance and repair service and maintains an inventory of parts"; and
- "Kubota-US conducts training classes for its dealership employees, instructing them on service and maintenance procedures."

The gray market importer contended that the above did not constitute material differences because its customers knew that they were purchasing Japanese tractors and the Japanese labels were readily apparent. Rejecting this contention, the court held that the lack of English "instructional and warning labels, operator manuals, and service manuals" was material, particularly

because they "were necessary to the safe and effective operation of the machine."

**Discounted Price/Lack of Warranty**

Likewise, the sale of gray goods as "new" without the manufacturer's standard warranty and/or at a significant discount to the price offered by the U.S. distributor constitutes a material difference. In *Perkins School for the Blind v. Maxi-Aids, Inc.*, 274 F. Supp. 2d 319 (E.D.N.Y. 2003), the gray marketer purchased gray goods overseas at a substantial discount to U.S. prices and resold them in the United States at a substantial discount to retail prices and without the manufacturer's standard warranty. The court held that, even if physically identical to the domestic goods, the gray goods were materially different because the discounted sale without the standard U.S. warranty or with an "inferior" warranty would likely "cause confusion as to both the quality and source."

**Even minor differences in the composition of the product can constitute a material difference.**

Similarly, in *Osawa & Co. v. B&H Photo*, 589 F. Supp. 1163 (S.D.N.Y 1984), the gray marketer sold cameras "at prices far below the prices of authorized [U.S.] dealers" and without the manufacturer's standard warranty. Finding these material differences, the court noted that the U.S. distributor "had devoted extensive expenditures, activities and energies to the successful development of goodwill for the [brand]," including (1) "advertising and . . . other public relations expenses" and (2) only selling the product through authorized dealers, which are required to receive continuing training from the distributor and keep a full inventory of product and parts on hand to meet customer needs. The court also found that customer confusion can result from "wide price disparities between legitimate and grey imports" because "consumers will wonder why the same equipment can be purchased so much more cheaply" overseas and "will no doubt assume the explanation is that the plaintiff is gouging, which will engender hostility to the mark." Such price disparity can result in "disaffection among authorized dealers," which in turn "creates a substantial risk of loss of enthusiasm or bad-mouthing (where it matters most since buyers are likely to look to dealers for advice on brands and equipment)."

**Composition and/or Appearance**

In addition, even minor differences in the composition of the product and/or physical appearances can constitute a material difference. In *Société des Produits Nestlé S.A.*, the U.S. distributor of Italian chocolates sought to enjoin the sale of chocolates that, although sold under the same name, were intended to be sold in South America. The First Circuit found it material that (1) the composition of the two chocolates differed and (2) the domestic and gray chocolates were sold using different packaging. Likewise, in *Lever Brothers Co. v. United States*, 877 F.2d 101 (D.C. Cir. 1989), the court found that minor differences in ingredients and packaging between U.S. and U.K. versions of bath soap constituted a material difference, while in *Ferrero U.S.A., Inc. v. Ozak Trading, Inc.*, 753 F. Supp. 1240 (D.N.J. 1991), the district court held that a U.K. version of "Tic Tac" breath mints was materially different because each mint had an extra one-half calorie and came in slightly different packaging.

**A Recent Example**

A recent example of gray goods litigation that involved several of the above material differences comes from a U.S. district court in Illinois—*Hyundai Construction Equipment U.S.A., Inc. v. Chris Johnson Equipment, Inc.*, 2008 WL 4210785 (N.D. Ill. Sept. 10, 2008). The defendant/gray marketer purchased at least 29 Hyundai heavy construction machines in Korea from Korean dealers that purchased the 29 machines directly from the manufacturer (Hyundai-Korea), the parent company of the plaintiff/U.S. distributor (Hyundai-U.S.A., which was represented by the authors). The gray marketer was able to purchase all 29 units at well below the cost for which Hyundai-U.S.A. sold like domestic machines to its dealers. As a result, the gray seller sold the gray machines at well below the cost of authorized Hyundai-U.S.A. dealers.

Hyundai-Korea, however, intended that these 29 machines be sold and used in Korea and/or China, not the United States. These 29 units thus did not have the standard "bumper-to-bumper" warranty that all U.S. machines came with and which was a cornerstone of Hyundai-U.S.A.'s quality control and marketing strategy. Furthermore, in an attempt to hide the source of the 29 machines, the serial numbers for all the machines had been crudely altered. In addition, many of the 29 gray market units (1) had non-English language safety, operational, and maintenance labels and manuals, unlike domestic Hyundai-U.S.A. machines; (2) contained non-EPA-compliant engines; and (3) included model numbers not sold in the United States.

The gray marketer did not take issue with the above differences, which the court held were all material. Instead, the defendant contended that there was no actual consumer confusion because its buyers were "sophisticated" and knew the 29 gray machines "were intended for sale in foreign markets," differed from domestic machines sold by Hyundai-U.S.A., and did not come with the standard Hyundai-U.S.A. warranty, and that the gray marketer was not an authorized Hyundai dealer. The purchasers, according to the gray marketer, only cared about the low price. The court held that this did not

matter because actual confusion is not a requirement under the Lanham Act and because this knowledge "would not protect subsequent customers."

The defendant also contended that Hyundai-U.S.A. did not have standing because it did not own the trademark and its agreement with Hyundai-Korea was not exclusive. Rejecting this contention, the court held that "the primary purpose of the Lanham Act is to protect consumers" and the goodwill of U.S distributors. Therefore, Hyundai-U.S.A. had standing because (1) it "spends large amounts of money in advertising and promoting Hyundai products from which [the gray marketer] benefited" and (2) lost sales to lower-priced and materially different gray machines "could lead to . . . the loss of goodwill." The court went on to permanently enjoin the gray marketer from importing or selling any Hyundai heavy construction equipment with less than 100 hours of operational time and awarded Hyundai-U.S.A., almost $1 million (the gray marketer's profits on the 29 gray market machines) in damages and its costs.

**Keeping Gray Goods Out of the U.S.**

The experiences of Hyundai-U.S.A. and the above U.S. distributors show that gray goods can enter the U.S. market without the knowledge or consent of the manufacturer and/or the U.S. distributor. To help stem the flow of gray goods into the United States, manufacturers should closely monitor and implement product control and tracking procedures for their non-U.S. distributors, including using the threat of termination if goods from the foreign distributor are repeatedly finding their way into the United States. In addition, upon discovery of a gray market importer in the United States, the U.S. distributor should immediately send a cease and desist letter and, if necessary, file suit under the Lanham Act making sure to seek disgorgement of profits, treble damages, and attorney fees.

**Conclusion**

Accordingly, counsel advising U.S. distributors, trademark owners, or manufacturers facing the threat of gray market goods should advise their clients on how to identify gray marketers, how to prevent gray goods from entering into the United States, and the benefits of fighting gray goods with the Lanham Act. BLT

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*Please see page 1 for information on the upcoming BLT Live teleconference on this topic.*