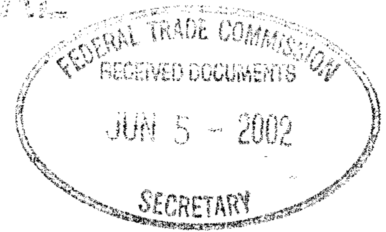

May 10, 2002

Donald S. Clark
Office of the Secretary
Federal Trade Commission
Room H-172
600 Pennsylvania Ave., NW
Washington, DC 20580

RE: Comments Regarding Competition & Intellectual Property Law and Policy in the Knowledge-Based Economy Public Hearings, Spring and Summer, 2002

Dear Secretary Clark:

The undersigned companies appreciate the opportunity to submit these comments to the Federal Trade Commission and to the United States Department of Justice Antitrust Division in connection with the hearings on "Competition and Intellectual Property Law and Policy in the Knowledge-Based Economy." The focus of our comments is narrow. We will address the problem of bad faith enforcement of intellectual property rights and the ability of parties who engage in this conduct to shield their actions from antitrust claims under the *Noerr-Pennington* doctrine.[1]

The signatories represent a broad array of wholesalers and retailers of consumer products who, from time to time, purchase and resell so-called diverted products. As wholesalers and retailers, we attempt to take lawful advantage of inconsistencies in the pricing policies of manufacturers. As discussed below, these pricing inconsistencies create opportunities for arbitrage. Through arbitrage, we are able to purchase genuine products at highly favorable prices. We can then pass the more favorable prices on to our customers.

Some manufacturers object to product diversion and use litigation and the threat of litigation to financially burden wholesalers and retailers who seek to participate in this free market process. One of the principal claims made by manufacturers seeking to thwart competition from product diversion is that the retailer or wholesaler selling the manufacturer's goods is infringing the manufacturer's trademarks and/or copyrights. Manufacturers have uniformly lost these cases. Nevertheless, the expense of litigating these claims does have a chilling effect on competition. We are concerned however, that the Supreme Court's decision in *Professional Real Estate Investors, Inc. v. Columbia Advertising, Inc.*, 508 U.S. 49 (1993) ("*PRE*"), which established an exceedingly high threshold for application of the "sham" exception to the *Noerr-Pennington* doctrine, may be interpreted in a manner that gives intellectual property owners free reign to file one baseless lawsuit after another. Accordingly, we believe that the *PRE* test for sham litigation should be limited to the facts of that case, i.e.,

[1] The *Noerr-Pennington* doctrine is based on the Supreme Court decisions in *Eastern R. Pres. Conf. v. Noerr Motor Freight, Inc.*, 365 U.S. 127 (1961) and *United Mine Workers of Am. v. Pennington*, 381 U.S. 657 (1965).

where the defendant files a single lawsuit challenged as a sham. However, where an intellectual property owner files a series of infringement actions as part of a pattern of harassment in order to chill competition, or where several intellectual property owners agree to file such claims, the *PRE* test for sham litigation should not apply. In these situations, courts should be free to inquire into the subjective intent of the person bringing the infringement action. As discussed below, this is precisely the position taken by the United States Courts of Appeal for the Second and Ninth Circuits.

The Federal Trade Commission has recently expressed concern about the misuse of the *Noerr-Pennington* doctrine to shield anticompetitive activity from the antitrust laws.[2] Unfortunately, the *PRE* decision provides opportunities for courts to indiscriminately apply the *Noerr-Pennington* doctrine to conduct that does not deserve First Amendment protection. We believe that, as a matter of policy, the Commission and the Antitrust Division should adopt a restricted view of *PRE*, and, whenever possible, the agencies should follow (and should urge courts to follow) the narrow construction of *PRE* adopted by the United States Courts of Appeal for the Second and Ninth Circuits.

I. The Signatories' Interest in Intellectual Property Issues.

A. The Practice of Product Diversion.

Virtually every consumer good sold in the United States is subject to product diversion, from automobiles to computers to corn flakes. Product diversion is simply a from of arbitrage that is normally made possible because a manufacturer has decided to price discriminate between customers located in different geographic regions or between customers who purchase at different times of the year. In the case of geographic diversion, manufacturers offer identical products at different prices in different regions of this country or in different regions of the world. When these pricing differences exist, a promotional wholesaler or a retailer will buy product from the region where prices are lower and sell it in a region where the manufacturer's prices are higher ("geographic arbitrage"). A second type of product diversion is sometimes referred to as "time diversion" or "forward buying." In this situation, purchasing opportunities exist when a manufacturer provides a promotion that is limited in time such as a seasonal promotion. In a forward buy diversion, products are acquired during the promotional period, or, in the case of seasonal merchandise, at the end of the season, and resold when the price returns to its usual level or in a region (or season) where the seasonal goods are in demand ("time arbitrage").

Product diversion can also occur when the manufacturer has created a closed distribution system in which "authorized" wholesalers and retailers are provided protected territories and are strongly "urged" to follow "suggested" resale prices. When the manufacturer attempts to derive excessive profits for itself and its authorized resellers through this closed system, opportunities arise to divert product into "unauthorized" wholesale and retail channels. This

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[2] *See, e.g.*, Memorandum of Law of *Amicus Curiae* the Federal Trade Commission in Opposition to Defendant's Motion to Dismiss filed on January 8, 2002 in *In re: Buspirone Patent Litigation*, MDL Docket No. 1410 (JGK) (S.D.N.Y.).

ultimately redounds to the benefit of consumers who have the opportunity to buy the manufacturer's product at lower prices by bypassing the manufacturer's closed distribution system. This type of closed distribution system is characteristic of the way in which so-called premium hair care products are sold, and no group has been more aggressive in using litigation to chill product diversion and the competition that it spawns than premium hair care manufacturers.

B. Opposition to Product Diversion.

Some manufacturers object to product diversion notwithstanding the fact that this practice results in more sales of their products. These manufacturers often will claim that product diversion encourages "free riding" or that product diversion creates health and safety issues or "customer confusion." The "free riding" arguments are vastly overblown. In reality, most consumer products require little, if any "point of sale" information or assistance. As discussed below, courts have consistently rejected "free rider" arguments used to buttress trademark infringement claims. Similarly, courts have rejected dubious "customer confusion" and health and safety arguments put forward by manufacturers to support trademark infringement claims.

We believe that those manufacturers who object to product diversion do so because the retail competition that arises as a result of product diversion adversely affects the manufacturer's profits. Product diversion can undermine a manufacturer's ability to enhance its profits by price discriminating between geographic regions Also, when an "authorized" retailer is faced with low price competition from a retailer who purchased the manufacturer's product from a product arbitrageur, the retailer may demand lower prices from the manufacturer.[3] For example, the Beauty and Barber Supply Institute, Inc ("BBSI") has devoted substantial sums to "stamp-out" product diversion because the BBSI members do not like the price competition caused by this practice. An article concerning recent efforts by BBSI and others to obtain federal legislation that would have made it illegal to remove or tamper with so-called "product identification codes"[4] stated, "There is much more than lofty ideals at stake - - like money. Estimates vary widely as to how much product diversion to the mass industry costs the professional (hair care) industry each year. However, it probably tops $100 million, according to estimates from the BBSI."[5]

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[3] In *John Paul Mitchell Systems v. Quality King Distributors, Inc.*, 106 F. Supp.2d 462, 475 (S.D.N.Y. 2000), the court aptly described the competitive effects caused by the diversion of premium hair care products. The plaintiff sold its hair care products only through designated hair salons. As a result of product diversion, the plaintiff's products became available to consumers at lower prices through other retail outlets. The court noted, "The salon owners stopped selling Paul Mitchell products only because the product appeared in retail outlets. They could no longer guarantee *a local monopoly* on sales of the product, and switched to products for which they would be one of the only sellers in a locality." Emphasis added. In reality, the more typical response of the manufacturer's designated retailers is to demand lower prices from the manufacturer so that they can compete with the "unapproved" retailers and continue to earn significant profits.

[4] The "product identification codes" that would have been protected under the legislation were not batch or lot codes that might be important in case of a product recall. Rather, they were product tracking codes that would permit the manufacturer to determine the origin of diverted products.

[5] September 10, 1999 article by Julie Naughton captioned "Bill Splits Hair Industry."

C. Misuse of Intellectual Property Rights by Manufacturers to Thwart Competition from Product Diversion.

One of the principal methods used by manufacturers to stop product diversion is to claim that a retailer's sale of a diverted product infringes the manufacturer's trademarks or copyrights, notwithstanding the fact that the product in question is being sold in the manufacturer's original package without any change whatsoever to the product or the package. Most courts have correctly concluded that these claims are precluded by the "first sale" or "exhaustion" doctrines and have summarily dismissed the claims. Nevertheless, manufacturers have continued to file these baseless trademark and copyright claims knowing that the burden of litigation will cause some retailers to stop purchasing merchandise from promotional wholesalers.[6]

For example, in *Matrix Essentials, Inc. v. Cosmetic Gallery, Inc.*, *supra*, Matrix, a manufacturer of premium hair care products, sued Cosmetic Gallery, an "unapproved" retailer, for, *inter alia*, trademark infringement under the Lanham Act, alleging that Cosmetic Gallery's resale of Matrix products that Cosmetic Gallery had obtained from a promotional wholesaler infringed Matrix's trademarks. The court noted, "It is well known in the industry that Matrix does not want its liquid products (defined by the court to include shampoos, conditioners, mousses, etc.) sold at retail by any seller other than a salon." *Id.* at 1240; parenthetical added. The court described Matrix's pricing policy as follows: "Matrix distributors generally mark up the product 40% when selling to salons. Matrix also recommends that salons mark up the product an additional 100%." *Id.* at 1241. The court noted that Matrix's aversion to diversion seems to be contrary to Matrix's economic interests,

> Plaintiff has argued that diversion causes financial loss to the company. There is a total absence of proof to support this factual proposition. It is fairly obvious that, at least in the short run, diversions increase the manufacturer's profit by exposing the product to potential buyers other than salon customers....
>
> Even if the court accepted as true the proposition that some salons would stop selling Matrix products if they were available in retail stores, or that such availability would reduce sales by salons that continued to stock Matrix goods, there is simply no basis for concluding that these lost sales would be greater than the increased revenue resulting from the availability of the product in ordinary retail outlets. *Id.* at 1242.

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[6] Manufacturers resort to litigation alleging trademark infringement, tortious interference and unfair competition claims to try to stop retailers from selling diverted product because they lack the ability to directly threaten the "unapproved" retailers by cutting off supply, the principal way that manufacturers stop their designated wholesalers and retailers from selling product to promotional wholesalers. *See, Matrix Essential, Inc. v. Cosmetic Gallery, Inc.*, 870 F. Supp. 1237, 1242 (D.N.J. 1994), *aff'd*, 85 F. 3d 612 (3rd Cir. 1996).

Matrix alleged that Cosmetic Gallery's sale of diverted Matrix products violated the Lanham Act because of the potential for "customer confusion." The court rejected this claim not only for Matrix product resold in unaltered Matrix containers, but also for Matrix products that were resold in a Matrix package or container had been altered in an insignificant manner.

Similarly, in *Matrix Essentials, Inc. v. Emporium Drug Mart*, 988 F.2d 587 (5th Cir. 1993), the court affirmed the grant of summary judgment in favor of the "unauthorized" retailer on the plaintiff's trademark infringement claim. The court rejected Matrix's trademark claim on the grounds that there was no possibility of customer confusion when the retailer sold the Matrix products in their original packages. Matrix argued that "the products sold by Emporium, without the potential for concurrent consultation or supervision by a licensed cosmetologist, were not 'genuine' products." *Id.* at 591. The court dismissed this variation of the "free rider" theory, noting that Matrix "does not require, monitor, or otherwise attempt to insure that consumers who purchase Matrix products in salons are assisted by a cosmetologist in selecting the proper Matrix product." *Id.* at 592. *See, also Graham Webb Int. Ltd. Partnership v. Emporium Drug Mart, Inc.*, 916 F. Supp. 909, 916 (E.D. Ark 1995) ["Recently, courts have become more skeptical of the need for professional consultation in the sale of goods ...." citing *Matrix Essentials*, 870 F. Supp. at 1253.]

The two Matrix cases discussed above are just two of a long line of losing cases brought by hair care products manufacturers seeking to thwart product diversion under the guise of protecting intellectual property rights. *See, e.g., Quality King Distributors v. L'Anza Research International, Inc.*, 523 U.S. 135 (1998); *Sebastian International v. Longs Drug Stores*, 53 F.3d 1073 (9th Cir. 1995), *cert. denied*, 516 U.S. 914 (1995); *Graham Webb Int. Ltd. Partnership v. Emporium Drug Mart, Inc., supra*; *Sebastian International, Inc. v. Consumer Contacts (PTY) Ltd.*, 847 F.2d 1093 (3rd Cir. 1988); *John Paul Mitchell v. Randalls Food Market*, 17 S.W.3d 721 (Tex. App. 2000).

II. The *Noerr-Pennington* Doctrine Should Not Shield Repetitive, Baseless Claims to Enforce Intellectual Property Rights from the Antitrust Laws.

The Supreme Court's decision in *PRE* created a two-part test for determining when litigation is a "sham" for purposes of overcoming *Noerr-Pennington* immunity:

> First, the lawsuit must be objectively baseless in the sense that no reasonable litigant could realistically expect success on the merits. If an objective litigant could conclude that the suit is reasonably calculated to elicit a favorable outcome, the suit is immunized under *Noerr*, and an antitrust claim premised on the sham exception must fail. Only if challenged litigation is objectively meritless may a court examine the litigant's subjective motivation. Under this second part of our definition of sham, the court should focus on whether the baseless lawsuit conceals "an attempt to interfere *directly* with the business relationships of a

involved only a single suit, whereas the plaintiff had alleged a concerted plan to bring numerous, baseless signal strength challenges.

Relying on the Ninth Circuit's decision in *USS-Posco Indus. v. Contra Costa County Bldg. and Constr. Trades Council, AFL-CIO,*[9] the Second Circuit held,

> In cases in which "the defendant is accused of bringing a whole series of legal proceedings," the test is not "retrospective" but "prospective": "Were the legal filings made, not out of a genuine interest in redressing grievances, but as part of a pattern or practice of successive filings undertaken essentially for purposes of harassment?" ... As the Ninth Circuit has noted, it is immaterial that some of the claims might, "as a matter of chance," have merit. The relevant issue is whether the legal challenges "are brought pursuant to a policy of starting legal proceedings without regard to the merits and for the purpose of injuring a market rival." (Citations omitted).

We believe that the Second Circuit and the Ninth Circuit have struck the correct balance between the First Amendment and the federal antitrust laws. Their approach will permit companies that are sued by persons wrongfully asserting intellectual property rights in an effort to thwart legitimate competition to bring counterclaims under the federal antitrust laws. Moreover, the interpretation of *PRE* adopted by the Second and Ninth Circuits will have the salutary effect of causing owners of intellectual property to think twice before instituting infringement claims if their real motives are to destroy competition. Therefore, we respectfully encourage the Federal Trade Commission and the Antitrust Division of the Justice Department to embrace the Second and Ninth Circuits' interpretation of *PRE* and to urge that interpretation by all courts.

Respectfully Submitted,

Victory Wholesale Grocers, a
Division of Brothers Trading Co., Inc.

David A. Kantor, President

Purity Wholesale Grocers, Inc.

Sal Ricciardi, President

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[9] 31 F.3d 800 (9th Cir. 1994).

Who We Are

Victory Wholesale Grocers (Victory) is a long-established, privately held, national wholesale distributor of grocery, health and beauty care, pharmaceutical, general merchandise and other consumer goods. Victory's customers are the nation's largest wholesale and retail grocery, drugstore and mass merchandise chains. They depend on Victory for a variety of quality products at competitive prices that help them win and hold customers. Their customers – America's consumers – benefit from these attractive food and personal care values.

Purity Wholesale Grocers, Inc. (PWG) was founded in 1982 as a privately held wholesale distributor of grocery products. PWG has grown into a nationally recognized and diversified company supplying the nation's wholesale and retail industries with grocery, general merchandise, candy, frozen foods, health and beauty care, private label, and pharmaceutical products. Through its corporate headquarters in Boca Raton, FL and distribution centers in New Jersey, Indiana, and California, consisting of over 850,000 square feet of warehouse space, PWG and its affiliated companies serve a broad array of customers by providing competitive prices, quality products and professional service.