



Decoding products

– where IP rights clash with competition rules

Cases involving decoding – where retailers alter or remove the identifying marks placed on goods by rights holders – sit at the intersection of IP and competition law and need careful analysis, depending on both the sector and jurisdiction involved

Decoding cases are one of the best examples of the interrelation between IP rights and competition rules, requiring an in-depth analysis of IP protection and free trade with – in most cases – rights holders on one side and parallel importers on the other.

These are nearly always complex situations. The sector to which the products at issue belong is also significant, as in some instances different regulatory requirements apply. In addition, different jurisdictions adopt different approaches, varying from a pro-IP rights stance to a pro-competition one, which will also affect how such issues are interpreted.

This article identifies the main issues to deal with when evaluating decoding cases and examines landmark decisions from the United States, the European Union and Turkey to provide useful insights into this niche practice for both rights holders and trademark practitioners.

Decoding – what it is and how it affects imports

Under the exhaustion principle, once a product that is subject to trademark protection is placed on the market by the rights holder or with its consent, the exclusive rights conferred by the trademark are deemed to be

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exhausted within that particular market. Third parties are entitled to import and market the trademarked genuine products freely without interference from the rights holder. The exhaustion principle is therefore generally considered in connection with parallel trade and vice versa.

The exception to this principle is where genuine products are altered or impaired, so that they can no longer be regarded as the exact products placed on the market by the rights holder. Where this happens, the rights holder is in principle entitled to exercise its trademark rights to prevent the import or marketing of the genuine goods. It is therefore crucial to determine what constitutes alteration or impairment.

Decoding genuine products is a form of alteration or impairment. Rights holders often put identifying marks or numbers on their goods and packaging so that they can keep track of their products within distribution channels, including what products are sold where and via which retailers.

The codes are therefore effective tools for quality and anti-counterfeiting control systems. In some sectors – such as electronics and automobiles – rights holders use this system as the basis for an efficient guarantee system for consumers. In other sectors, such as food and

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beverages, coding is a legal obligation for product safety and recall purposes.

However, tracking is criticised by some as it provides the rights holder with a means of monitoring those that deal in its products, especially in relation to parallel imports. In such instances decoding becomes an effective tool for dealers to maintain their anonymity. In practice, dealers decode products before selling them to parallel importers in order not to be identified by the rights holder as the source of the products. This can be prompted by a wish to conceal a breach of contract or simply to avoid a commercial dispute – while the former implies an unfair commercial act by the dealer, the latter suggests uncompetitive oppression by the rights holder.

Decoding cases thus often require a balancing act between IP rights and competition rules, where regulatory issues also arise.

The way that the codes are applied and removed is also significant. Decoding may alter or damage the product and its packaging in different ways, where the impact can easily be detected by everyone or can be noticed only upon careful examination, or in a way that cannot even be visibly observed. In some cases, codes may be placed on or under other elements of the packaging (eg, the label) which may be independently protected by an IP right. Accordingly, questions arise as to whether such situations must be treated differently from a trademark law perspective, sometimes prompting a review of the essential functions of a trademark.

If the question is whether the decoding of genuine products constitutes trademark infringement, the answer may thus not always be yes. Different jurisdictions may have different approaches, varying from a pro-IP rights stance to a pro-competition one. Therefore, rights holders must carefully examine the specifics of the dispute when enforcing their rights against decoded parallel imports.

European Union: *Loendersloot v Ballantine's*

In the EU context, while the exceptions to the exhaustion principle remain the alteration or impairment of the genuine product, with regard to parallel trade cases the principle of free movement of goods also comes into question.

In the landmark decoding case of *Loendersloot v Ballantine's*, Loendersloot was engaged in the parallel trade of genuine Ballantine's branded whisky products. In doing so, Loendersloot removed the original labels from the bottles, deleted the identification numbers underneath and then reaffixed the original labels bearing Ballantine's trademarks or replaced them with copies. The case thus concerned the reaffixing of trademarked elements, re-labelling and decoding all at the same time.

In the landmark decoding case *Loendersloot v Ballantine's*, the question remained as to how non-regulated products or luxury goods subject to selective distribution should be handled

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Ballantine's sued Loendersloot for trademark infringement. Loendersloot argued that the alterations to the product were necessary in order to enter particular markets through lawful parallel trade.

After referring to its settled law on pharmaceutical repackaging cases, the European Court of Justice (ECJ) held that:

the owner of trade mark rights may rely on those rights to prevent a third party from removing and then reaffixing or replacing labels bearing the trade mark, unless:

- *it is established that the use of the trade mark rights by the owner to oppose the marketing of the relabelled products under that trade mark would contribute to the artificial partitioning of the markets between Member States*
- *it is shown that the repackaging cannot affect the original condition of the product, and*
- *the presentation of the relabelled product is not such as to be liable to damage the reputation of the trade mark and its owner.*

The genuine condition of the product was not an issue in this case. On the other hand, the ECJ suggested that the national court determine whether it was really necessary for Loendersloot to amend or replace the labels in order to be able to enter the market, implying that such a necessity would justify the alterations. The court also suggested inquiring as to whether the alterations made were likely to damage Ballantine's reputation as a luxury brand.

The ECJ eventually held that such coding is a regulatory requirement of EU law and that rights holders are obliged to keep track of foodstuffs in order to combat counterfeiting and enable products to be recalled if necessary.

The ECJ stated that: "in those circumstances, where identification numbers have been applied – for purposes such as those mentioned in the preceding paragraph – the fact that an owner of trade mark rights makes use of those rights to prevent a third party from removing and then reaffixing or replacing labels bearing his trade mark in order to eliminate those numbers does not contribute to artificial partitioning of the markets between Member States. In such situations there is no reason to limit the rights which the trade mark owner may rely on under Article 36 of the Treaty."

The court concluded by stating that if the rights holder also uses the codes to combat parallel imports in addition to this legitimate purpose, the parallel importer should seek protection under competition law.

Even though this decision is quite precise for decoding cases where the coding is the result of a regulatory requirement, the question remains as to how non-regulated products or luxury goods subject to selective distribution should be handled. US cases address this issue to some extent.



United States: *Mont Blanc* and *Davidoff*

Under the first sale doctrine, US trademark protection is exhausted after the rights holder's first authorised sale of the individual product. However, the rights holder can still exercise IP rights over genuine goods that are materially different from those which it places on the market. 'Material difference' is defined broadly as encompassing "any difference between the registrant's product and the allegedly infringing – gray – goods that consumers would likely consider to be relevant when purchasing a product".

The landmark *Mont Blanc* and *Davidoff* cases demonstrate that US courts take a pro-IP rights approach, with a wider interpretation of the functions of a trademark – including the guarantee and advertising functions.

In *Mont Blanc*, high-quality pen products were subjected to exclusive and selective distribution in the United States by the rights holder. The goods were intended to be sold through authorised dealers under certain quality retail requirements.

The US court held that decoding these products prevented the rights holder from conducting its intended quality control and thus damaged its goodwill in the mark. The mere fact that the goods were materially different from those placed on the market by the rights holder gave rise to a presumed likelihood of confusion on behalf of consumers.

However, on the question of what constitutes 'material difference', the US courts have emphasised the need to keep the threshold low. While physical alteration qualifies as material damage, it cannot be limited to the physical appearance of the product or its packaging – it can also relate to the rights holder's requirement to provide quality control over its products. Accordingly, even if the alterations are not easily discernable – as is the case in some decoding cases – they may still qualify as a material difference because they interfere with the guarantee and advertising function.

In *Davidoff* the material difference was indeed

The *Mont Blanc* case demonstrates that the US courts take a pro-IP rights approach with a wider interpretation of the functions of a trademark, including the guarantee and advertising functions

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physical. The retailer removed the batch codes from the *Davidoff* perfume bottles by etching the glass where the decoding left small marks. The court held that such an alteration could be seen by consumers, who were likely to be confused as they might believe that the product had been harmed or tampered with. Confirming that a vendor was selling not only the product inside the bottle, but also the "commercial magnetism" of the trademark affixed to the bottle, the court held that the bottle's appearance was material to the consumer's decision to purchase it.

Accordingly, the material difference and the damage to the reputation of the mark were clear, as the bottles played an important role in consumers' purchasing decisions.

The court hinted in its decision that even if the removal of the batch code did not visibly alter the product's packaging, it would still qualify as a material difference, as a result of the interference with *Davidoff*'s quality control system. The court accepted that, in principle, the lack of quality control could give rise to a material difference from the rights holder's product and create a likelihood of confusion. However, there was no need to enter into such a discussion in this particular case, as the physical alteration could be observed by consumers.

Compared to the EU system, the US system can be said to place stronger emphasis on the likelihood of consumer confusion when evaluating the material damage giving rise to trademark infringement, which can be physical or even immaterial. Quality control is to be regarded as inherent in a trademark, at least for luxury goods, which can be subjected to a material difference even without a mark.

The rights holder's quality control systems are to be protected not only because they are dictated by regulatory provisions, but also because they serve the purpose of maintaining the mark's quality and reputation.

Turkey: decoded whisky bottles

Turkey has adopted the national exhaustion rule: once the rights holder puts a genuine product on the Turkish market, it can then exercise its trademark rights only where the genuine product has been altered or impaired.

Bordering both EU and Middle Eastern countries and serving as a gateway between East and West, Turkey is a key market for nearly all global brands. It accommodates large volumes of parallel imports and grey-market activities. However, the number of cases in which parallel imports are evaluated in relation to trademark protection does not reflect this dynamic environment.

Although Turkish practice is pro-free trade and protective of parallel imports on general issues, the overall tendency has been to favour rights holders whenever IP protection and regulatory issues are concerned.

In its landmark decision in *Lancome*, rendered in the late 1990s, the Court of Appeal held that both the rights holder and the licensee could exercise their rights against the genuine parallel imported goods

not only if these were altered or impaired, but even if they were imported in a way that involved a customs violation. In *Refectocil*, the court dismissed the trademark infringement claims as the goods were not altered or impaired.

However, it upheld the unfair competition claim, as the parallel imported genuine goods did not fulfil the regulatory requirements with regard to labelling and instructions of use, and the defendant had been able to sell the goods at a much cheaper price as a result of these savings.

Returning to decoding cases, one of the most straightforward reviews of the issue was the Court of Appeal's decision in *Loctite*. The case concerned genuine glue products imported from India where the labels showed some visible marks and erasures. The court found that this amounted to explicit alteration and impairment of the products, which served as an exception to the exhaustion rule. The court held that this constituted trademark infringement and unfair competition and ordered the deletion of the genuine mark from the goods or – if this was not possible – their destruction.

The *Southern Comfort* decision is an example of the early practice of Turkish courts in decoding cases. The court was clear that the decoding itself gave rise to trademark infringement, without entering into a discussion as to whether it altered or damaged the bottle to an extent visible to the consumer. However, it did spend a significant amount of time determining the parallel importer's liability. There was much discussion as to whether the parallel importer could be held liable for the infringement, as it had not altered or damaged the products itself – the decoding took place without its knowledge and it was not even aware of this situation until the plaintiff confiscated its products at Customs.

The court eventually declared that, irrespective of whether it was aware of the decoding, the parallel importer was still responsible for the infringement. While this finding was specific to this case, the decision is still significant as it implies that the decoding of alcoholic beverage bottles will be regarded as impairment because it interferes with the rights holder's quality control over its products. This decision therefore can be said to be representative of the US approach.

The court took a similar approach in a more recent case involving the decoding of genuine whisky bottles that were parallel imported into Turkey – in this case the decoding left visible marks on the bottles. Based on a simple comparison between the original and the decoded products, the court granted a preliminary injunction in favour of the plaintiff, based on the *prima facie* trademark infringement created by the alteration. Accordingly, the court held that the decoded bottles should be removed from the market.

At subsequent stages of the main proceedings, the court reviewed all aspects of the dispute in further detail. To address the defendant's defence, the court went back to basics and questioned whether decoding itself can give rise to trademark infringement or whether it can be allowed for the sake of free trade. The court ascertained the reasoning behind the coding and considered

whether it could be regarded as an act by the rights holder to artificially partition the market, rather than to protect its brand and business, and whether such coding is a regulatory requirement.

As in the European Union, coding beverages is a regulatory requirement in Turkey for recall and anti-counterfeiting purpose, as well as for public health reasons. Breach of these regulatory requirements gives rise not only to administrative penalties, but also to unfair competition claims by competitors. As the court acknowledged this point, the competition law concerns appear to have been resolved in the proceedings, which are still pending.

If the overall direction that Turkish practice is taking is examined based on these cases, *Loctite* suggests that as long as decoding alters or impairs the product or the packaging to a point that is visible to consumers, the courts are likely to regard it as straightforward trademark infringement.



If the question is whether the decoding of genuine products constitutes trademark infringement, the answer may not always be yes

Southern Comfort takes this to the next level by implying that, irrespective of any marks, interfering with the rights holder's quality control over its products gives rise to infringement. Then comes the pending action on the decoded whisky bottles, where – even though the court rendered a preliminary injunction in favour of the rights holder – it went back to basics to verify such a pro-IP rights approach by considering whether such coding itself could in any way be regarded as hindering free trade. With the confirmation that decoding is not an option, but a requirement, it can be said that the tone is set. However, the final decision is eagerly awaited in the hope that it will shed more light on this hot topic in global IP practice.

Conclusion

If the practices in the above-mentioned legal systems were placed on a scale with IP protection at one end and competition rules at the other, the United States would be located somewhere towards the IP protection end, whereas Europe would be more towards the competition end; Turkey stands somewhere in between, with its precise position soon to be determined. **WTR**



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