RECENT DEVELOPMENTS IN THE AREA OF GREY MARKETING: TOUGHER TIMES FOR LICENSEES AFTER SMITH & NEPHEW

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In what it called a classic case of grey marketing, the Federal Court of Appeal has recently decided in *Smith & Nephew Inc.* v. *Glen Oak Inc. and al.*[1] that goods which originate in the stream of commerce with the owner of a trade-mark are not infringing goods simply because they may have arrived in a particular geographical market where the trade-mark owner does not wish them to be distributed. In reaching its decision, the Court of Appeal indicated that licensees acting as exclusive distributors in Canada could find no support in the isolated case of *Mattel Canada Inc.* v. *GTS Acquisitions and Nintendo of America Inc.*[2] which was, in the Court's view, wrongly decided back in 1989[3].

HISTORICAL OVERVIEW

Grey market goods are goods that are imported and distributed in Canada, against the wishes of a trade-mark or copyright owner, authorized importer or distributor, and that originate from a source having some relationship to the intellectual property right owner. They have been called "grey" because they were legitimately marketed and acquired abroad but doubts exist as to whether they can be imported in Canada without infringing a local trade mark or copyright. However, after the recent decision of the Federal Court of

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1 A-683-94, June 4, 1996, Hugessen, Desjardins and Linden, J.A.

2 (1989) 27 CPR (3d) 358

3 See Hugues G. Richard, *La propriété intellectuelle et ses récents développements*, The Canadian Institute May 10, 1990; wherein the errors of the *Mattel* case are denounced.

Appeal in *Smith & Nephew* the "grey" in grey goods seems to have faded somewhat in light of the unambiguous decision reached by the Court.

Historically, the problem raised by grey marketing is twofold: goods that attract grey marketers are those that can be purchased on the world market at prices substantially lower than the prices charged domestically by the intellectual property owner or his authorized distributors enjoying a quasi-monopoly. Lower prices being evidently more attractive to consumers, the grey marketers' business will thrive and the "legitimate" distributor can easily be driven to financial difficulty. From the perspective of consumers and free competition advocates, a grey market situation is to be encouraged.

However, from the intellectual property owner perspective, high local prices may be perfectly justified, for example, by higher overhead and costs, expensive after-sale service, the establishment of a large distribution network to cover the territory or compliance with local legislation and regulations. Once its network is well established, it is embarrassing and costly for the trade mark or copyright owner to compete with its own goods, possibly having different components and packaging and sold at a lower price. Therefore, from the perspective of international intellectual property owners, a grey market situation is far-off from one to be encouraged.

Grey marketing is sometimes referred to as "parallel distribution" or "parallel import". Trying to prevent, by whatever legal means, grey marketing causes problems and will most assuredly cause problems in the future, in light of the Court's decision in *Smith & Nephew*.

I.P. RIGHTS AS A TOOL TO DEFEAT GREY MARKETING

In the past, trade marks have been used to stop grey marketing scenarios and prevent the flow of goods bearing the trade marks even if such goods were genuine, provided that appropriate legal protection (flowing from a combination of the law and the facts) existed.

In the 1960's, when grey marketing was not as popular as it is today, it was believed that ownership of a trade mark by a Canadian operation would, in all cases, be sufficient to prevent grey marketing. In the simplest cases, a trade mark owner would be able to defeat grey marketing of its products by bringing an infringement action. Under Section 19 of the *Trade-Marks Act*[1], the owner of a valid Canadian trade mark registration has the exclusive right to use the trade mark, throughout Canada, in association with the wares for

[1] 1985 RSC, c. T-13

which the trade mark is registered, and this right is infringed by the unauthorized use of the trade mark.

This was the scenario in *Remington Rand Limited* v. *Transworld Metal Company Limited*[1], where an interlocutory injunction was granted to the plaintiff on the above principle to prevent the parallel importation in Canada of electric shavers from the United States. In that case, the trade marks were owned by the plaintiff, a Canadian company. The validity of the registrations was not contested and the wares were not originating from the plaintiff but from a common manufacturing source in the United States. Commenting on the balance of convenience, the Court found that a purchaser could be deceived if, buying a U.S. shaver, he later found that the shaver was not sold and not warranted by the plaintiff.

In a case where the facts were similar, *Wilkinson Sword (Canada) Limited* v. *Juda*[2], an injunction was refused, the trade mark registrations in issue having been found invalid for lack of distinctiveness by the Court. The WILKINSON marks had been used in Canada for over 40 years by a United Kingdom company and later assigned to its Canadian subsidiary, in 1965, prior to bringing an action against a parallel importer. The Court found that the trade marks, when the action was brought, signified to the Canadian purchasing public what they had always signified, notwithstanding the transfer to the Canadian subsidiary.

The same conclusion prevailed in *Brecks Sporting Goods Co. Ltd.* v. *Magder*[3]. The Supreme Court of Canada, confirming the Federal Court of Appeal, found that the registration for the trade mark "MEPPS", owned by the Canadian distributor of the goods following successive assignments of the mark, to be invalid for lack of distinctiveness, the mark still being associated by the public to the manufacturer of the wares, its original owner.

In all these cases, the mark was owned by the Canadian company dealing with the products on an exclusive basis and in all cases where the validity of the registration was put in issue, it was declared invalid or the validity was placed in doubt. In all cases the Court found that the mark was still associated by the public in Canada, with the manufacturer of the goods abroad, the original owner of the mark.

As one can see, life was being made difficult by Canadian Courts for exclusive contractual distributors, even when they owned a trade mark

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1 [1959-60] 19 Fox PC 204

2 [1968] 2 ExCR 137

3 [1976] 1 SCR 527

registration. Normally, exclusive distributors have no trade mark interest in the product they distribute. The financial and administrative commitment of these distributors is however substantial since they have the obligation to maintain a trained sales staff, produce promotional materials and others, expenses unknown to grey marketers. Exclusive distributors are vulnerable to parallel importers who benefit from their advertising and promotion expenses.

THE SEIKO CASE

Owning a trade mark registration being insufficient, other original ways had to be found to protect local markets. An attempt was made by an authorized distributor to rely upon the law of passing-off to prevent grey marketing, when the facts showed that the public could be deceived into thinking it was getting goods provided by an authorized distributor with all the benefits attached to these goods when in fact it was not. This was the era of the "extended passing-off action".

In 1984, in the SEIKO case, the Supreme Court of Canada limited the right of action of authorized distributors against grey marketers. Firstly, the Court supported the policy of freedom of competition and held that attempts to restrict grey marketing would be influenced by the doctrine of exhaustion or, in other words, the right to resell goods legally acquired on the world market.

Seiko Time Canada Ltd. was the exclusive distributor of SEIKO watches in Canada and was neither the registered owner or a registered user of the trade mark SEIKO. The watches were manufactured by K. Hattori & Company Limited in Japan, the registered owner of the trade mark. The product was marketed around the world through a distribution system consisting of authorized distributors and their authorized dealers. By contractual arrangements, Seiko Time Canada was an authorized distributor and was entitled to choose authorized dealers who would sell SEIKO watches in Canada, provide the service and respect the manufacturer's warranty. The defendant, Consumers Distributing Co. Ltd., was not an authorized dealer of SEIKO watches.

The products sold by the two companies were physically identical. The only difference was that the guarantee booklet accompanying the watches sold by Consumers Distributing was intended for the United States and stated that the guarantee would be valid only if properly filled by an authorized dealer. The plaintiff was asking for a permanent injunction enjoining the defendant from advertising or selling SEIKO watches in Canada or, alternatively, a permanent injunction restraining the defendant from holding itself out as an authorized SEIKO dealer of the plaintiff by advertising and selling SEIKO watches as internationally guaranteed, and damages.

Mr. Justice Holland of the Ontario Supreme Court found[1] that the SEIKO product comprised the watch itself boxed with an instructional booklet, the point of sale service, the warranty properly filled out by an authorized dealer, and the after sale service. The watches sold by Consumers Distributing were announced and sold as SEIKO products. The defendant was misleading the public since it offered only one of the four elements of the "product".

He also found that the Common Law action of "passing-off" applied to the present case for a number of reasons. There is a misrepresentation to the public, made by a trader in the course of trade, to prospective customers, which is calculated to injure the business or goodwill of another trade, and which causes actual damages to the business or goodwill of the trader by whom the action is brought. The judge granted, *inter alia*, an injunction permanently enjoining the defendant from advertising and selling SEIKO watches in Canada and awarded $5,000 for damages suffered by the plaintiff.

Consumers Distributing appealed the injunction described above[2]. The appeal was dismissed for the reasons given by the trial judge and particularly because of the fact that the product marketed by the plaintiff was not simply a watch alone.

In the Supreme Court[3], Mr. Justice Estey, for the Court, found that the conduct of the defendant did not amount to "passing-off", as the concept is known in Canada, for many reasons:

(a) First, elements such as the point of sale service and the after sale service which were offered by Seiko Time Canada for its authorized dealers only cannot be included in the definition of the "product". The defendant was selling precisely the same watch, coming from the same source, as the plaintiff.

(b) Restraining grey marketing of "legitimate" products could be perceived to be a restriction to the right of free competition in the marketplace and would have the following consequences:

- The public would be deprived of the right to purchase SEIKO watches on the alternative basis that the watch would be unsupported by the manufacturer's warranty;

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[1](1980) 50 CPR (2d) 147

[2](1981) 60 CPR (2d) 222

[3](1984) 1 CPR (3d) 1

- A monopoly would be established similar to that established by a validly issued patent except that the monopoly would be for an unlimited period of time.

(c) Attempts to restrict grey marketing by asserting trade mark rights must be influenced by the doctrine of exhaustion. Once "legitimate" goods are sold into the marketplace anywhere in the world, there can be no further restriction on their physical transfer by the assertion of intellectual property rights that reside in the goods.

(d) There is a requirement in passing-off cases that there must be a misrepresentation or deceit of some kind to the public by reason of the sale of grey goods. In SEIKO, there was no such misrepresentation or deceit once the defendant was ordered to warrant the public by way of notices posted at point-of-purchase locations that Consumers Distributing was not an authorized dealer and that the watches it sold were not internationally guaranteed by Seiko Time Canada.

(e) The extended definition of the "passing-off" action was not applicable because the watches sold by Consumers Distributing were not falsely described; both Seiko Time Canada and Consumers Distributing gave retail buyers a form of guarantee and, in each case, the trade mark SEIKO distinguished the product from all others.

The appeal was allowed and the injunction permanently enjoining Consumers Distributing from advertising or selling SEIKO watches in Canada was ordered to be deleted from the judgement issued at trial. However, the Court noted that nothing was advanced by Seiko Time Canada with reference to any rights flowing by way of a registered trade mark in the name of the owner K. Hattori & Company Limited, or rights flowing from an appointment as registered user of said mark.

The Supreme Court of Canada did not rule out, in every case, the possibility of success of a passing-off action to prevent grey marketing. Any misrepresentation by grey marketers could still be enjoined.

A CLASSICAL SCENARIO TO DEFEAT GREY MARKETING

More recently, a decision by the Trial Division of the Federal Court of Canada in *H.G. Heinz Company of Canada Ltd.* v. *Edan Foods Sales Inc.*[1] confirmed that the only solution to prevent grey marketing of legitimate goods lies in the

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[1] (1991) 35 CPR (3d) 213

early establishment of a separate and independent Canadian operation exclusively dealing in the products within the territory and understood as such by the consumers, to protect the distinctiveness of the trade mark. In such circumstances, the Canadian operation preferably from the start or as early as possible when the world market justifies it, becomes owner of the registered trade mark, by filing an application or through assignment of the mark together with the goodwill. As seen from above, exclusive distributorship will always create problems when direct intervention is needed to prevent grey marketing of goods, legally marked abroad with the registered owner's trade mark.

The rights of the registered owner of a trade-mark should be recognized when some degree of business independence from the control of a foreign parent can be shown and that a "Canadian" goodwill in the trade mark exists in fact. The absence of distinctiveness of the trade mark can always be raised and may be easy to show if the trade mark was recently assigned, for the purpose of litigation, specifically to protect the territory from grey marketing.

THE SMITH & NEPHEW CASE

In its recent decision in *Smith & Nephew*, the Federal Court of Appeal refused to comment on the above scenario to defeat grey marketing, noting that such cases as *Remington Rand* and *H.G. Heinz Company of Canada Ltd.* turned on the fact that the Canadian subsidiaries of the multi-nationals concerned were the registered owners in Canada of the trade marks in question; the Court indicated that the question as to whether a Canadian subsidiary of a multi-national can sufficiently distance itself from its parent so as to assert rights in a Canadian trade mark owned by the subsidiary against persons importing similarly marked goods originating with a parent offshore is a difficult one which need not be answered under the circumstances. In its *obiter*, the Court raised doubts as to whether the accepted scenario described above to defeat grey marketing is indeed acceptable.

The facts in *Smith & Nephew* were far simpler and allowed the Court to adopt an unequivocal solution to the parties' grey marketing dispute: appellants Glen Oak Inc. ("Glen Oak") and Dylex Limited ("Dylex") were respectively the importer/distributor and the retailer of certain products, namely a facial cream and facial soap bearing the well-known trade mark NIVEA. That trade mark was and is still the subject of several registrations in Canada which are owned by the German company Beiersdorf AG ("Beiersdorf"). The respondent and plaintiff Smith & Nephew Inc. ("Smith & Nephew") was the registered user and, since the coming into force of new Section 50 of the *Trade-Marks Act* on June 19, 1993, a licensee of those trade-marks. The facial cream imported and distributed by Glen Oak and retailed by Dylex bearing the trade mark

NIVEA was manufactured and put on the market by a Mexican affiliate or subsidiary of Beiersdorf. The packaging and labelling produced by the Mexican affiliate indicated that NIVEA was a "marca registrada" and that the goods originated with Beiersdorf. The label also indicated that one of the ingredients was "sol. formaldehido y acido citrico" and advised that the product was manufactured by "Smith + Nephew" and some by Beiersdorf U.K. Ltd.; mention was also made that the trade mark NIVEA was owned by Beiersdorf AG. On the other hand, the goods which were marketed in Canada by Smith & Nephew Inc., Canadian licensee of the various NIVEA trade marks, were imported by it from the United States where they were manufactured by Beiersdorf Inc. a wholly owned subsidiary of Beiersdorf. The facial cream imported from the United States did not contain any formaldehyde. In light of the Court's decision, it is important to note that differences existed in source and composition of both parties' NIVEA products.

Before the Trial Division of the Federal Court, a motion judge had granted Smith & Nephew's application for an interlocutory injunction enjoining Glen Oak and Dylex from selling and distributing products bearing the NIVEA trade marks. On appeal, Glen Oak and Dylex took issue with all branches of the three part test for interlocutory injunctions (a serious case; irreparable harm; balance of convenience). Essentially, the Court's attention was drawn to the first part of the test: Does Smith & Nephew have a serious case? Can a plaintiff as licensee of a registered Canadian trade mark assert any rights against persons importing, distributing and selling goods bearing those same trade marks which the owner thereof has put into the stream of commerce?

At the outset, the Court made it clear that Smith & Nephew as plaintiff in the Trial Division could not assert any rights other than such as may flow to it from the *Trade-Marks Act* and its status as licensee of the registered NIVEA marks. Therefore, it could not bring a purely Common Law action for passing-off in the Federal Court. As a licensee of the NIVEA trade marks, Smith & Nephew's rights were governed by Section 50 (as it now reads since June 9, 1993) of the *Trade-Marks Act*. From a reading of subsection 50(3), the Court indicated that Smith & Nephew, as a licensee of Beiersdorf, could assert no higher rights flowing from the latter's registered trade marks than could its licensor. After reviewing U.K. jurisprudence, the Court noted that Smith & Nephew as a Canadian licensee and importer of goods bearing Beiersdorf's trade marks could not complain of the sale in Canada of other goods which were also manufactured by or under license from Beiersdorf and exhibited the same trade marks; there could be no deception as to the origin of the goods, which were exactly what they purported to be, that is NIVEA facial cream and soap whose quality and character was controlled by Beiersdorf. In the Court's opinion, it was manifest that Smith & Nephew could not assert rights as licensee against goods which, directly or indirectly, originated from its licensor. If Smith & Nephew had any complaints to make, it should have taken the issue up directly with Beiersdorf itself.

Having reached this unambiguous conclusion, the Court discussed Smith & Nephew's arguments that it could assert rights to a statutory action in passing-off under Section 7 of the *Trade-Marks Act* and more particularly under paragraphs 7(b) and 7(e). Dismissing paragraph 7(e) for obvious constitutional reasons, the Court noted that paragraph 7(b) was of little assistance to *Smith & Nephew* in the circumstances of its case: no doubt that Glen Oak and Dylex were directing attention to the wares they sold in a way which might cause confusion with the wares sold by Smith & Nephew; however, in both cases, the wares in question were not those of Glen Oak and Dylex or Smith & Nephew, but rather those of Beiersdorf who is the owner of the trade mark and the goodwill associated with it; therefore, the statutory passing-off action like its Common Law counterpart could only be brought by it as the owner of such goodwill. The Court therefore allowed the appeal and dismissed Smith & Nephew's application for an interlocutory injunction.

The Court's decision is unequivocal and even goes a bit further than the Supreme Court of Canada's decision in SEIKO. One recalls that Mr. Justice Estey in SEIKO specifically noted and left open the question of the possible impact of a registered trade mark and the result on a passing-off action: "I do not want to leave this subject, dealing as it does with the marketing of manufactured goods identified by a registered trade mark, without stating that nothing was advanced herein by the respondent with reference to any rights flowing to it by way of a trade mark registered in the name of Hattori under the *Trade-Marks Act* of Canada. Indeed, Hattori would be a requisite plaintiff if any such claim were made. Perhaps the respondent, if it held an appointment as a registered user of the registered trade mark, registered under the *Trade-Marks Act* of Canada, would have the requisite status". The Court in *Smith & Nephew* indicating that these comments by Mr. Justice Estey were not to been seen as opening the door to some kind of extended statutory passing-off action; rather, he was simply drawing attention to the fact that the case before him was not concerned with the specific statutory rights which registration of a trade mark vests in the owner or registered user thereof.

CONCLUSION

After *Smith & Nephew*, the legal uncertainty created by grey marketing has diminished somewhat. The Court's decision is a confirmation that Canada is a country where free competition is the rule and monopoly the exception: when goods distributed are legitimate, whatever their source in a trade mark owner's various affiliates, licensees or exclusive distributors of products in

Canada ought to take up the issue of grey market goods with the trade mark owner abroad in order to "secure leaks" rather than applying for injunctions before the Federal Court of Canada. After *Smith & Nephew*, the writing on the wall for licensees and exclusive distributors in Canada is as clear as ... black and white.

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