23 Free Movement Rules and Competition Law: Regulating the Restriction on Parallel Importation of Trade Marked Goods

Research Fellow: Yuka Aoyagi

The purpose of this report is to clarify the relationship between the free movement rules and the competition laws in the laws of the EC Member States by mainly studying parallel imports cases related to intellectual property rights.

The Treaty establishing the European Community (or the EC Treaty) uses the Internal Market as the most important means for achieving its economic and social purposes. The free movement rules and the competition laws are a central core of rules to make the Internal Market function effectively. For the purpose of the text of the EC Treaty, both legal systems appear to have different objects of regulation, but overlapping application of such systems can be observed, depending upon the matter in question. This report studies the formulation of jurisprudence cases by the European Court of Justice (ECJ) from an early stage as a subject matter of cases of parallel imports of brand products. It studies the understanding of the ECJ behind the application of the free movement rules and the competition laws, and clarifies the relationship between and the function of such rules and laws in securing effective functioning of the Internal Market through the restriction of parallel imports.

I Introduction

The purpose of this paper is to study the function of legal systems of the free movement rules and the competition laws to the extent that such rules and laws are overlappingly applicable to parallel imports related to intellectual property rights.

The free movement rules are rules forming the foundation of the European Community (EC), one of the objects of which is the integration of the Internal Market. In the Internal Market, which is an area made up of EC Member States, tariff and non-tariff trade barriers of the EC Member States are in principle prohibited by such free movement rules. In other words, the EC Member States are prohibited from using systems impeding the free movement of goods, persons, capital and services between the EC Member States, as well as from imposing tariff barriers, thereby allowing the free movement of goods, persons, capital and services within the Internal Market to establish a single market.

As stated above, a basic rule of the Internal Market is the free movement principle. In addition, the EC has competition laws to complement this rule. In general, the purpose of the EC competition laws is to impose regulations on acts which restrict competition in the Internal Market; such competition laws are a rule to make the Internal Market function based on fair competition. The EC competition laws are the same as the US antitrust laws and the Japanese Antimonopoly Law in that they impose regulations on conducts by multiple businesses and unilateral conducts which restrict competition; however, they are also unique in that they put regulations on acts hindering the function of the Internal Market as a violation of such competition laws.

The rules on free movement and competition, despite having different initial purposes, are now used in the case of the EC to form the Internal Market; and from an early stage it has been pointed out that the competition laws together with the free movement rules will carry out a function to promote market integration. In Japan, however, it appears that no argument about the relationship between such free movement rules and competition laws has been made, although there have been several academic studies made which introduce and examine

the free movement rules and the competition laws respectively. In this paper, therefore, I will study how the systems function at specific stages, and clarify the relationships between such systems.

It is, however, difficult to carry out the above in all fields, and as such it is necessary to set limitations on the number of subjects when studying the relationship between the free movement rules and the competition laws. This is because both free movement rules and competition laws are applicable to a wide range of subjects: the free movement rules are applicable to four subjects, namely goods, persons, capital and services; while the competition laws apply to a wide variety of actions. In this paper, therefore, I will concentrate on the application of the free movement rules and the competition laws to restrictions on parallel imports of brand products to the Internal Market.

II Overview of Free Movement Rules and Competition Laws

Chapter II provides an overview of the free movement rules and competition laws applicable to the restricting acts of parallel imports of brand products. The EC has a broad range of economic and social policy objectives, and the Internal Market is signified as the principal means in the Treaty establishing the European Community (or the EC Treaty). The EC Treaty provides for the free movement rules and the competition laws to secure the actual function of the Internal Market deemed to be important as such.

1 Significance of Free Movement Rules and Competition Laws

The importance of the legal systems is understood as follows.

(In principle) the purpose of the free movement rules is to abolish trade barriers imposed at the level of Member States. As used in the definition of the Internal Market, the provisions of free movement to secure the free movement of goods, persons, services and capital by abolishing trade barriers in the Internal Market are considered to be indispensable to the formation of the Internal Market.

The function of the EC competition laws is deemed to ensure (i) fair competition and (ii) the integration of markets. Within the scope of this manuscript, the latter becomes particularly problematic. The intention of businesses to divide markets within the Internal Market through various methods (unilateral conducts or conducts by multiple businesses) (in many cases, a possible division of markets along borders) is nothing but the formation of effective barriers to free movement. For this reason, the competition laws put regulations on the division of markets by such businesses in certain cases.

As stated above, in promoting the integration of markets and securing the function of the Internal Market, the free movement rules and the competition laws, which are closely connected with each other, are signified as playing a pivotal role in EC Internal Market Laws.

2 Overview of Rules

The rules on free movement and on competition laid down in Article 81 of the Treaty Establishing the European Community (or EC Treaty) are similar in that both the rules on free movement and competition laws are composed of prohibiting provisions and provisions which provide exceptions. Concerning the provisions which provide exceptions, however, the free movement rules apply the objectives of the measures as justification for the provisions which provide exceptions, and such grounds for justification are limited; while the provisions, which provide exceptions, of the competition laws provided as exceptions on the grounds of a competition-promoting effect, assuming that the act in question satisfies certain requirements. Restrictions as seen in Article 30 of the EC Treaty are not imposed for the purposes of such acts.

However, there seem to be several differences according to the text of provisions and case laws.

For the purpose of the text of the EC Treaty, there is a difference in the addressees or objects of regulation between the free movement rules and the competition laws. The text sets forth that the objects of regulation are Member States for the free movement rules, but businesses as far as the competition laws are concerned.

There is also a difference in the scope of application between the free movement rules and the competition laws. In the application of the competition laws, there is the condition of threshold that if effect on the Internal Market does not satisfy certain criteria, the

competition laws shall not apply to businesses; while in the free movement rules, the application of *de minimis* rule is excluded.

III Regulations for Restriction on Parallel Imports under Free Movement Rules

Chapter III deals with the case laws regarding the application of the free movement rules to acts restricting parallel imports of trade mark products.

1 Free Movement Rules and Intellectual Property Rights

The relationship between Article 28, a provision concerning the free movement of goods, and intellectual property rights is discussed below. First of all, the quantitative restriction on free movement of goods and "measures of equivalent effects" (MEEs) are prohibited by Article 28. In accordance with Article 30, however, Article 28 may not be applied to the exercise of intellectual property rights by reason of "protection of industrial and commercial ownership." In other words, it may only be applied to the protection of intellectual property rights, to the extent of the proportionality principle, only within the scope of protection of the specific subject-matter of intellectual property rights. Furthermore, intellectual property rights are applicable under the community exhaustion theory. This theory is applicable if a product to which the intellectual property rights are applied is distributed (i) within the community and EEA region or (ii) by or under approval of the rightful owner.

Accordingly, if a trade mark product is distributed by or under the approval of the intellectual property right owner in another member state, including EEA member states, the owner cannot stop the parallel import of such products by exercising intellectual property rights.

2 Restrictions on Parallel Imports and Free Movement based on Trade Marks

The above is a summary of the community extinguishment theory and its inherent objectives with respect to the relationship between free movement rules and intellectual property rights. In this respect, precedents have been outlined below, in particular in respect of trade marks.

First of all, the inherent objective of the trade mark is to assure the trade mark owner of the exclusive right to use the trade mark in order to first distribute a product protected by the trade mark and accordingly to assure the protection of the owner against competitors who intend to take advantage of the status and reputation of the trade mark by selling goods for which the trade mark has been illegally used

Furthermore, the ECJ claims that the "essential function" must be considered in judging the trade mark's inherent objective. The "essential function" of trade marks approved by the ECJ in its past judgments corresponds to three functions primarily comprising the trade mark function theory, namely, (i) the origin function, (ii) the quality function, and (iii) the advertising function.

Based on the above understanding, we will discuss below the function of the free movement rules from the case laws regarding community extinguishment and the inherent objectives.

3 Review of Precedents

In this chapter, the exercise of trade mark rights against the parallel import of trade mark goods is discussed for each type of transaction in relation to Article 30. The free movement rules have been reviewed primarily from the viewpoint of four functions to promote free movement within the Internal Market, but the question remains as to whether any other matters requires consideration. After reviewing precedents aware of this issue, the following conclusions were reached.

(1) Function to Assure Free Movement

The first function of the free movement rule is to assure free movement. Precedents for the application of Articles 28 and 30 to trade mark rights reveal the following.

Articles 28 and 30 provide that the free movement rule cannot be applied to intellectual property rights. Exercise of trade mark rights against parallel imports under domestic laws, however, has the same effect as the separation of the Internal Market along the border. Accordingly, the ECJ created Dichotomy to divide intellectual property rights into "existence" and "exercise" to formulate the base of case laws that makes it possible to apply free movement rules to the exercise of intellectual

property rights. This shows that the ECJ has made strong demands to assure the free movement in respect of Article 28.

The precedent also states that non-application of Article 28 under Article 30 is subject to the fulfillment of certain requirements even if exercising trade mark rights against parallel imports of trade mark products. In other words, rights are to be extinguished if the trade mark product is distributed by or under approval of the trade mark owner.

Thus, by introducing the extinguishment theory, the ECJ allows only a limited "exercise" of rights under Article 30.

As mentioned above, it is understood that, for Articles 28 and 30, the ECJ emphasizes the role of free movement rules to assure free movement within the Internal Market in interpreting the restrictive exercise of intellectual property rights.

A series of repackaging judgments showed that the trade mark owner could justifiably exercise rights in certain cases. Subsequently, however, in the Bristol-Myers Squibb v Centrafarm case and the Merck v Paranova case, the court argued that the exercise of rights against repackaging by parallel importers was deemed to be an "artificial market division among member states" if necessary for "effective market access." In the case of relabeling, too, the "effective market access" theory was adopted.

Of note here is the fact that free movement rules look for the effectiveness of free movement (i.e. "market access"), rather than intending only to facilitate free movement. In other words, free movement rules characteristically aim not only for the free movement of original trade mark products, but also the sale of such products in a form suitable to distribution in the host country.

(2) Function to bring about a basis for competition

The ECJ has created the community extinguishment theory so that trade mark rights will be extinguished if the trade mark product is distributed by or under approval of the trade mark owner within the community. At the same time, however, the ECJ admits that trade mark rights may not be extinguished in certain cases. In other words, case laws has been formulated whereby trade mark rights are not extinguished in respect of certain objectives coming about as a result of the essential functions of the trade mark even after the trade mark product has been distributed. According to the precedent, all three primary functions applied in the theory (i.e. origin function, quality function and advertising function) are deemed as the "essential functions" of the trade mark and also as inherent objectives.

Even for the protection of "essential functions" (i.e. "inherent objectives"), however, trade mark rights are not always justifiably exercised without application of Article 28.

In the HAG II judgment, the ECJ revoked the "theory of common origin" because it considered that trade marks which describe certain qualities and origins of products to consumers are essential for the "undistorted system of competition" that the Treaty intends to establish and maintain. Accordingly, the ECJ is of the opinion that trade mark rights can be justifiably exercised in accordance with Article 30 to prohibit the trade mark product from being imported because even the same trade mark of "common origin" may impair the origin function and quality function.

To achieve the "undistorted system of competition" that the Treaty intends to establish and maintain, it can be seen that the ECJ has narrowed the scope of application of free movement rules. Conversely, the HAG II judgment shows that the assurance of a competitive market base, that is, an "undistorted system of competition" is taken into consideration in interpreting whether or not to apply free movement rules.

IV Rules Applying to Restrictions of Parallel Imports under Article 81 of the Competition Laws

Chapter IV has identified the various case laws according to type of activity for the application of the competition laws to activities restricting parallel imports of trade-marked products. The ECJ's interpretation is as follows.

The judgment of Consten & Grundig clarified that any agreement between businesses for restrictions on parallel imports of trade-marked products could be subject to the application of the competition laws.

In the application of the competition laws

the existence of restrictions on competition should be recognized in terms of "intention" or "effect." In this respect, trade mark rights seem to be taken into consideration to a certain extent in the precedents regarding actions to restrict parallel imports of trade-marked products. Handling would appear to differ according to the whether trade mark rights are independent or coexistent.

The judgment of Nungesser went one step further from the decision made in the judgment of Consten & Grundig. The judgment of Consten & Grundig held territorial restrictions by assignment of trade mark rights to be illegal. On the other hand, the judgment of Nungesser held open, exclusive licenses to be lawful. This decision by the ECJ is based on its interpretation of intellectual property rights that granting an exclusive license to a licensee should lead to decreased risk of entry by a business into a new market, thereby promoting licensing. Thus, it may be safe to argue that in the evaluation of the competition laws in the case of licensing of intellectual property rights, the ECJ takes the stance of permitting certain effects of restrictions on competition which may be accompanied with the use of intellectual property rights.

Despite this, the ECJ held the absolute, exclusive license to be illegal in the above judgment. In other words, to build a licensing relationship to restrict parallel imports is against the competition laws. So in the case of a (substantially) independent holder of rights, there is no regard to intellectual property rights when the entry by parallel imports into the market (namely, free movement of goods) is impaired.

A series of judgments for parallel existent holders of rights held the restrictions on parallel imports with the use of trade mark rights to be in principle not in violation of the competition laws. The judgment of Ideal Standard held that the dividing of markets based on such trade marks is naturally legal even in the case of voluntary assignment of rights.

Originally in accordance with Article 81 of the competition laws any action by a business shall be subjected to regulations if there is the "intention" or "effect" of restricted competition. However, in the case of the judgment of Ideal Standard the ECJ, while admitting there was an "effect" of dividing the market through the assignment of a trade mark, held that such effect alone was not illegal in itself.

On the other hand, the ECJ also decided in the above judgment that whether the competition laws are applicable should depend on a review of "the background of any assignment, the factors behind the assignment, the intention of the parties concerned and in consideration of the assignment."

In this respect, the same applies to the judgment of BAT following the above judgment. The judgment of BAT is a case referring to not geographical but habitat segregation of the product markets. The ECJ held any agreement for habitat segregation of the markets for trade-marked products to be lawful to the extent of mutual benefit of the parties if such agreement is made for the purpose of eliminating confusion or conflict of trade marks, provided, however, that this is subject to regulations by the competition laws if there is any intention of restricted competition.

Therefore, in the case of parallel existent holders of trade mark rights, the enforcement of the competition laws to secure free movement is different from that in an ordinary situation. "Effect" is not the only criterion for judgment, and "intention" for arrangements between businesses could be seen as a more important criterion. This makes the application more restrictive than in the case of licensing with non-parallel existent rights.

V Free Movement Rules and Functions of the Competition Laws under Restrictions of Parallel Imports: Review of the Theories

This chapter identifies and studies conflicting reviews of the relationship between the free movement rules and the competition laws.

For the purpose of the text of the EC Treaty, there is a difference in the addressees or objects of regulation between the free movement rules and the competition laws. The text sets forth that the objects of regulation are Member States for the free movement rules, but businesses as far as the competition laws are concerned. However, a case in which free movement rules were applied to the actions of businesses that were

restricted in their parallel imports of products vested with intellectual property rights triggered a conflict of theories as to the interpretation of the subject for regulations (the addressee) under both rules. What underlies this conflict is a difference in interpretation of the objectives of the free movement rules and the competition laws.

The theory of comprehensive application is a view made by Pescatore in order to cope with the invalidity of regulations concerning certain activities caused out of the scope of the addressee under the provisions of free movement rules and the competition laws. The theory of separate interpretation was initially proposed by Marenco to challenge this idea.

According to the theory of comprehensive application, for the purpose of the text of the Treaty, the free movement rules are intended for Member States and the competition laws are intended for businesses. In actual application, however, the free movement rules are applicable to businesses and the competition laws to Member States.

The theory of separate interpretation holds that free movement rules are intended for Member States and the competition laws for businesses in accordance with the provisions of the Treaty.

There are some differences in both the subjects of regulations and the interpretations of the objectives of the two legal systems. The theories of comprehensive application and separate interpretation share the viewpoint that both systems have the same objective of establishing free movement. Furthermore, the theory of comprehensive application is characterized by its interpretation that the free movement rules and the competition laws share the same ultimate objective, which affects any interpretation.

VI Conclusions

This chapter has reviewed in light of the theories the precedents concerning the cases on activities which restrict the parallel imports of trade-marked products to which free movement rules and the competition laws, which were examined in Chapters III and IV, have been applied and the following conclusions can be made.

There is no objection to the overlapping application of both free movement rules and the competition laws to the activities restricting parallel imports of trade-marked products in the EC.

However, there remains room for review of the objectives of regulations of the free movement rules and the competition laws. The conflict of theories is as follows. Concerning the objectives, the theory of comprehensive application interprets the objectives of free movement rules and the competition laws in an integrated way, while the theory of separate interpretation holds that the objectives of the regulations of the free movement rules and the competition laws overlap in terms of the promotion of market integration through established free movement, with the competition laws having other objectives of regulating competition-restricting activities.

How does the ECJ interpret these objectives? A series of judgments concerning the free movement rules indicates the ECJ's stance placing a high value on the function of establishing free movement. This was triggered by the Dichotomy of “existence” and “exercise” concerning intellectual property rights held by the judgment of Consten & Grundig. In other words, the case laws restricts the scope of justification on grounds of the protection of intellectual property rights whose deviation from Article 28 has been evidenced by Article 30. Due to a growing tendency to restrict the scope of such justification in subsequent judgments, the ECJ appeared to be of the opinion that it was necessary to establish free movement by applying free movement rules to the exercise of intellectual property rights more extensively.

On the other hand, the ECJ made it clear in the case laws that the justification under Article 28 should be recognized to some extent on grounds of the protection of intellectual property rights. Within the scope of this paper, justification under Article 30 should be recognized with some restrictions considering the original functions of trade marks to be a unique objective. In particular, the ECJ made the HAG II judgment bearing in mind the Internal Market based on the “undistorted competition system,” to which the source indication and quality assurance function of trade marks are indispensable. In this judgment, the ECJ does not adopt the free movement rules. This ECJ judgment may be based on the interpretation that trade marks create the market order in which

competition is organized. A similar judgment was made in the Ideal Standard case, with the ECJ introducing the concept of competition through its interpretation of the free movement rules. It holds that it should contribute to the creation of competition by not applying free movement rules in some cases. In other words, the ECJ can be seen as passive in requesting the establishing free movement and "undistorted competition system" in respect of the objectives and functions of free movement rules.

The ECJ's interpretation of competition and free movement as the objectives of regulations under the competition laws is evidenced by the case laws in addition to the fact that in the application of the competition laws the wording illustrates with examples the prohibition on market division, provided, however, that such application is limited to activities restricting competition.

Based on the organization of the case laws described above, the general interpretation by the ECJ of the objectives of regulations under the free movement rules and the competition laws concerning activities restricting parallel imports of trade-marked products can be seen as follows. The two legal systems have their respective primary objectives for regulations. Under the competition laws, any activities causing free movement to be disturbed by market division should be regulated for the primary purposes thereof. The primary objective of the free movement rules is to establish free movement. However, the concept of competitive order is incorporated into the interpretation of the provisions thereof so that the objective of regulations may be the establishment of substantial functions in the Internal Market in a wider sense. This interpretation by the ECJ could be described as closer to the objectives of regulations contained in the theory of comprehensive application.