COMMENTS

Parallel Imports: The Tired Debate of the Exhaustion of Intellectual Property Rights and Why the WTO Should Harmonize the Haphazard Laws of the International Community

Christopher B. Conley*

I. INTRODUCTION

The doctrine of exhaustion is one of the most enigmatic concepts of intellectual property (IP) rights. Exhaustion defines the territorial rights of IP owners after the first sale of their protected products. The *national* exhaustion theory, which is a clear example of a nontariff barrier to trade, prevents the importation of IP unless authorized by the holder of the IP

 J.D. candidate 2008, Tulane University Law School. This Comment received an Honorable Mention in the 8th Annual Foley & Lardner IP Writing Competition. The author would like to thank his wife, Naomi, for her continued support throughout law school and Professor Edward T. Hayes for his guidance in writing this piece. This Comment is dedicated to my late grandmother, Betty Jane Schleiff.

right.[1] For example, a patent holder may block the importation of any patent-infringing work or the sale of the patented product on the domestic market. However, under no circumstances may the producer control the subsequent resale of the patented product after he has *exhausted* the right of first sale in the domestic market. Conversely, under the *international* exhaustion theory, the patent holder loses his exclusive privilege after the first sale of the product anywhere in the world, thus allowing parallel imports from abroad.[2] A hybrid is the *regional* exhaustion theory where "parallel trading is allowed within a particular group of countries," such as the European Union, but prohibited from countries outside the region.[3] The importation of patented products is called "parallel" or "gray market" imports.

Naturally, these gray market goods are unwelcome competition to businesses selling the same goods obtained at a higher cost. IP rights occasionally exclude such products. If products sold or imported by third parties fall within the scope of valid patents in the imported country, the gray market goods are typically considered infringing. Owners of IP rights have the exclusive right to place their product on the market. However, once the owner of an IP right has authorized the goods to enter the market, he has exhausted those rights, and there is nothing he can do to control subsequent acts of commercial exploitation on the domestic market.[4]

As one can imagine, parallel imports are quite controversial, so an understanding of the "gray market" label, referring to the distribution channel for a patented product to enter a protected country, is essential.[5] These goods are legally produced, sold, and exported. Thus, the patent holder has either exploited the patent himself or has authorized another party to exploit the patent. The product is then sold and exported to another territory that has issued the same patent rights of that product to the same patent holder. The most common method is *passive parallel imports* where goods are purchased in a foreign market and resold in the domestic market.[6] In contrast, *active parallel imports* occur when a

---

1. MITSUO MATSUSHITA ET AL., THE WORLD TRADE ORGANIZATION: LAW, PRACTICE, AND POLICY 734 (2006).

2. *Id.*

3. Carsten Fink, *Entering the Jungle of Intellectual Property Rights Exhaustion and Parallel Importation*, *in* INTELLECTUAL PROPERTY AND DEVELOPMENT: LESSONS FROM RECENT ECONOMIC RESEARCH 171, 171 (Carsten Fink & Keith E. Maskus eds., 2005).

4. Christopher Heath, Parallel Imports and International Trade, http://www.wipo.int/edocs/mdocs/sme/en/atrip_gva_99/a_99_6.pdf (last visited Oct. 3, 2007).

5. *Id.* at 1.

6. Fink, *supra* note 3, at 171-76.

foreign licensee exploits the patent and then enters the domestic market in direct competition with the patent holder and other official domestic licensees.[7]

The purpose of this Comment is to identify the need for harmonization of parallel import laws by the World Trade Organization (WTO). To do so, it is necessary to explain, analyze, and identify the discrepancies between different theories of exhaustion of IP rights. However, this study will not advocate any one theory—simply that the status quo is insufficient and harmonization must be achieved. First, the Comment will address the origins of the WTO, as it is the regulator of international trade. Second, a brief overview of the different IP rights will be given. Third, the legal regimes governing international IP rights will be outlined. Fourth, an economic analysis will be conducted of the different theories of exhaustion. Fifth, the argument for harmonization will be made. Last, a conclusion will be drawn highlighting the attributes of each theory and how none is truly superior to the others. In sum, we have too much to lose by not having, and everything to gain by having, a stable IP trading environment, and the WTO is the only organization capable of orchestrating such an endeavor.

II. THE WORLD TRADE ORGANIZATION

The second quarter of the twentieth century witnessed a marked increase of international trade tension. Many agree that this increase in tension began in 1930 when the United States passed the Smoot-Hawley Tariff Act (Tariff Act).[8] This protectionist statute raised tariff rates on most articles imported into the United States and provoked U.S. trading partners to institute comparable tariff increases.[9] The Tariff Act is often cited as a factor in spreading and precipitating the Great Depression and World War II.[10]

After World War II, the United States and the United Kingdom sought to ensure a stable environment for worldwide trade and economic development.[11] They began laying the groundwork for the creation of an organization to regulate international trade. Their first meeting took

---

7. *Id.*

8. Richard N. Cooper, *Trade Policy as Foreign Policy*, *in* U.S. TRADE POLICIES IN A CHANGING WORLD ECONOMY 291, 291-92 (Robert M. Stern ed., 1987).

9. *Id.*

10. *Id.*

11. Edward T. Hayes, *Changing Notions of Sovereignty and Federalism in the International Economic System: A Reassessment of WTO Regulation of Federal States and the Regional and Local Governments Within Their Territories*, 25 NW. J. INT'L L. & BUS. 1, 6 (2004).

place in Bretton Woods, New Hampshire, in 1944.[12] During the Bretton Woods conference, the creation of an organization responsible for the global trade environment was discussed and a draft charter for the International Trade Organization (ITO) was created.[13]

There were several subsequent conferences discussing the ITO.[14] A 1947 conference in Geneva was a significant first step.[15] First, a draft charter for the ITO was to be drawn up.[16] Next, negotiators were to "prepare schedules of tariff reductions."[17] Finally, the negotiators were to "prepare a multilateral treaty containing general principles of trade, namely, the General Agreement on Tariffs and Trade (GATT)."[18] A preparatory committee drafted the ITO Charter, and it was approved in 1948 at a conference in Havana, Cuba.[19]

The first problem arose early in the negotiation process: "how to bring the tariff cuts and the GATT into force right away without waiting on the final round of negotiations to form the ITO."[20] To solve this dilemma, the negotiating countries signed a Protocol of Provisional Application (PPA), which was to apply provisions of the GATT "provisionally on and after January 1, 1948."[21] Though the PPA provided an immediate, quick solution, further problems lingered.

Ultimately, the ITO sputtered and died. Support from the United States was critical to ensuring its success.[22] Thus, the other negotiating countries, though ready to adopt the ITO Charter, waited for Congress's reaction.[23] The ITO Charter was immediately rejected by the U.S. Congress, and eventually President Harry Truman "announced that [his administration] would no longer seek congressional approval for the

---

12. MATSUSHITA ET AL., *supra* note 1, at 1. The International Monetary Fund and World Bank were also created at the Bretton Woods conference. *Id.* at 2 n.2.

13. Hayes, *supra* note 11, at 6.

14. MATSUSHITA ET AL., *supra* note 1, at 2 ("Negotiations . . . were held in several stages: at Lake Success, New York in 1947; in Geneva in 1947; and Havana in 1948").

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*; The General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A-11, T.I.A.S. 1700, 55 U.N.T.S. 194 [hereinafter GATT].

19. JOHN H. JACKSON ET AL., LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS: CASES, MATERIALS AND TEXT ON THE NATIONAL AND INTERNATIONAL REGULATION OF TRANSNATIONAL ECONOMIC RELATIONS 212 (4th ed. 2002).

20. MATSUSHITA ET AL., *supra* note 1, at 2.

21. *Id.*; Protocol of Provisional Application, T.I.A.S. 1700, 55 U.N.T.S. 308 [hereinafter PPA].

22. MATSUSHITA ET AL., *supra* note 1, at 2.

23. *Id.*

ITO."[24] However, the PPA was still alive, and through this mechanism the GATT survived.[25]

Adoption of the ITO was critical to the success of the Bretton Woods conference and its subsequent negotiations. The other institutions created at Bretton Woods, the International Monetary Fund and World Bank, were designed to operate with a "third pillar"—the ITO.[26] Further, the GATT was simply considered a smaller part of the ITO Charter.[27] As such, the GATT was not intended to contain much organizational structure.[28] This lack of detail within the agreement initially created organizational difficulties. To fill this void, the GATT eventually "evolved into a de facto organization."[29] Because the GATT was not designed to operate as a central organization, it suffered from what Professor John H. Jackson has called "birth defects."[30]

The creation of the WTO, though its evolution is ongoing, attempted to resolve the "birth defects" of the GATT.[31] On April 14, 1994, the Uruguay Round of multilateral trade negotiations, conducted under the GATT, concluded with the signing of the Final Act in Marrakesh, Morocco.[32] During the Uruguay Round negotiations, the "parties recognized the need for a supranational organization with sufficient authority to regulate the massive new agreement" that included significant new disciplines and structures.[33] As a result, the negotiation created a WTO with an "organizational structure, legal personality, and separate legal status."[34] Another important characteristic of the WTO is

---

24. *Id.*
25. Hayes, *supra* note 11, at 6.
26. MATSUSHITA ET AL., *supra* note 1, at 2.
27. JACKSON ET AL., *supra* note 19, at 213.
28. Hayes, *supra* note 11, at 6.
29. *Id.*
30. MATSUSHITA ET AL., *supra* note 1, at 3 (citing John H. Jackson, *Designing and Implementing Effective Dispute Settlement Procedures: WTO Dispute Settlement Appraisal, and Prospects*, *in* THE WTO AS AN INTERNATIONAL ORGANIZATION 161, 163 (1998)). The "birth defects" Professor Jackson refers to are

> [t]he lack of a charter granting the GATT legal personality and establishing its procedures and organizational structure; [t]he fact that the GATT had only "provisional" application; [t]he fact that the Protocol of Provisional Application contained provisions enabling GATT contracting parties to maintain legislation that was in force on accession to the GATT and was inconsistent with the GATT (so-called grandfather rights); and [a]mbiguity and confusion about the GATT's authority, decision-making ability and legal status.

Id.

31. Hayes, *supra* note 11, at 7.
32. *Id.*
33. *Id.*
34. *Id.*

the Dispute Settlement Understanding[35] (DSU), which allows for resolving disputes through a dispute settlement panel and a right of appeal to a standing appellate body.[36]

The legacy of the GATT is its success in reducing tariffs and nontariff barriers worldwide.[37] In the early negotiating rounds of the GATT, the reduction of tariffs was the main goal, whereas in later negotiating rounds, especially the Tokyo and Uruguay Rounds, the reduction and elimination of nontariff barriers was a priority.[38] Nontariff barriers are the primary concern with respect to parallel imports and the doctrine of exhaustion.

The purpose of the WTO is to "facilitate the implementation, administration, and operation as well as to further the objectives of the WTO agreements."[39] The WTO is designed to add security and predictability to international trade by allowing members some measure of protection when engaging the international marketplace. For precisely this reason, the doctrine of exhaustion of IP rights must be addressed. "As the sole global intergovernmental organization responsible for international trade, its role has become indispensable to the functioning of the world economy."[40] As discussed *infra*, the WTO regulation of IP rights through the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement)[41] is an ideal forum for the harmonization of parallel import laws.

III. INTELLECTUAL PROPERTY RIGHTS

The three primary classifications of IP rights are patents, copyrights, and trademarks.[42] However, this Comment primarily addresses the IP rights of patents. Nonetheless, a brief overview of the different rights created, and their significance to the economy, is helpful

---

35. Understanding on Rules and Procedures Governing the Settlement of Disputes, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, Legal Instruments—Results of the Uruguay Round, 1869 U.N.T.S. 401, 33 I.L.M. 1225 (1994) [hereinafter DSU].

36. *Id.*

37. MATSUSHITA ET AL., *supra* note 1, at 5.

38. *Id.* at 6.

39. *Id.* at 9.

40. *Id.* at 17.

41. Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, Legal Instruments—Results of the Uruguay Round, 1869 U.N.T.S. 299, 33 I.L.M. 1197 (1994) [hereinafter TRIPS Agreement].

42. JACKSON ET AL., *supra* note 19, at 921. Another common IP right is a trade secret. *Id.* However, this Comment will not discuss trade secrets.

to understanding the issues surrounding parallel imports and the theory of exhaustion.

A. Patent

Black's Law Dictionary defines patent as "[t]he governmental grant of a right, privilege, or authority" which gives its owner "[t]he right to exclude others from making, using, marketing, selling, offering for sale, or importing an invention for a specified period."[43] Therefore, the creator of a new invention has the exclusive right over that invention for a certain period of time.[44] The inventor may sell licenses to reproduce the invention and, subject to national competition laws, restrict the reproduction of the invention or its use.[45]

The policy rationale for patents has been a source of contention. Economically speaking, the rationale is to promote innovation.[46] Research costs are significant, and if inventors are not adequately remunerated, subsequent innovations may be hampered.[47] Additionally, if inventions are not sufficiently protected with exclusivity rights, there is nothing to prevent others from exploiting and profiting from the inventor's efforts; this is a costly risk.[48] However, the right of exclusivity comes at a cost to society.[49] If it is profitable to expend resources for a new invention, then that invention is valuable, not only to the economy, but also to society in general, as in the development of medicines. Therefore, because innovations are a progression of the status quo, the exclusive right to patents should not be so stringent that it results in a loss of societal wealth.[50] In essence, the monopoly of a patent should not be used to "charge a monopoly price over the life of the patent, thus introducing the distortion of monopoly pricing into the economy."[51]

B. Copyright

A copyright is "[t]he right to copy; specif[ically], a property right in an original work of authorship . . . fixed in any tangible medium of expression, giving the holder the exclusive right to reproduce, adapt,

---

43. BLACK'S LAW DICTIONARY 1156 (8th ed. 2004).
44. JACKSON ET AL., *supra* note 19, at 921.
45. *Id.*
46. *Id.* at 921-22.
47. *Id.* at 922.
48. *Id.*
49. *Id.*
50. *Id.*
51. *Id.*

distribute, perform, and display the work."[52] Only "literary and artistic expression[s]" may be copyrighted.[53] Similar to a patent holder, a copyright holder also has the exclusive right to her creation and may sell reproduction licenses for a fee.[54] The underlying policies of copyright are similar to those of patents.[55] However, unlike patents, copyrights do not create monopoly distortions in the economy because they are not as unique as patents.[56] For example, one may write a book or create a new board game and rightfully own the copyright to the creation. Thus, the copyright holder would have the right to prevent subsequent reproduction from unauthorized sources. However, because the copyright is merely of a book or a board game, consumers may instead purchase similar things as a replacement. Conversely, a patent grants the exclusive right to a wholly new innovation—something that cannot have a comparable substitute. Therefore, a copyright does not tend to distort demand elasticity the way a patent does.[57] Nonetheless, copyrights are a necessary form of protection in order to give incentive for further expressions of literary and artistic work.

C. Trademark

A trademark is essentially the signature of the mark holder;[58] it is "[a] word, phrase, logo, or other graphic symbol used by a manufacturer or seller to distinguish its product or products from those of others."[59] The main purpose of a trademark is to protect against fraud.[60] Manufacturers tend to differentiate their products in a number of ways, such as quality, place of origin, and historical significance. However, without a commercial signature and the protection of that signature, there would be nothing to prevent competitors from misleading consumers as to the actual maker of the goods.[61] By defrauding consumers as to the actual maker of the product, competitors are able to free ride on the research and goodwill that the trademark holder has expended significant

---

52. BLACK'S LAW DICTIONARY, *supra* note 43, at 361. Examples of copyrighted material are "[b]ooks, films, songs and paintings . . . but copyright can also extend to computer programs and operating systems, to a blueprint for making a computer chip, or to databases even though the individual bits of data are not themselves copyrightable." JACKSON ET AL., *supra* note 19, at 923.

53. JACKSON ET AL., *supra* note 19, at 923.

54. *Id.*

55. *Id.*

56. *Id.*

57. *Id.*

58. BLACK'S LAW DICTIONARY, *supra* note 43, at 1530.

59. *Id.*

60. JACKSON ET AL., *supra* note 19, at 924.

61. *Id.*

resources to obtain. Further, competitors may not produce goods with the same quality control as the trademark holder, and the quality of the product is lessened. As a result, well-known brand names become damaged, and the incentive for further production of that good is lessened.[62] Therefore, "the rationale for trademark . . . law is in large measure akin to the rationale for sanctioning fraud—misleading statements can cause individuals to enter transactions that are not valuable to them and that they would not enter but for the misinformation."[63]

IV. THE LEGAL SOURCES OF INTERNATIONAL INTELLECTUAL PROPERTY LAW

The realm of IP law has changed markedly over its history. Initially, there was very little protection for IP.[64] Yet, as the demand for industrial innovations increased, the need for protection of these new innovations became apparent.[65] The Paris Convention for the Protection of Industrial Property (Paris Convention),[66] discussed below, was the first attempt to safeguard these progressions in technology.[67] Because the GATT did not directly address IP rights,[68] the Paris Convention was the primary source of protection during the twentieth century.[69]

However, that changed with the WTO and the TRIPS Agreement. The TRIPS Agreement, a product of the Uruguay Round, significantly changed the face of IP rights. Though the bulk of the Paris Convention's substantive provisions were incorporated into the TRIPS Agreement,[70] the differences between the two are not slight. Most importantly, all members of the WTO are required to implement and enforce the IP rights afforded in the TRIPS Agreement.[71]

---

62. *Id.*

63. *Id.*

64. WIPO Handbook on Intellectual Property, The Paris Convention for Intellectual Property 241, http://www.wipo.int/about-ip/en/iprm/ (last visited Oct. 3, 2007) [hereinafter WIPO Handbook].

65. *Id.*

66. Paris Convention for the Protection of Industrial Property, July 14, 1967, 21 U.S.T. 1853, 828 U.N.T.S. 305, *available at* http://www.wipo.int/treaties/en/ip/paris/trtdocs_wo020.html.

67. WIPO Handbook, *supra* note 64, at 241; JACKSON ET AL., *supra* note 19, at 961.

68. The only protection offered was indirectly in the form of "national treatment in matters affecting the importation of goods" addressed in GATT article III. JACKSON ET AL., *supra* note 19, at 961.

69. The Berne Convention was concluded in 1886 and primarily focuses on copyright. *Id.* For the sake of discussion, however, only treaties relating to patent protection will be discussed.

70. TRIPS Agreement, *supra* note 41, arts. 1-2.

71. *Id.* art. 1, ¶ 1.

Prior to the Paris Convention, there was no unifying international IP law.[72] Strategically, applications had to be filed simultaneously in all countries throughout the world "in order to avoid a publication in one country destroying the novelty of the invention in the other countries."[73] Naturally, due to this lack of protection, few patents were actually obtained.[74] Inventors throughout the world desperately sought change.[75]

In the late 1800s, international trade flow increases made harmonization of industrial property laws urgent in the patent field.[76] For example, in 1873, the Austro-Hungarian Empire held an exhibition of inventions in Vienna.[77] Although the Empire issued a worldwide invitation for inventors to participate, few attended because foreign visitors were unwilling to risk their inventions due to inadequate legal protection offered to exhibited inventions.[78] This low turnout sparked the Empire to bolster IP protection.[79] The Empire took the lead and changed its laws to protect all inventions in the exhibition.[80] Next, the Congress of Vienna for Patent Reform was convened, and it laid down "a number of principles on which an effective and useful patent system should be based, and [it] urged governments 'to bring about an international understanding upon patent protection as soon as possible.'"[81]

In 1878, the International Congress on Industrial Property was convened in Paris.[82] The French government proposed an international regime for the protection of industrial property rights.[83] As a result, the International Conference in Paris of 1880 was convened.[84] There, a draft was adopted containing virtually the same substantive provisions that are still today the main features of the Paris Convention.[85] The Paris Convention was finally approved and signed in 1883 by eleven States.[86]

---

72. WIPO Handbook, *supra* note 64, at 241.
73. *Id.*
74. *Id.*
75. *Id.*
76. *Id.*
77. *Id.*
78. *Id.*
79. *Id.*
80. *Id.*
81. *Id.*
82. *Id.*
83. *Id.*
84. *Id.*
85. *Id.*
86. JACKSON ET AL., *supra* note 19, at 961. The original signatory nations were Belgium, Brazil, El Salvador, France, Guatemala, Italy, the Netherlands, Portugal, Serbia, Spain, and Switzerland. Less than a year later, Great Britain, Tunisia, and Ecuador had signed as well, bringing the number of member countries to fourteen. WIPO Handbook, *supra* note 64, at 241.

Interestingly, the United States did not become a signatory member until 1967, when it signed the Stockholm Act.[87] By and large, the membership base of the Paris Convention was the same until shortly after World War II.[88]

The Paris Convention covered "industrial property."[89] This broad phrase included "patents, trademarks, marks of origin, and . . . unfair competition."[90] The Paris Convention, as well as other international accords regarding IP rights, are governed by the World Intellectual Property Organization (WIPO).[91] There has been a slow development of the regime over the years, but the agreements of the Paris Convention have been maintained.[92]

As mentioned previously, the WTO TRIPS Agreement is the most important development in the field of international IP rights. This agreement mandates that any country wishing to be a member of the international trading community must implement and enforce comprehensive rules for the protection of IP rights.[93] Additionally, members are required to enact domestic laws "so as to permit effective action against any act of infringement of [IP] rights covered by th[e] Agreement."[94] Failure to do so gives a cause of action under the WTO dispute settlement system.[95]

The TRIPS Agreement incorporates the substantive provisions of the Paris Convention.[96] The Paris Convention, however, failed to provide guidance on the doctrine of exhaustion.[97] Likewise, negotiations of the TRIPS Agreement during the Doha Round failed to reach agreement. The TRIPS Agreement states, "For the purposes of dispute settlement under this Agreement, subject to the provisions of Articles 3 and 4 nothing in this Agreement shall be used to address the issue of the

---

87. WIPO, Contracting Parties of the Paris Convention, http://www.wipo.int/treaties/en/Remarks.jsp?cnty_id=334C (last visited Aug. 30, 2007).

88. WIPO Handbook, *supra* note 64, at 241.

89. JACKSON ET AL., *supra* note 19, at 961.

90. *Id.*

91. *Id.* WIPO was created by the United Nations in 1974 with the purpose to administer all IP matters recognized by the Member States of the United Nations. The history of the WIPO is available at WIPO Treaties, General Information, http://www.wipo.int/treaties/en/general/ (last visited Oct. 3, 2007).

92. TRIPS Agreement, *supra* note 41, art. 1, ¶ 3.

93. *Id.* art. 1, ¶ 1.

94. *Id.* art. 41, ¶ 1.

95. *Id.* art. 64.

96. *Id.* art. 1, ¶ 3.

97. Christopher Heath, *Legal Concepts of Exhaustion and Parallel Imports*, *in* PARALLEL IMPORTS IN ASIA 13, 22-23 (Christopher Heath ed., 2004).

exhaustion of intellectual property rights."[98] Members of the WTO, therefore, have been given the freedom to choose national, regional, or international exhaustion, and that decision may not be challenged under the DSU. To date, no international IP convention or treaty has adopted a particular regime.[99]

The United States has implemented a system of national exhaustion.[100] In fact, most industrial countries have adopted the national exhaustion theory and thus maintain tight reigns on parallel imports.[101] However, there have been surprising exceptions. In Japan, the Supreme Court stressed the importance of unimpeded international trade when it held that a patentee can control subsequent cross-border transactions when the restrictions are clearly displayed on the patented products.[102]

The European Union (EU) has adopted a regional exhaustion doctrine.[103] Parallel imports are prohibited from outside the EU but are allowed within the EU.[104] In the early 1970s, the European Court of Justice held that national exhaustion would be incompatible with the Treaty of Rome's intention of creating a common market.[105] Other regional trade agreements neglect to address the doctrine of exhaustion. Both the North American Free Trade Agreement and the Treaty of Asuncion, which established the Southern Cone Common Market,[106] provide no clear provision on the exhaustion question.[107] Finally, exhaustion rules may be hashed out in future free trade agreements. Of note, the 2003 free trade agreement between the United States and Singapore prevents parallel imports of patented pharmaceutical products.[108]

V. ECONOMIC CONSIDERATIONS OF PARALLEL IMPORTS

This Part will examine the different theories of exhaustion, their economic implications, and the issues policy makers should consider when formulating their appropriate national policy. But first, the question sought to be answered must be addressed:

---

98. TRIPS Agreement, *supra* note 41, art. 6.
99. Fink, *supra* note 3, at 173.
100. *Id.* at 174.
101. *Id.*
102. *Id.*
103. *Id.* at 173.
104. *Id.*
105. *Id.*
106. Also known as Mercado Comun del Sur (MERCOSUR) between Argentina, Brazil, Paraguay, and Uruguay.
107. Fink, *supra* note 3, at 173.
108. *Id.* at 174.

> To what extent should [IP] rights holders within particular national/regional territories be entitled to restrict the importation of goods and services into those territories on the basis of local [IP rights] ownership when the subject goods and services have been placed on the market outside the territory of importation with their consent?[109]

In section VI, the guidelines for answering this question will be outlined. But first, let us consider the impact of global economics on an individual level.

A. National Exhaustion

A system of national exhaustion gives patent holders absolute control over the distribution of their product on an international scale. Though such a level of vertical restraints may be anticompetitive to some extent, there are nonetheless pro-competitive benefits to such a system. First, it prevents "free rid[ing] on the investments made by official licensees and distributors."[110] Many manufacturers require their distributors and retailers to invest in advertisements in order to promote the product to the public.[111] Point-of-sale services are also commonly required in the retail spectrum, entailing high employment costs.[112] Considerable expenditures of before-sales and after-sales services are also often absorbed by distributors and retailers.[113] Because some parallel imports from different sales territories do not provide these services, free riding is a problem in the import market.[114] Therefore, maintaining separate distribution systems may maximize consumer welfare because the amount of investment expended by domestic distributors and retailers could plummet as a result of free riding. Second, if a system of international exhaustion were adopted, licenses might not be issued in a different market unless the patentees could be assured that they would not compete with parallel imports of the product in whichever market(s) the patentee operates.[115] Consequently, the global market could see

---

109. Frederick M. Abbott, *First Report (Final) to the Committee on International Trade Law of the International Law Association on the Subject of Parallel Importation*, 1 J. INT'L ECON. L. 607, 608 (1998).

110. Fink, *supra* note 3, at 179-80.

111. Nancy T. Gallini & Aidan Hollis, *A Contractual Approach to the Gray Market*, 19 INT'L REV. L. & ECON 1, 6 (1999), *available at* http://econ.ucalgary.ca/fac-files/ah/irle99.pdf.

112. *Id.*

113. *Id.*

114. Fink, *supra* note 3, at 180.

115. *Id.*

slowed technology and information dissemination which is "harmful to follow-on innovation and productivity growth."[116]

Yet, there are still other advantages to a system of national exhaustion. One significant advantage is that it allows producers to charge different prices for the same product in different markets. *Price discrimination* is often considered exploitative conduct by the producer, and parallel imports are thought to restrain such behavior.[117] However, this general categorization of *price discrimination* is not necessarily accurate. Rather, it is *price differentiation* that takes place.[118] This welfare-enhancing pricing structure can occur when different prices are charged to different consumer groups with diverse demand structures.[119] Consider the following example:

> Suppose there are two countries—one rich, one poor—and a firm would serve only the consumers in the rich country if parallel trade between the two countries were allowed and the firm could thus not price discriminate. In contrast, it would charge the same price to consumers in the rich country but also serve the consumers in the poor country at a lower price if parallel trade were prohibited.[120]

When parallel trading is prohibited, "both the firm and the consumers in the poor country would be better off, and consumers in the rich country would not be worse off."[121] By allowing price differentiation based on different demand structures, more utility is derived throughout the global economy.

Under a system of international exhaustion, firms would simply choose to distribute their product in markets prohibiting parallel imports. Thus, countries adopting a system of international exhaustion would not receive that welfare, resulting in a corresponding decrease in economic welfare.[122] Another advantage worth mentioning is that a system of national exhaustion increases the strength of IP protection.[123] This is because the theory of national exhaustion is firmly founded on the assumption that firms will invest additional resources in "knowledge and information–generating activities, which may lead to an accelerated pace

---

116. *Id.*
117. *Id.* at 176.
118. *Id.*
119. *Id.* at 176-77.
120. *Id.* at 177.
121. *Id.*
122. Abbott, *supra* note 109, at 619.
123. Fink, *supra* note 3, at 177.

of industrial innovation and increased production of new literary and artistic works."[124]

However, the most compelling argument in favor of national exhaustion is the narrow case of minimum price caps placed on pharmaceutical drugs by governments. The general assumption is that free competition in the market creates low prices. However, low prices are not always the result of competitive market forces. For example, some governments limit the rate of return on certain products.[125] Now, is it fair to engage in parallel trading of patented goods subject to government intervention, and thus resulting in artificially low prices? Consider the following hypothetical:

> 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.[126]

Certainly this is unfair competition and a system of national exhaustion would deny such parallel imports. However, as a rebuttal to the proposition that this possibility is unfair, an arguably sufficient response would be for the drug manufacturer to only produce enough of the item to satisfy the local demand.[127]

This argument is "relevant only for those government interventions that target domestic consumption and would thus lead to a different treatment of parallel exports compared with regular exports."[128] Typically, price controls are an attempt to ensure a certain good is affordable to domestic, low-income consumers.[129] Attaching such a restriction to exports is an unacceptable extension of national public policy. However, even if such an extension of public policy were acceptable to certain countries, patent holders are not obligated to continue their service to the exporting country.[130] Consequently, price-controlled markets may suffer from reduced access to IP altogether.

---

124. *Id.* at 178.
125. *Id.* at 179.
126. Abbott, *supra* note 109, at 623.
127. Fink, *supra* note 3, at 179.
128. *Id.*
129. *Id.*
130. However, article 31 of the TRIPS Agreement provides Member States with the opportunity to abrogate the patent and produce the drug without consent of the patentee. This process is known as compulsory licensing and is highly controversial. The issue comes down to

The primary anticompetitive effect of national exhaustion is that this vertical restraint reduces intra-brand competition. This variety of competition occurs between distributors of the same product rather than between manufacturers of like products. Manufacturers therefore maintain complete control over the domestic supply chain. Accordingly, intra-brand competition is at its lowest when IP holders segregate markets, thus preventing unauthorized imports. The general consensus is that reduced intra-brand competition is not so anticompetitive that it should be per se illegal. For one, if manufacturers were prohibited from limiting intra-brand competition, they would simply vertically integrate and cut out the independent distributor. Economically, depending upon the market, there is usually enough inter-brand competition to keep prices competitive between like products. However, if the manufacturer had a monopoly market share, such restrictions on intra-brand competition are obviously anticompetitive.

Another issue for policy makers to consider is that it may be in a patentee's best interest to encourage parallel trade between segmented markets in order to reduce the opportunity for its distributors to collude.[131] However, a system of national exhaustion would apply to every good covered by a particular IP right. In that case, this system would be undesirable because it may be advantageous "to have complete denial of parallel imports for some goods, restrictions on . . . others, and no limits on . . . still others."[132]

B. International Exhaustion

The theory of comparative advantage is the most fundamental concept in international trade. Simply put, "[s]pecialization and free trade will benefit all trading partners . . . even those that may be absolutely less efficient producers."[133] A system preventing parallel imports does not comport with the theory of comparative advantage because nations are unable to specialize in what they do best. Therefore,

---

the "balancing [of] two opposing interests: namely, the interests of inventors and of technologically advanced countries and those of licensees and of technologically less-advanced countries." MATSUSHITA, *supra* note 1, at 730. The four main principles of compulsory licensing are: (1) the Member State must "obtain authorization from the right holder on reasonable commercial terms and conditions . . . [but such condition] may be waived . . . in the case of a national emergency; (2) it is "limited to the purpose for which it was authorized"; (3) it is "predominantly for the supply of the domestic market . . . [and shall] be terminated if and when the circumstances which led to it cease to exist and are unlikely to recur"; (4) "the right holder shall be paid adequate remuneration." TRIPS Agreement, *supra* note 41, art. 31(a)-(h).

131. MATSUSHITA, *supra* note 1, at 730.

132. Fink, *supra* note 3, at 180.

133. KARL E. CASE & RAY C. FAIR, PRINCIPLES OF MICROECONOMICS 377 (7th ed. 2004).

because a system of national exhaustion conflicts with the principle of free trade, it is no surprise that economists argue in favor of a system based on international exhaustion.[134]

Let us for a moment consider this in the context of new technology. First, for the sake of discussion, assume that it requires more resources to create new technology than it does to produce the product derived from the new technology. Second, also assume that the creation of new technology requires fewer resources in highly industrialized nations than in less-industrialized nations. Finally, assume that it requires fewer resources to produce the product derived from the new technology in less-industrialized nations than it does in highly industrialized nations. The less-industrialized nations have a comparative advantage over the highly industrialized nations when it comes to producing the product derived from the new technology. Highly industrialized nations should specialize in creating new technology, and less-industrialized nations should specialize in producing the goods derived from the new technology. Accordingly, each nation, by specializing in its relevant industry and trading the two products, will maximize its own production capacity and thereby maximize overall welfare. However, a system prohibiting parallel imports, by erecting trade barriers, requires each nation to produce each respective product individually, and therefore lowers the overall economic welfare because production capacity is not maximized.

Unfortunately, the *unstated* assumptions upon which the argument for free trade relies do not fit into the reality of a world where parallel trade takes place. The foundation of the theory of comparative advantage relies upon two critical assumptions: the market operates under the conditions of (1) free entry and (2) perfect competition.[135] Only with those assumptions will competition force prices down to the marginal costs in all free-trading markets.[136] Accordingly, a market with perfect competition erodes the purpose of parallel imports.[137] However, parallel imports only occur in markets with imperfect competition.[138] Imperfect competition is the result of firms maintaining pricing power and price differentiation schemes.[139] In the context of IP, as discussed in the previous Part, holders of IP rights must receive adequate protection in

134. Fink, *supra* note 3, at 175.
135. *Id.* at 176.
136. *Id.*
137. *Id.*
138. *Id.*
139. *Id.*

order to protect their investment. There will likely always be formal protection of IP rights that will serve as a nontariff barrier to parallel trading. Therefore, parallel imports are at odds with the free trade argument based on the theory of comparative advantage, and this theory, as it stands, is inapplicable to the theory of exhaustion of IP rights.[140]

Some economists argue that parallel imports should be restricted through private contractual arrangements, subject to competition laws.[141] The biggest critique of a system of national exhaustion has been of the strictness of its ban on all parallel imports. The bright-line rule fails to balance and separate the pro-competitive benefits of gray market trading with the anticompetitive effects of market segregation. Therefore, parallel imports may be better served if "scrutinized from an antitrust perspective."[142] If so, national competition laws would invalidate contractual provisions contrary to public policy.[143] Second, contractual restrictions provide producers with the ability to address directly products relative to their given industry and its environment.[144] Third, contractual restrictions are not bound to national territories.[145] Indeed, modern business contracts typically contain foreign venue or arbitration clauses in the case of controversy.

Both the United States and the EU recognize the validity of territorial restrictions in IP licensing agreements.[146] It is common practice in the United States to have exclusive dealings and territorial restriction contracts between producers and distributors. The EU authorizes contractual provisions that create territorial restrictions within the EU with regard to active parallel trading.[147] Licensing agreements have also been utilized to include vertical restrictions that have been recognized throughout the international community.[148]

The common law approach to exhaustion allows contractual provisions to limit passive parallel imports.[149] Patent holders may deny parallel imports by incorporating provisions into licensing and purchasing agreements, "for example, by attaching a label on a product indicating '[n]ot for sale in countries X, Y, and Z.'"[150] However, it is

140. *Id.*
141. *Id.* at 180; Gallini & Hollis, *supra* note 111, at 1.
142. Gallini & Hollis, *supra* note 111, at 1.
143. Fink, *supra* note 3, at 181.
144. *Id.* at 180.
145. *Id.* at 180-81.
146. *See* Abbott, *supra* note 109, at 614.
147. *Id.*
148. Fink, *supra* note 3, at 181.
149. *Id.*
150. *Id.*

unlikely that such a system would be workable on a worldwide level because proper notice would be problematic, and it would have to be in several languages.[151]

The biggest critique of a system of private contractual arrangements is that there must first be harmonization of national competition laws on an international scale.[152] There are currently too many countries with emergent competition laws, as well as others that are fundamentally inapposite of one another.[153] Further, many developing, and especially the least-developed, nations do not have adequate laws or courts with sufficient power to enforce private contracts.[154] The problem is determining how much harmonization is needed in order to provide the framework for an international system based upon private restraints. "Undoubtedly, the development of competition institutions in developing countries and increased international harmonization of competition policies would facilitate the functioning of private contractual regulations on parallel imports and thus ease the need for national exhaustion systems."[155]

Another problem with a system based on contractual limitations is its underlying philosophy. Producers and distributors seek an exclusive territory and may achieve this by contracting in a system of international exhaustion. Many countries consider such vertical nonprice restraints as per se legal and therefore desirable. However, this philosophy is problematic on two fundamental grounds. First, as already discussed, there would have to be a substantial overhaul and harmonization of competition policies throughout the international community for such a system to work. Second, an application of the Coase Theorem[156] provides that it does not matter which system of exhaustion is utilized as long as it is consistent. Therefore, if the default rule is based on a system of national exhaustion, and market segregation for the protection of IP rights is provided, private parties may contract around this restriction to provide for sufficient intra-brand competition. Indeed, if the law of contracts is flexible enough to provide for sufficient restrictions of gray

151. Heath, *supra* note 4, at 12.
152. Fink, *supra* note 3, at 181.
153. *Id.*
154. *Id.*
155. *Id.*
156. The theory provides that "[u]nder certain conditions, when externalities are present, private parties can arrive at the efficient solution without government involvement." CASE & FAIR, *supra* note 133, at 313. Three conditions must be met for this theory to work: (1) the default rule must be clear, (2) there must not be any transaction costs, and (3) the number of parties involved must be minimal. *Id.* This theory also provides that "bargaining will bring the contending parties to the right solution regardless of where rights are initially assigned." *Id.*

market goods as has been argued,[157] then it is equally flexible to provide producers with the means to contract around unwanted restrictions in a system of national exhaustion.

Although it may seem odd for a producer to actually want intra-brand competition, it can be beneficial. Consider antitrust policy in the United States. Minimum price fixing between a producer and distributor is per se illegal.[158] Maximum price fixing is subject to a rule of reason analysis and therefore may be held as illegal.[159] There are markets where a distributor or retailer may have a monopoly on the good being sold, but the producer of the good does not have monopoly power due to stiff inter-brand competition. Accordingly, natural market conditions force the producer's price down to a competitive level. However, those market conditions have no effect upon the retailer or distributor. A producer is left with three options: (1) allow the distributor to extract monopoly prices to the detriment of the manufacturer, (2) fix a maximum price for the product and be subject to antitrust litigation under a rule of reason analysis, or (3) create nonexclusive territories for its goods, thus allowing intra-brand competition. Depending on market conditions, the manufacturer's best option is likely the latter of the three.

My critique of the contractual restrictions argument is essentially a difference in starting positions. Instead of requiring producers and distributors to bargain over exclusive territories, my position presumes that exclusive territories are the standard and thus requires producers and distributors to bargain over the exception of nonexclusivity. The purpose of this is merely to ensure the protection of distributor costs and to promote retail or distributor franchises. Relying on the Coase Theorem, producers may contract around the default rule of exclusive territory and thus allow intra-brand competition from parallel trading.

---

157. *See generally* Gallini & Hollis, *supra* note 111.

158. Retail price maintenance is a classic vertical price restraint that the United States Supreme Court has held to be per se illegal. *See* Dr. Miles Med. Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911); *see also* Cal. Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc., 445 U.S. 97, 103 (1980). The Court in *California Retail Liquor Dealers* found that "vertical control destroys horizontal competition as effectively as if wholesalers 'formed a combination and endeavored to establish the same restrictions . . . by agreement with each other.'" *Cal. Retail Liquor Dealers Ass'n*, 445 U.S. at 103 (Justice Powell writing for the Court and quoting *Dr. Miles*, 220 U.S. at 408).

159. State Oil Co. v. Khan, 522 U.S. 3, 22 (1997) ("[A]ll vertical maximum price fixing is [not] per se lawful. Instead, vertical maximum price fixing . . . should be evaluated under the rule of reason.").

VI. THE ARGUMENT FOR HARMONIZATION

The basic question pertaining to parallel imports was addressed at the outset of the previous Part and then followed by a discussion of the issues policy makers must consider before adopting a system. This Part of the discussion will identify the boundaries within which the question must be answered. As already presented, the purpose of this discussion is to advocate for the WTO to harmonize the laws governing parallel imports. Because parallel imports are solely within the realm of international trade law, the boundaries of the WTO should be used as guidelines to answer the question. The WTO operates "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."[160] This basic idea is founded on the theory of comparative advantage and means that "liberal international trade rules move the global economy closer to its production possibility frontier."[161] Application of this theory is crucial because globally, there is a "scarcity of goods and services"; therefore, "the enhancement of productivity is essential."[162] From this basic idea, the WTO has implemented a set of rules specifically "designed to reduce and eliminate tariff and nontariff barriers to trade in goods and services."[163]

Harmonization is the key regardless of the theory utilized; although the theory of international exhaustion is attractive, there are pros and cons to each respective theory with regard to both consumer welfare and producer welfare. As previously discussed, there will always be trade-offs regardless of the theory adopted. Further, it is unlikely that anyone will ever truly know the results of a nearly impossible balancing act of the different issues.[164] The test balances the interests of consumers and producers, and one will ultimately be given priority over the other.[165] Consumer interests are price, quality, availability of variety, and product support.[166] Producer interests are simply the return on investment.[167]

---

160. Abbott, *supra* note 109, at 611.
161. *Id.* at 611-12.
162. *Id.* at 612.
163. *Id.*
164. *Id.* at 613.
165. *Id.* at 612.
166. *Id.*
167. *Id.*

Additionally, Professor Frederick Abbott identifies two major deficiencies in current economic models of parallel imports. "First, empirical studies on parallel importation in the international context are sparse, and in many cases quasi-anecdotal."[168] There is just not enough information for economists to evaluate adequately the realm of international IP trade because importers do not report parallel imports and customs authorities do not collect data.[169]

Second, the studies attempting to model the different approaches to parallel imports are based on too many oversimplified assumptions.[170] Therefore, they do not reflect an adequate picture of the real world and should not be used "as tools for decision-making."[171] Yet, we can still benefit from the history and results of unequal international trade laws by studying the origins of the GATT. We see that harmonization of the doctrine of exhaustion is imperative and that the WTO is the only body capable of such an enormous task.

VII. CONCLUSION

There are compelling arguments for both the national and international theories of exhaustion. Conversely, there are equally compelling arguments against them. IP rights law has radically evolved since the nineteenth century when there was no structure, to the present where there are complex legal systems and rules in place. However, the issue of exhaustion is far from settled law. Considering the protectionist nature of countries and their pursuit to ensure the economic security of their markets, the inconsistency throughout the world is no surprise. The only thing that is certain is the need for harmonization.

The better system of exhaustion is not easy to identify. If the purpose of IP rights is to protect the interests of inventors and concomitantly disseminate new technology and information to society, then a system based on national exhaustion is more appropriate. If the purpose of international trade law is to open up markets and tear down barriers to trade in order to utilize the theory of comparative advantage, then a system based on international exhaustion is more appropriate. Fortunately, the strains on international relations and dangers to national and economic security, which barriers to free trade have created in the recent past, are easier to identify. Policy makers learned from those mistakes and created the WTO. There is no reason why the haphazard

168. *Id.* at 613.
169. *Id.*
170. *Id.*
171. *Id.* at 613-14.

laws of the international community regarding parallel imports should be any different.

The current system is unsustainable for an indefinite period of time. The WTO needs to remedy the confusion surrounding parallel imports. An international governmental body purporting to be the high priest for world trade and IP rights is the only body with the ability to answer the question presented in this discussion. This debate is not new and will likely not be settled anytime soon. Governments are stubborn, and the economics are certainly not clear. The only certainty is that the debate over which system of exhaustion is best is a tired one, and some attempt of harmonization is necessary to put it to rest.