

Parallel imports: Towards a flexible uniform international rule

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ABSTRACT Parallel imports are goods that are placed into a market in one country which subsequently are traded without the authorisation of the holder of intellectual property rights ('IPRs') belonging to those goods in another country. Whether a sale in one nation exhausts the rights of the IPR holder determines the legality of an 'unauthorised' resale. The 1996 Agreement on Trade-Related Aspects of Intellectual Property Rights ('TRIPS') provided substantive minimum IPRs and non-discriminatory treatment with an underlying goal that IPRs 'do not themselves become barriers to legitimate trade'. Art. 6 of TRIPS reflects the failure of the parties to TRIPS to resolve the question of exhaustion rights by declaring that TRIPS does not define an obligation on a nation to adopt a particular rule regarding exhaustion of IPRs. This paper articulates that economic analysis of parallel imports and their effects on incentives to innovate lead to the conclusion that certain policies regarding exhaustion rights are more efficient than others on the global scale. Further, a single, *rigid* uniform rule is, however, unlikely to lead to such a maximally efficient state and would be limited in its ability to address local needs such as specific healthcare exigencies. Therefore, this paper attempts to answer whether a uniform supranational rule regarding parallel imports is desirable, and if so, what such a rule should look like. The section 'Background principles of IPRs: exhaustion and first-sale' discusses the background principles of exhaustion rights and parallel imports. The section 'An economic perspective on exhaustion and parallel imports' examines economic perspectives towards parallel imports. The section 'IPRs and the need for flexibility in a uniform rule' examines the justifications for IPRs individually, that is qua patents or qua trade marks, and asserts that a uniform rule must allow flexibility in light of the differing justifications for IPRs. The section 'A framework for a flexible rule on exhaustion' suggests an exhaustion rule and framework. In light of recent economic analyses regarding the effect of parallel imports on incentives to innovate and economic efficiency, a *flexible* system of national exhaustion only (restrictive of parallel imports) between countries with high trade costs and a system of regional exhaustion among countries with low trade costs is proposed. A procedural framework whereby a country can make an individualised showing of need with respect to particular IPRs in particular goods, for example patent rights in pharmaceuticals, achieves flexibility. An international accord would ensure that deviations from an ideal rule are minimised (thereby limiting negative externalities) but allow local

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economies to make choices regarding critical local concerns. In particular, the resulting market segmentation would provide cost benefits and the flexibility in the rule would allow additional optimisation with respect to narrow, defined concerns. In summary, two main arguments are made: (1) national exhaustion of rights only (no international exhaustion) with provisions for regional exhaustion in the case of closely linked trading nations is the best uniform rule; and (2) consensus is more likely to be achieved if a uniform rule provides flexibility for countries to deviate at least temporarily from the uniform rule when local exigencies so require.

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INTRODUCTION

Parallel imports are products placed into the marketplace by the owner of a trade mark, copyright, or patent that are subsequently sold in another territory without the express consent or authority of the right-holder in the second market.¹ In the United States, parallel imports have raised difficult policy questions regarding access to low-cost pharmaceuticals that are imported from countries such as Canada at reduced cost relative to retail prices in the United States.² There is continued debate over whether parallel imports should be banned globally or whether exhaustion principles should continue to be within the purview of national policy.³

Generally, the solution regarding the question of parallel imports has been reduced to three possibilities:

1. A rule of international exhaustion of a particular IPR, which in some cases will depend on the relationship between the holder of the IPR and the party that placed the good on a foreign market. Whether or not the right is exhausted may depend on whether the party placing the good on market is...the IPR holder...[an affiliate]... or a manufacturing licensee[;]
2. International exhaustion as under (1) unless the original marketer has given sufficient notice that the goods are not licensed for import into the country in question[;]
3. No international exhaustion of a right.⁴

This paper argues that none of these possibilities *alone* is the correct solution. Rather, a treaty should define under what circumstances a country might adopt an exhaustion policy that deviates from an international norm generally prohibiting exhaustion rights with certain exceptions for regional markets such as those in the European Union ('EU'). In other words, certain local exigencies may require a country to have sufficient flexibility to adapt its exhaustion policy in order to meet pressing local needs such as healthcare. Such flexibility would be narrowly defined with respect to the type of intellectual property right (IPR), that is patents, copyrights, or trade marks, and also with respect to the class of goods, for example pharmaceuticals as opposed to clothing.

While advocating for a flexible rule, this paper will also argue that a rule generally prohibiting international exhaustion will increase the willingness of IPR holders to place goods into local markets because the risks of a grey-market are decreased. The resulting market segmentation will also result in lowered prices and increased global economic benefits. To the extent that market segmentation does not address local need, a flexible rule would allow *limited* parallel importation as a means for addressing price and demand issues. As such, this paper will discuss the arguments for and against harmonisation of exhaustion rights on a global

level with a focus on the individual justifications for IPRs qua trade marks, patents, and copyrights. Also, the need for flexibility in a uniform rule is discussed.

In summary, two main arguments are made: (1) a rule allowing *only* national exhaustion (and therefore prohibitive of parallel imports) with provisions for regional exhaustion in the case of closely linked trading nations is the best uniform rule; and (2) consensus is more likely to be achieved if a uniform rule provides flexibility for countries to deviate at least temporarily from the uniform rule when local exigencies so require. The next section discusses Trade-Related Aspects of Intellectual Property Rights (TRIPS), introducing it as an instructive model regarding the policy debate surrounding a uniform system of exhaustion rules.

The conundrum raised by TRIPS

When TRIPS was ratified in 1994, it was the culmination of attempts by multinational corporate producers and owners of products incorporating IPRs to provide basic national minimums and non-discriminatory treatment.⁵ The TRIPS accord was, however, unable to resolve the difficult question of parallel imports and instead stated that the proper substantive law regarding parallel imports remains an issue for local resolution.⁶ Art. 6 states:

For the purposes of dispute settlement under this Agreement, subject to the provisions of Articles 3 [National Treatment] and 4 [Most-Favoured-Nation Treatment] nothing in this Agreement shall be used to address the issue of the exhaustion of intellectual property rights.⁷

Since the TRIPS accord defined IPRs based largely on economic policy justifications, why was the proper treatment of parallel imports not merely a matter of determining whether maximum economic efficiency is reached under a system in which parallel imports are allowed to compete freely (under the doctrine

of international exhaustion of IP rights) or under a strict territorial application of IPRs in which parallel imports are considered infringing (national exhaustion)?⁸ Further, if restrictions on parallel imports are considered forms of non-tariff barriers (NTBs) to trade, are such restrictions not in blatant disregard to the stated policy objective of TRIPS to 'to reduce distortions and impediments to international trade...and to ensure that measures and procedures to enforce intellectual property rights do not themselves become barriers to legitimate trade[?]'⁹ Professor Chiappetta has argued that while TRIPS IPRs 'rest primarily (if not exclusively) on economic utility policy justifications', that 'maximizing the economic return under the distinct justifications for the various classes of IPRs (patents, copyrights, trade marks, and trade secrets) leads to conflicting outcomes on exhaustion'.¹⁰

This paper will present recent economic analyses that suggest a different conclusion and will also discuss how a flexible rule on exhaustion can address the occasional instances in which a rigid, uniform rule does not provide the optimal outcome. Further, while TRIPS does not use the term, a concordance on an exhaustion rule requires a discrete understanding of what is meant by one critical term: economic efficiency. As member countries debated the various provisions of TRIPS, it is likely that differing perspectives as to the components and determinants of such efficiency fomented disagreement. The next section discusses why.

A catalyst for disagreement: The determinants of economic efficiency

It would seem intuitive to consider economic efficiency as well defined because it is a term that economists, as applied mathematicians, use as a metric. Unfortunately, economic efficiency is a sufficiently vague enough concept to present a ripe basis for political disagreement when the term will define entitlements under the law. So what is meant by efficiency? Developed countries are likely

to argue that efficiency includes optimal incentives for research and development (R&D) (by ensuring maximal profits according to the market features of a price-segmented region), maximal entry by IPR holders into developing markets (and related technology transfer), maximal protection against counterfeit, potentially dangerous goods, and the availability of lower priced goods in developing markets.¹¹ Developing countries will instead argue that international exhaustion – that is permitting parallel imports – fosters WTO free-trade principles and is efficient in preventing high retail prices because of increased local competition.¹² Arguably, the determinants used by developing countries in assessing efficiency are also likely to include good-specific factors such as healthcare need for pharmaceuticals.

Indeed, the way a country defines efficiency and how particularised a country's analysis becomes is likely to result in discordant results. For example, developed countries such as the United States might determine under a particularised efficiency analysis *limited to pharmaceuticals* that a policy allowing parallel imports is more efficient. Such a result would naturally follow if the key determinant of efficiency were the extent to which US nationals are provided access to low-cost pharmaceuticals. Once the efficiency analysis, however, includes other determinants, for example lost incentives to innovate, the result is likely to change.¹³ These decisions are policy decisions that are inherently political, normative, and contextual. In order to accommodate such local features, a uniform rule must be sufficiently flexible to allow some manoeuvrability within the rule. Economic efficiency provides the starting, default rule and a locus about which limited flexibility is allowed.

Any potential rigid and globally uniform system, whether applying international, national, or some hybrid form of exhaustion, is insufficient to address certain local concerns. Indeed, while the general World Trade Organization (WTO) principle stated in

TRIPS to reduce impediments to international trade is laudable, it is simply too much to say that this necessarily implies a policy of international exhaustion or even a rigid policy of national exhaustion only.¹⁴ Discord at TRIPS resulted because developing countries, as large-scale consumers of products embodying IPRs, typically favour parallel imports¹⁵ but producer countries typically (though not always) favour rules prohibiting parallel imports.¹⁶

Global policies towards the rule of exhaustion determine whether parallel imports can occur.¹⁷ For example, if all countries had a rule of international exhaustion, goods that are sold with the authorisation of the IPR holder can be resold anywhere in the world. If all countries, however, have a rule of national exhaustion, a good can only be resold in the country of sale. By resisting a uniform rule of national exhaustion, developing countries retained the option that parallel imports could occur. Of course, without a uniform rule, individual countries, such as the United States, can nonetheless impose their own rule of exhaustion. The result is a global marketplace in which some countries impose an exhaustion rule that recognises a sale in a foreign country as permitting the resale of that good in the home country, and others which do not.

An economic analysis might determine that maximum *global* efficiency (a somewhat inchoate determinant) is achieved by a global rule of national exhaustion.¹⁸ Arguably, developing countries might have seen this as so contrary to their interests that they would have strongly resisted harmonisation on this issue because such a rule might not be efficient *locally*.¹⁹ This narrows the problem: how can maximum *global* economic efficiency be achieved while addressing local need?

The resulting inability to reach an accord in TRIPS regarding exhaustion rights is not the result of a failure to determine the economically correct view regarding the harmonisation of exhaustion rights, but rather because (1) the context-specific situations of

individual countries could not adequately be addressed with a rigid rule, or (2) a rigid rule did not give the appearance of sufficient manoeuvrability to address local needs. A flexible rule can address local need while maximising global economic efficiency, and to the extent that flexibility is unnecessary, it nonetheless gives assurance to countries that might otherwise be less inclined to adopt the rule. Local concerns such as the availability of essential goods and medicines for populations that would be unable to bear the retail price of such goods if parallel imports were disallowed could be addressed with a flexible rule. For example, if the United States allowed limited international exhaustion of rights (assuming a uniform rule of national exhaustion only) with respect to certain pharmaceuticals then low-cost drugs from Canada could be imported into the United States to address the healthcare needs of those who could otherwise not afford medication. Of course, flexibility does not address two other critical questions: if flexibility is allowed from a uniform rule, what rule is best; and is uniformity even possible? The section 'An economic perspective on exhaustion and parallel imports' addresses which uniform rule (anti-international exhaustion is proposed), while the next section discusses whether uniformity is possible.

Is uniformity possible?

The failure of TRIPS to reach an accord also raises the question of whether an accord regarding exhaustion rights is even possible.²⁰ This paper argues that an accord is possible but that any uniform rule²¹ must provide adequate safeguards for the critical local needs of countries when the uniform rule acts against the best interest of the country and the international market. In other words, if presented with two blanket uniform rules, for example rules 1 and 2, which are opposite of each other (eg one allows X, the other disallows X), and it is determined that rule 1 is best (eg most economically efficient globally), it is logical to pick rule 1. If it is,

however, found that in limited circumstances rule 2 is better, then allowing limited application of rule 2 provides an even better outcome (eg better economic efficiency than rules 1 or 2 alone). The need for uniformity as opposed to allowing countries to individually decide the content and scope of their rules is discussed in the section 'An economic perspective on exhaustion and parallel imports'.

The proposed exhaustion accord would begin with a policy generally²² prohibiting international exhaustion, that is prohibiting parallel imports, but would also provide a procedural framework whereby a country can make a showing of need²³ that allows said country to deviate from the international norm in particular classes of goods (eg medicines) and to the extent feasible, IPR rights (eg trademark protection of medicines).²⁴

The next section discusses the background principles of exhaustion rights and parallel imports. The section 'An economic perspective on exhaustion and parallel imports' examines economic perspectives towards parallel imports. The section 'IPRs and the need for flexibility in a uniform rule' examines the justifications for IPRs individually, that is qua patents or qua trade marks, and asserts that a uniform rule must allow flexibility in light of the differing justifications for IPRs. The section 'A framework for a flexible rule on exhaustion' suggests an exhaustion rule and framework.

BACKGROUND PRINCIPLES OF IPRS: EXHAUSTION AND FIRST-SALE²⁵

IPRs are typically accorded by the sovereignty of a nation unto persons who fulfil the procedural and statutory obligations towards such a claim.²⁶ Because these rights are national in scope and delimited by type, a potential right-holder must seek protection for a trade mark, copyright, patent, or other IPR in each individual country in which they wish

to assert their rights.²⁷ The owner can therefore own a set of ‘parallel’ IPRs.²⁸ On a national level in the United States, IPRs are subject to the principle of exhaustion or ‘first-sale’ limitations.²⁹ This doctrine of national exhaustion limits the rights of IP owners to control the disposition of an article after it has been sold with the authority of the owner of those rights.³⁰

In the United States, the doctrine of exhaustion of rights or first-sale limitations are an answer to the question of what happens when a holder of IPRs sells a chattel or service incorporating IP without express provisions as to the scope of use that purchaser is entitled to.³¹ The thorniest questions, however, arise in the international context where competing interests create a tension between those who believe that the market benefits from the resale of goods embodying IPRs at lower prices in markets where the genuine goods are already sold and those who argue that such ‘parallel imports’ confuse consumers, expose them to inferior products, and harm both the market for those goods and the manufacturers of genuine goods.³² In addition, some object to international exhaustion because price arbitraging results in reduced profits for the right-holder with the added result that incentives to invest are decreased.³³

Without an express license, the sale of a chattel incorporating IP rights raises an important question: what is the scope of rights granted in the sale?³⁴ The United States has addressed this question in a number of ways. Under one standard, an implied license is considered to accompany the sale of a chattel.³⁵ Another conceptual model deems the first authorised sale *in the United States* as exhausting the owner’s IP rights *in the United States*.³⁶ The rights may be deemed exhausted with respect to foreign countries depending on the foreign country’s exhaustion rule. In other words, the principle of territoriality which is applied to IPRs means that IP rights are not deemed exhausted in the United States when a good protected by a foreign

IPR is first sold in a foreign country. This means that a product protected by a foreign patent is still subject to the IPR holder’s IP protection in the United States notwithstanding the foreign sale.

Goods have been denoted as ‘grey-market’ goods when the reseller exports them to another territory and sells them, thereby competing directly with the IPR owner.³⁷ The reseller is commonly known as the parallel importer. In addition to national³⁸ and international³⁹ exhaustion of rights, some countries, most notably the conglomeration of countries forming the EU, utilise a system of regional exhaustion of rights, whereby sale within a defined group of countries exhausts IPRs.⁴⁰ Table 1 summarises some of the most common exhaustion systems globally.

The US system, at least with respect to trade marks, is a hybrid of sorts.⁴¹ Under the first-sale doctrine, liability is generally precluded from resale but there are numerous exceptions.⁴² Reselling a trademarked good that is ‘a materially different product’ is considered infringement.⁴³ In addition, the quality-control exception recognises that if the reseller does not adhere to the trademark holder’s quality control standards, then the reseller will be liable for the resulting tarnishment of the trademark’s image.⁴⁴ In other words, the trade mark is no longer a genuine good. Additionally, a repackager of a good must identify that it has repackaged the goods and not the product’s original maker.⁴⁵

The ‘first-sale’ principle has been likened as a principle that ‘promotes the free alienation of goods and the free market system, which are generally considered favourable goals’.⁴⁶ These proponents of exhaustion rights argue that free trade implies a lack of ‘barriers for the movement and sale of goods between countries’ and that the exhaustion principle therefore promotes free trade.⁴⁷ In contrast, under a system of national exhaustion only, the person or entity holding an IPR is subjected to a segmented marketplace in which prices are congruent to the demand of that market alone because the holder can

Table I: Global exhaustion systems

Country	Trademarks	Patents	Copyrights
US	National exhaustion ^a but also international exhaustion only when common control and no-confusion	National exhaustion but no international exhaustion	National exhaustion but no international exhaustion
EU	Regional and national exhaustion only	Regional and national exhaustion only	Regional and national exhaustion only
Japan	International and national exhaustion unless price-controlled sale or contract	Same as trademarks	International and national exhaustion except for motion pictures
Australia	International and national exhaustion	National exhaustion but no international exhaustion unless sold by patent owner without clear restrictions	National exhaustion but no international exhaustion except for books and compact discs
India	International and national exhaustion	International and national exhaustion	National exhaustion with some limited international exhaustion

Source: See Maskus, *Vertical Distribution*, supra, at 322.

National exhaustion: sale within the denominated country exhausts the class of IPR in that country only; international exhaustion: sale anywhere in the world exhausts the class of IPR in that country only. Regional exhaustion: sale anywhere in a predefined region exhausts the class of IPR in those countries only.

^aThe exhaustion rules are not necessarily mutually exclusive: a country may allow national exhaustion and also allow international exhaustion. Typically, most countries allow national exhaustion. The exceptions are those that *also* allow international exhaustion of rights.

prevent the importation of goods sold in foreign markets.⁴⁸

Most international treaties, including TRIPS, regulating IPRs did not focus on harmonising substantive rights⁴⁹ but instead usually provided that countries were to accord equal treatment to parties that were non-nationals as those that were.⁵⁰ This principle of national treatment therefore provided that each country could fashion its substantive provisions to coincide with local policies. Clearly, the greatest variation between substantive provisions would have been between countries that were dominantly IP producers⁵¹ and countries that were dominantly IP consumers. Indeed, developing countries tailored their substantive IP provisions to favour less stringent enforcement and protection.⁵² Arguably, parallel imports can have negative effects globally because IP producers are subject to increased competition by goods that are priced lower (in part because such parallel imports can free-ride on marketing by the manufacturer), thereby

further reducing the incentives to innovate because of decreased profit margins.⁵³

While parties to TRIPS were able to provide non-discriminatory treatment and basic minimum IPR standards, the exhaustion question remained unresolved.⁵⁴ Parties favouring exhaustion believed that a common global market would result in economic efficiency, that is increased competition would foster lower prices for all. The contrary view was that exhaustion would limit the incentives to innovate, since lower prices and the resulting lower margins would inhibit investment in R&D. Some have even contended that a global exhaustion regime would run counter to the traditional principle of territorial application of IPRs and that globalism may actually depend on territorialism.⁵⁵ Professor Bradley has stated:

[T]he extraterritorial application of US laws into other countries is arguably more parochial than global and more likely to undermine rather than promote

international cooperation. To put it differently, as long as the nation-state continues to be the principal actor in international relations, global cooperation and development may actually *depend* on territorialism.⁵⁶

A flexible uniform rule provides two major benefits: (1) it ensures that negative externalities that result from countries acting in self-interested manners are minimised and (2) it ensures that countries are given manoeuvring room to address local political and normative concerns without undue constraint. An externality is defined as a cost or benefit from a transaction that those who are external to the transaction receive. For example, the pharmaceutical industry in the United States is affected by the negative externalities created by the grey-market in medicines, which results in decreased profits and monies for R&D. A uniform rule that prevents such grey-market goods in appropriate circumstances would minimise this negative externality. The key proposition is that while those who benefit from grey-market goods would be worse off under a uniform rule prohibiting such goods, the resulting benefit to those who were harmed by the goods is much greater than the loss, such that the global welfare is increased. For example, see Figure 1 where hypothetical

countries *A* and *B* are trading on the grey-market and country *C* is a producer of goods that enter the grey-market.

As can be seen, countries *A* and *B* are made worse off from their local perspective but the negative externalities their behaviour causes (onto country *C*) via the grey-market are eliminated; as a result, the global benefit is increased. In some instances, despite the increased global welfare, other concerns might trump the increased economic efficiency. For example, suppose countries *A* and *B* are situated such that country *B* can supply country *A* with low-cost medicines but the global economic benefit would be decreased if country *A* were allowed to adopt a rule of international exhaustion. A flexible rule allows deviations from the ideal global rule to account for local exigencies such as healthcare need. For example, see Figure 2, where special local needs are included in the accounting.

Countries *A* and *B* are made better off with a limited exception for importation and exportation of pharmaceuticals (but not for other goods); whereas country *C* is harmed only marginally because grey-market goods are only allowed for a one market class. Ideally, such an arrangement would lead to increased economic benefit overall or at most only a marginal decrease. Of course, the ‘global benefit’ is determined based on what

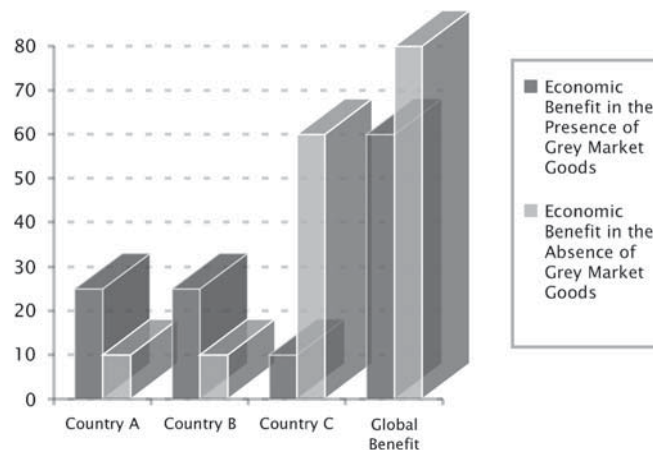


Figure 1: Negative externalities.

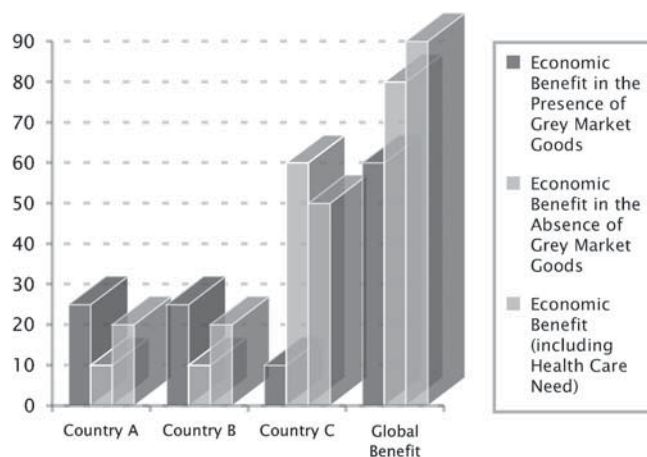


Figure 2: Negative externalities and a limited exception from an ideal rule.

factors constitute ‘benefit’. If addressing healthcare need is weighted sufficiently highly and reduced incentives are weighted less highly then the above calculus would likely result in a finding that the global economic benefit is increased by addressing local healthcare need.⁵⁷ The determinants of such benefit, that is economic efficiency, are discussed in the section ‘An economic perspective on exhaustion and parallel imports’ as well as the general arguments for a flexible, uniform rule.

AN ECONOMIC PERSPECTIVE ON EXHAUSTION AND PARALLEL IMPORTS

Parallel imports have been a concern to manufacturers and distributors.⁵⁸ These groups, and policy makers rallying behind them, contend that parallel imports reduce incentives to innovate and to invest in R&D because expected profits are decreased.⁵⁹ A ‘central claim by the research-intensive pharmaceutical industry is that if the United States were to deregulate restrictions on parallel imports in brand-name drugs from Canada and Europe, pharmaceutical companies would be forced to cut R&D expenditures’, with the implication that fewer new drugs would be created.⁶⁰ The industry also contends that there are insufficient

protections to ensure that imported drugs meet US safety standards.⁶¹

Some economists have suggested that policies permitting parallel imports may harm developing countries.⁶² As Professor Abbot in his ‘First Report on Parallel Imports’ stated:

Rather than suffering the erosion of high prices in developed country markets as a consequence of low priced parallel imports from developing countries, these manufacturers/licensors may elect to raise prices in the developing countries, or they may cease to sell in these countries.⁶³

Further, in the absence of producers *with technological know-how*, local producers may make inferior products (or none at all).⁶⁴ Indeed, recent economic analysis of the relationship between parallel imports and R&D incentives indicates that the general proposition that parallel imports reduce innovation is correct.⁶⁵ As the world economy continues to experience dramatic growth in knowledge-based industries and the production and subsequent international trade in IP, nations must once again confront the question of whether the goal of an international barrier-free market is attainable and desirable. Finally, to understand the economic effects a uniform rule on exhaustion would have on the global economy, it is

important to understand why parallel imports occur. This is discussed next.

What are the causes of parallel imports?

Two basic economic models have been offered in recent years to explain the existence of parallel imports. The first is a retail arbitrage model. Arbitrage exists because price differences exceed importation or transport costs.⁶⁶ An international scheme of purely national exhaustion of rights leads to a segmented market system in which price discrimination occurs; an international system of parallel imports, by contrast, leads to more uniform prices.⁶⁷ This model has not clearly indicated whether banning parallel imports would hinder or benefit global welfare⁶⁸ but it leads to an obvious question: are uniform global prices desirable? In one respect, they may actually harm developing countries since a uniform global price for a good may be well above what a majority of local consumers can afford.

The second model posits that parallel imports occur because of pricing decisions by a manufacturer in order to exert 'vertical' control over its distributors.⁶⁹ An example will help explain this concept. If a widget manufacturer distributes a widget in market *A* at a sufficiently low wholesale price, a competitor unencumbered by transport costs will buy such goods and sell them in market *B* where the retail price is higher than in market *A*. In response, the manufacturer may then exert 'vertical price control' over the market interloper by raising its wholesale costs to prevent the interloper from arbitraging the manufacturer's goods. Professor Maskus has analysed parallel imports using a vertical price control model and has made two broad conclusions.⁷⁰ First, '[w]hen transportation costs are small, the manufacturer raises its wholesale price in order to control [parallel imports]'.⁷¹ This prevents the manufacturer from achieving maximal profit because the most efficient price cannot be achieved unless transportation costs are high. Secondly, under

their vertical pricing model, parallel imports inhibit R&D and manufacturers achieve higher profits without parallel trade than with parallel trade.⁷² Finally, while these models describe why parallel imports exist, they do not directly address why some producers desire to ban them beyond pure price considerations. One possibility is that preventing parallel imports allows producers to invest in different marketing strategies without fear of free-riding by competing parallel imports.⁷³

In the next section, the effects of parallel imports on the global economy are discussed. It is important to note that an analysis of parallel imports as generally detrimental to the global economy suggests that a uniform rule on exhaustion should default to a rule of national exhaustion only, since such a rule would prohibit parallel imports and therefore raise the global welfare.

An economic analysis of parallel imports

Market segmentation

Economists, such as Professor Maskus above, have argued that price discrimination, which is most readily achieved by segmentation of a market, can in certain conditions raise the general welfare.⁷⁴ In a recent analysis of parallel imports utilising their vertical price control model, Maskus argues:

If vertical price control is an important determinant of parallel imports...an important policy implication emerges. Between countries where transport costs are high, attempts to deter parallel trade through setting a wholesale price are socially inefficient. Thus, it seems advisable to preclude parallel imports in such cases. However, between countries where transports costs are low, a policy of permitting parallel trade would be beneficial. This finding suggests that a policy of regional exhaustion among free trade areas whose members are in close proximity is sensible.⁷⁵

Banning parallel imports, it is argued, achieves market segmentation whereas allowing them results in uniform international pricing.⁷⁶ The only external constraints on uniform pricing are transport and marketing costs.⁷⁷ In markets where a manufacturer has already invested marketing costs, however, a parallel-importer can often free ride on the manufacturer's investment.⁷⁸

Demand elasticity

Another determinant in the economic analysis of parallel imports is demand elasticity. Goods in local economies can be described as having elastic or inelastic demand. Such elasticities define a ratio between the price of a good and the demand for that good at that price.⁷⁹ Goods are considered inelastic when there is little or no change in demand as the price fluctuates.⁸⁰ Typically, necessary items such as pharmaceuticals (with no generic substitutes) have relatively inelastic demand curves because a consumer is usually willing to pay any range of prices to cure a disease, especially a life threatening one.⁸¹ Elastic items, for example, non-necessary goods such as notebook paper, are subject to very strict demand–price changes. A consumer will choose the cheapest of any number of similar generic items because they are equivalent.⁸²

Markets can similarly be defined as elastic or inelastic.⁸³ The functional result is that economies with 'high demand elasticities' should experience lower overall prices under a system of price discrimination. Manufacturers who supply goods at high retail prices in elastic economies will find their goods unsold until retail prices are sufficiently lowered. Under a regime allowing parallel imports, countries with elastic demand 'might not be supplied by foreign IPR owners because local demand might be insufficient under uniform pricing'.⁸⁴ Professor Maskus notes that international exhaustion (allowing parallel imports) could lower the general welfare of developing countries through higher prices and lower product availability.⁸⁵ Professor Maskus' economic analysis suggests that most

countries have elastic markets; therefore, market segmentation ensures low prices and results in improved general welfare.⁸⁶

The resistance of developing countries to a global rule of non-exhaustion

This analysis would suggest that developing countries would be harmed by parallel imports, and yet developing nations typically do not prohibit (indeed they favour) parallel imports.⁸⁷ There are two possible explanations. One, countries are concerned that 'banning parallel imports would invite abusive behaviour in their markets on the part of foreign right-holders'.⁸⁸ As such, parallel imports help minimise unfair or collusive trade practices fostered by systems with strict territorial restraints.⁸⁹ Another is that countries see parallel imports as an opportunity for local development, for example by creating a parallel import 'export' market.⁹⁰ To the extent that such concerns are empirically true, it is nonetheless irrational to support a general rule of global exhaustion. Undoubtedly, global exhaustion has some benefit. The key question is whether such benefit outweighs corresponding detriments. It is proposed that a flexible rule would do much to assuage the above-mentioned fears and would be the most rational choice for a uniform rule.

A policy aside: NTBs

From a perspective of policy, restricting such trade may constitute a form of NTB to goods.⁹¹ Such barriers arguably constitute portioning of markets in violation of WTO proscriptions aiming towards market integration. Professor Chiappetta has stated that not only would a rule of non-exhaustion be contrary to stated WTO free-trade objectives but also that a rule allowing exhaustion to be within the domain of national policy 'means that the TRIPS mandated WTO-wide strengthening of national IPR regimes affirmatively provides IP producers a new and extremely effective tool for dividing [the] marketplace along national boundaries'.⁹²

But while the professed goal of TRIPS is to remove NTBs to trade, it does not follow that prohibiting parallel imports is an NTB of the type that *should* be restricted. In general, NTBs to trade are restrictions on imports. They are seen as barriers to free trade. But, prohibitions on parallel imports may in some circumstances foster trade. Companies are more likely to avoid markets where their goods will be exported to other markets (because of a lower wholesale price) as grey-market goods if a parallel import policy allows such importation.⁹³ Therefore, preventing parallel imports may open certain markets to goods otherwise unavailable. To the extent that economies benefit from such restrictions, it seems incongruent to criticise prohibitions on parallel imports as NTBs solely because they are technically NTBs.

The proposed rule: Flexible, uniform, and anti-international exhaustion

But the question still remains whether the aggregate effect, which is the *global* economic effect, of parallel imports would result in the most efficient maximisation of wealth. Arguably, this is the question that TRIPS should have addressed as a treaty whose purpose was to create a common economy. If the net benefits of prohibiting parallel imports outweighed its costs, then a policy prohibiting parallel imports follows. The economic models that reach this conclusion, however, are invariably limited both by their conceptions of value (a determinant of efficiency) and by unavoidable simplifying assumptions that must be made. It is argued that a more nuanced economic analysis would indicate that a global uniform rule could be inefficient whether the rule is for global international exhaustion or national exhaustion. The solution is flexibility because it allows for fine-tuning with respect to efficiency. In some circumstances, efficiency requires regional exhaustion, whereas in others a prohibition on parallel imports is best. Further, local needs with respect to individual IPRs and classes of goods can vary.

It is possible that the most efficient exhaustion (parallel import) policy allows parallel imports for some goods but not others. It may even impose selective restrictions on imports depending on the type of IPR those goods embody. This paper suggests that a general rule restricting parallel imports is the ideal policy rule for a global economy in which transportation (import/export) costs are high and regional exhaustion is best for linked economies with low import/export costs.⁹⁴ These arguments follow from the economic analyses of Professor Maskus.

Again, this rule is uniform, but it also incorporates a degree of flexibility. In certain circumstances, deviations from the rule are justified. This raises an important question: how is a proposed uniform rule, with flexibility, different than no provision at all? First, no international rule on exhaustion implies that each country is free to decide its policy entirely on its own unless and until it negotiates otherwise through treaty. In contrast, a uniform rule sets a default point and then constrains deviation from that point by requiring such deviations to be justified. In most circumstances, countries would be constrained to the uniform rule. In those limited cases where they deviate, the deviation would be narrowly tailored, that is limited in scope. In general, it is argued that policies towards exhaustion rules and parallel imports differ because countries act in self-interested manners.

Outliers: Another reason for a uniform, flexible rule

The dichotomy between IP-producing and IP-consuming countries, which usually coordinate with developed and developing countries, respectively, fails to explain, however, why certain developed countries such as Japan and Australia in part have international exhaustion (pro-parallel import) regimes. One explanation is that these countries have traditionally not been IP producers and therefore did not regard IPR protection as paramount.⁹⁵ Alternatively, as

between IP owners and consumers, such countries may simply – by custom – side with consumers.⁹⁶ In other words, protectionist policies for local IP producers who would be most effected by a pro-parallel import policy did not exist. Another possibility is that retail prices are inordinately high due to some other externality. As a result, the concomitant price reduction, which can result from a pro-parallel import policy, was seen as desirable. This would naturally lead to resistance of a regime that fostered market segmentation because consumers would no longer benefit from the decreased cost of goods due to price competition. The result is that a balance between net gain to consumers of such goods and between the producers of such goods must be maintained even in developed countries and may favour the consumer when retail prices are high. If a country's parallel import policy, however, were merely a result of tradition or protectionism of its economy without regard for the external effects such a policy would have, a uniform accord would ensure that countries modify their policies. Uniformity by treaty removes the deadweight of tradition and self-interest of both IPR holders and consumers in one local.

Why do we need a uniform rule (with flexibility)?

Without a supranational norm regarding exhaustion rights, countries will not be constrained by the negative externalities they create in the global marketplace. For example, a country might stand to benefit under a rule that allows the importation of grey-market goods. Such importation, however, would affect prices globally and would result in decreased profits. In areas where R&D is key to innovation, decreased profits can result in decreased ability to innovate.⁹⁷ To the extent that technological growth is cumulative, such effects can have drastic consequences. The ability of a country to deviate from the uniform rule will be limited by the country's responsibility under a treaty to narrowly tailor its policy with respect to specific IPRs and

classes of goods. The result is that while there might be numerous exceptions to a uniform rule, the overall effect will maximise economic efficiency by preventing purely self-interested behaviour.⁹⁸

The underlying thesis of this paper is that *rigid* global uniformity is not appropriate. Based on the economic models developed by Professor Maskus, the ideal rule for maximising global welfare is a *global* rule of national exhaustion only, that is no international exhaustion, with limited exceptions for regional exhaustion in certain circumstances.⁹⁹ If the economic perspective on parallel imports, however, were to change to a general view that parallel imports are the ideal policy rule for a global economy, an international accord would nonetheless require flexibility. For example, a first-sale rule of exhaustion could be tempered by exceptions specific to certain market exigencies such as the need to control the grey-market in pharmaceuticals. An exception that would prohibit the parallel importation of grey-market pharmaceuticals would increase a company's willingness to export drugs to developing nations where need is high but the risk of arbitrage is even higher. Such flexibility needs to be controlled.

IPRS AND THE NEED FOR FLEXIBILITY IN A UNIFORM RULE

The section 'Background principles of IPRs: exhaustion and first-sale' provided the basic framework for the principle of exhaustion and the section 'An economic perspective on exhaustion and parallel imports' has explored the economic analysis of parallel imports. This section posits that the key to resolving the exhaustion conundrum may require more than an analysis of which model would provide the economically most efficient global result. The answer may also lie in evaluating various IPRs individually and the effects that a particular regime would have on countries with local market exigencies.

What are some of the basic justifications for IPRs?

Patents and copyrights

The US Constitution provides in Art. I, s. 8 that:

Congress shall have power... To promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries.

It is generally accepted that this clause provides the power to create substantive provisions regulating copyrights and patents in the United States and that the underlying goal of such protections is to foster incentives to innovate and to create. A balance must be maintained, however, between the right created and the social and welfare costs that such rights concomitantly create. Under the patent system, an inventor is given the right to exclude others from making his invention for a period of time.¹⁰⁰ This rent is a cost to society. The benefit to society is the resulting innovation, disclosure, and entry of the invention into the public domain after a period of time. This balance is affected by a country's exhaustion policy (whether pro or anti-parallel imports). Allowing parallel imports minimises the ability of an inventor to fully recoup the costs of R&D.¹⁰¹ A rule preventing parallel imports allows an inventor to recoup costs but can limit access of the public to essential goods such as medicines.

Copyrights also create additional costs in prohibiting the use of certain expressive elements for lengthy periods of time.¹⁰² Depending on the jurisdiction, copyright is 'intended to provide economic and moral support for authors and artists and, through their efforts, to enhance human wellbeing'.¹⁰³ Parallel imports certainly reduce the economic support an extended monopoly can provide whereas denying them limits the dissemination of information. What is clear is that while the individual policy justifications for patents or copyrights do not themselves point to a single

rule of exhaustion, they do suggest that a balance must be struck. One advantage of a *flexible* uniform global rule that prohibits parallel imports in cases where transportation costs are high and allows regional exhaustion (limited parallel imports) where they are low is that countries which have legitimate reasons for divergent policies have the onus to make a showing that their local exigencies require deviation. Negotiating members need not attempt to consider every local market exigency in adopting a generally applicable global rule since individual countries can deviate under certain defined circumstances and only for so long as those circumstances exist.

Trade marks

In contrast to patents and copyrights, as demonstrated by the trademark system in the United States, trade marks are not provided statutory protections in order to create incentives.¹⁰⁴ Rather, trade marks have been traditionally recognised as serving two primary purposes. They aid the consumer by ensuring that they can reasonably rely on a trademarked product or service as coming from the same source as another identically trademarked good.¹⁰⁵ Also, trade marks aid the producers of goods by protecting the value created around a product or service in the form of goodwill by preventing the use of the mark by other, so-called, free riders.¹⁰⁶

Arguably, these justifications lead to one rational result regarding the exhaustion scheme. Exhaustion should be allowed when the goods sold by the manufacturer in the foreign market are materially and substantially similar to the goods sold in the local market. Consumer confusion in such an instance does not occur. Exhaustion should not be allowed in the contrary instance where the goods are so different that consumers are harmed by their mistaken belief that they are acquiring the goods represented by the trade mark. Such a system would be a hybrid between an exhaustion and non-exhaustion and is exemplified by the US system.¹⁰⁷ Under the

first-sale doctrine, liability is generally precluded from resale but there are numerous exceptions.¹⁰⁸

Since trade marks, however, protect more than just consumer expectations but also producer goodwill, a system that allows materially and substantially similar goods to be imported into local markets still affects the producer's expectations and investments. Not only does the parallel importer free ride on the local investment in goodwill but the parallel importer also can adversely affect that goodwill. Indeed, there is a considerable market in the United States and elsewhere for sumptuary goods – that is goods that are desirable in part because their cost and exclusivity confer social status. Parallel importation of such goods affects the goodwill of the product because their sumptuary status is reduced.¹⁰⁹

The problem of holistic analysis

The inherent interplay between cost and benefit is an exercise in balancing. How important is innovation, creativity, and disclosure? Is protection against consumer confusion to be accorded as much weight regardless of the product or do certain commodities require less protection because their authenticity is less important than their availability? Such balancing may require specific empirical data or it might be a qualitative balancing informed by social, moral, and normative concerns. The degree to which a right imposes costs and benefits is therefore highly contextual. A substantive provision that attempts to denude the law of context ignores these concerns. More importantly, a substantive provision that looks at IPRs as an indistinct mass of merged property rights, rather than focusing on the individual components, blurs distinctions that must remain intact. The policy justifications for a system of patents and copyrights are decidedly different than those for a system of trade marks. Within these individual spheres, there are additional distinctions that must be

made in according value that are determined by local concerns.

Of course, there can be practical problems with particularised analyses of IPRs. Patented goods may also be trademarked or incorporate a copyrighted image on the packaging. Flexibility can still be achieved. For example, if a patented product incorporates a trade mark and a country is urging an exception to the rule of national exhaustion only, the company may only be able to show that it has a valid claim to an exception via the patent only. The country would have the onus on providing a solution. It might submit that any products it distributes will have the trade mark (or copyrighted image) obscured or destroyed. In some situations, even such efforts may be impractical. To the extent that they are, the exception may have to be broad. The idea, however, is to address local need (a positive benefit on global welfare) and minimise unnecessary interference with an IPR holder's expectations (a negative effect). Rigid horizontal uniformity is unnecessary because in those situations in which IPRs *can* be separated by type, it is inefficient. The next section expands on this concept.

The problem with rigid horizontal uniformity

When the push for global exhaustion is analysed against the policy justifications for individual IPR regimes, the obvious conclusion is that a rigid exhaustion regime can produce unwanted results. Imagine a hypothetical country that is enduring a health-crisis such as widespread HIV infection. The social cost of restricting access to medicine would undoubtedly be determined as extremely high. How would this inform policy with regards to IPRs? A local patent regime or indeed a local exhaustion regime might allow importation of low-cost medicines because the economic benefit a strong-patent system might have in the long term is outweighed by the immediate need for access to cheap medicines.¹¹⁰ Yet such a

regime on a global level would reduce the necessary incentives for a pharmaceutical company to innovate and develop.¹¹¹ It would also likely prevent importation of such drugs into markets where a significant grey-market has developed. Ideally, a global uniform rule would incorporate exceptions for specific local exigencies. While a developed country, such as the United States, might find countries willing to export cheaper medicines, what of developing countries? This is where market segmentation, a result of a rule prohibiting international exhaustion, provides an answer. To the extent that the grey-market is inhibited¹¹² producers who can sell medicine above the cost of manufacturer will supply such markets at prices the market can afford.

How does the analysis change with respect to trademark rights? Arguably it might favour strong trademark protection for pharmaceutical products to prevent counterfeit goods that would harm the public but would favour weak patent enforcement to ensure that genuine pharmaceutical products can enter the marketplace and lower drug costs. To the extent that the trade mark is not necessary to serve its purpose as identifying the authenticity of the medicine, a flexible rule might (as discussed above) require the trade mark to be destroyed or replaced.

As can be seen, a uniform regime favouring exhaustion or denying it could be inconsistent with at least one of the goals of particular class of IPRs. This may have been a critical shortcoming leading to the failure of TRIPS to reach an agreement on exhaustion rights.¹¹³ Any uniform exhaustion regime would likely have interfered with at least some parts of some countries' policy goals and individual needs. This is not to say that a single uniform rule is incorrect or unattainable; rather, any uniform supranational rule regarding exhaustion must be sufficiently flexible to balance the need to constrain negative externalities caused by non-uniform, self-interested behaviour and the need to accord

nations' sufficient autonomy to address legitimate local needs.

A FRAMEWORK FOR A FLEXIBLE RULE ON EXHAUSTION

To the extent that TRIPS instituted an international framework of national treatment and minimum enforcement and protection regimes, it failed to provide for a uniform treatment of exhaustion. As the preceding discussion showed, a rigid uniform treatment of exhaustion can result in sub-optimal treatment because specific local market norms and exigencies may differ depending on the IPR or type of IPR at stake. Exigencies also depend on the type of good in question.

Again, this does not imply that uniformity is not possible but rather that an international agreement concerning exhaustion rights must make two provisions. One, deviation from a uniform rule must be allowed in certain instances with respect to individual IPRs (if possible) and individual classes of goods. Two, local markets must be provided with an opportunity to make specific showings which exclude them, at least for a temporary period, from certain exhaustion requirements. In the next section, an example of how a flexible rule might work in practice is presented.

An example of the problem (and the solution): The EU and regional exhaustion

The EU has adopted a rule of regional exhaustion, mostly through decisional law,¹¹⁴ that allows exhaustion of rights within the confines of the EU. For example, a genuine good manufactured and sold in Germany can be resold in France but the same good sold in the United States may not. For example, the rule of regional exhaustion applies to trade marks and has been codified in a harmonisation directive by the EU Council, specifically stating:

[T]he trade mark shall not entitle the proprietor to prohibit its use in relation to

goods which have been put on the market in the Community under that trademark by the proprietor or with his consent.¹¹⁵

Such a rule generally meets with favour among developed countries outside the EU such as the United States because goods, such as blue jeans,¹¹⁶ which are significantly cheaper in the United States, can be sold at higher retail rates in the EU without competition from grey-market imports. The rule reflects a general belief that within the EU union, greater benefits will accrue via a common market. Why? As the nation states in Europe progressed from isolated, independent countries into a more interdependent confederated conglomeration, their markets and their interests also aligned. Europe is in many respects a Single Market of developed countries. As developed countries, they are net creators instead of consumers of IP. Harmonisation within the EU regarding exhaustion is the inevitable result of having aligned economic and normative interests. Further, it is economically efficient, at least under a vertical price model.¹¹⁷ Regional exhaustion, in other words, makes perfect sense.

In contrast, developing nations may or may not be situated differently than the EU. To the extent that parallel imports are desirable to such nations, a rule allowing regional exhaustion will foster cooperation among nations to lower trading costs with such countries. Further, a flexible rule will allow all countries to make special exceptions for certain IPRs in certain goods, for example trade marks in medicines, as necessitated by local exigencies.

For example, suppose country *A* requires access to certain medicines to treat a widespread disease. Country *A* is situated next to country *B* and both countries are prohibited from allowing parallel imports by treaty. Country *B* has access to medicines at lower cost because of the segmented market system. A flexible rule would – after a showing of need has been made – allow

country *B* to export these low-cost drugs to country *A* where there is a need but country *A*'s parallel import policy would not be changed with respect to any other good. There is a risk that when country *B* begins such export, manufacturers will raise wholesale prices to exert vertical control. Country *A*'s parallel import policy, however, is temporary and limited. While certain diseases such as HIV are unlikely to go away soon, the flexible rule would ensure that as HIV infection goes up or down, the amount that can be imported must also adjust. In addition, a country invoking such a rule may be required to show it is using its best efforts to ensure that alternate means of addressing local need are also used. For example, a country may be required that to show that it has instituted an education programme regarding HIV and its transmission. Balanced by country *B*'s own desire to keep retail prices low and by the temporary/limited nature of the policy, manufacturers need not worry that country *B* will continue to export such medicines indefinitely. Any flexibility in the rule is tempered by a procedural framework, discussed below, which narrowly tailors the deviation from the policy to meet critical local needs.

Arguably, such a policy promises more flexibility than it might actually deliver, since country *A* needs more than just the flexibility to adjust its law such that it can import low-cost medicines. It must also find a country *B* with private producers willing to export its drugs. A country *B* with such producers might be hard to find. Indeed, even if Africa as a whole had an integrated economic community with regional exhaustion, it is uncertain that this alone would be sufficient to address healthcare need. What the proposed rule does, however, is not provide a panacea but rather an improvement. Ideally, a flexible rule minimises risks to these '*B*' countries and the producers located there by minimising market effects because deviations are only allowed to address key local concerns. What constitutes a key local

concern worthy of deviation? This is a matter that would be negotiated but most likely would include pressing health concerns. A general idea of what is a key local concern, however, can be articulated. Key concerns are those that focus on conditions imposing their own negative externalities. For example, a populace ravaged by disease is unlikely to have an optimal economic base, especially if the economy's workers are sick. A deviation is allowed because it will result in a stronger economy in the long term. The short-term loss is outweighed by the long-term benefits.

The regional exhaustion rule can also be fine-tuned by negotiators to ensure that regulation of the grey-market is achieved. For example, regional exhaustion could be limited to countries within certain geographical areas, that is all countries within a single continent or other defined radius or region. As such, regional exhaustion in Africa would not extend to Europe (absent a solution to the grey-market) and vice-versa. While a regional exhaustion rule in Africa would probably not provide the continent with many economic benefits (since producers are still wanting), proper market segmentation and control of the grey-market could ensure that consumers are supplied with items at lower cost. Admittedly, the general rule regarding exhaustion is imprecise as currently defined; however, the key proposition in this paper is not what the correct rule is but rather how rigid such a rule should be.

The economic argument revisited

Given perfect data and given a model sufficiently complex and multivariate, it seems a given that an economic analysis could provide an answer to the question of exhaustion rights. After all, given the right equation and the right data, the answer is merely a matter of maximising efficiency. There is a fundamental flaw in such an analysis however. It assumes that there is a single objective model that can be applied. Value, the corner stone of such a model, is a subjective principle. It consists of normative,

moral, social, and human-rights dimensions. Indeed, any of these dimensions can hypothetically be given a number.¹¹⁸ Happiness can be given a metric and weighted in as much as wealth can. The underlying assumption that wealth maximisation is the proper determinate of an appropriate exhaustion system fails not because the economic analysis is flawed; rather, it fails because variables have been ignored. The pressing question then becomes, who decides the metric and who decides the weight? Who decides the variables? There is an answer.

International treaties have two major areas of law that they can influence: substantive provisions and procedural provisions. TRIPS provided a framework of minimum standards along with procedural protections for the rights therein. TRIPS failed to provide an exhaustion provision because a rigid uniform rule either favouring international exhaustion or favouring a prohibition on international exhaustion did not make economic sense. What was not considered, however, was the possibility that a uniform rule might make sense if it accounted for the local need for flexibility. In essence, TRIPS negotiators failed to consider a suitable escape valve for the restrictions that a single rigid rule would provide. The lack of a uniform rule has not been disastrous but it is also not the best possible outcome. In the end, resistance to a provision which favoured one country, for example the United States – a supporter of the benefits a denial of parallel imports would provide, strongly over another, for example a developing country – which might find parallel imports allow room to address local needs, was the natural outcome. While many developing countries acceded to TRIPS because of pressure from developed countries such as the United States, the area of exhaustion was likely a final attempt to protect perceived vital local interests. The key to resolving exhaustion rights lies in a uniform provision providing flexibility in a harmonised procedural framework that allows deviations from such a uniform rule.

The procedural framework

Members to TRIPS would first meet to determine an ideal exhaustion system. This paper posits that the ideal system is a mixture between regional and national exhaustion based on recent economic studies.¹¹⁹ The basic assumption all parties would operate under, however, is that once the various exigencies of local nations are met, for example economic, healthcare, cultural needs, then alignment regarding an ideal exhaustion system is much more likely to occur. Of course, developing countries will enter these negotiations without having had such needs met. They would negotiate from a position of hypothetical improvement, in other words, they would determine which exhaustion policy would best fit their market should their country become a developed nation. Once an ideal policy towards exhaustion rights has been negotiated, a procedural framework that provides the means for countries to make individual showings of need is negotiated. Such a showing can be made not only by developing countries but also by developed countries.

An example will clarify such a system. Country *A*, a developed country with a need for low-cost pharmaceuticals, enters into the newly negotiated treaty that prohibits parallel imports. Country *A* is not situated to take advantage of the regional exhaustion exception since transport costs to/from country *A* are high.¹²⁰ Country *A* can make a showing before the WTO that it has met certain prerequisites to allow parallel importation for patented pharmaceuticals. Such prerequisites might include a showing that there is a need for certain classes of pharmaceuticals (eg necessary medications such as antiretroviral drugs as opposed to hair treatments) or that protective measures against such goods being exported as grey-market goods are met. With respect to the individual IPRs in this example, the exception would not likely affect copyright, might affect trade marks, and would certainly affect patent rights, and would therefore be additionally

narrowly tailored with respect to the type of IPR. For example, as stated before, if IPR holders are concerned about their trademark and copyright protections and the country seeking the exception can only make a showing that a limited patent right policy change is required, then to the extent possible, such IPRs must be removed.

The showing could be before a specialised tribunal that would independently review an application from the nation and determine whether the country has made a showing according to negotiated standards that it should be allowed to deviate from the uniform rule. If so, the country can institute a policy reflecting its local needs. Such deviation, however, is not designed to be permanent. Outside countries are free to negotiate in good faith with local countries to provide incentives to further minimise the deviation from the ideal rule. Such incentives could include a commitment towards investment in the local infrastructure, better technology transfer, improved drug prices, and so on. Periodically, countries deviating from the ideal rule will reappear before the tribunal or other system and make a renewed showing. As conditions on the local level improve, deviations from the ideal rule must diminish.

CONCLUSION

Individual countries should be allowed an opportunity to answer the value question with regards to exhaustion rights themselves by making showings regarding their local conditions. These determinations would be made with regards to individual IPRs, namely patents, trade marks, and copyrights and with respect to individual classes of goods to the extent possible. Underlying such a procedural framework towards substantive harmonisation is the assumption that the developing nations have as a common goal that they become developed nations.

An accord would ensure that nations can make a showing that local needs require substantive fine-tuning. Such a system is

favourable to both developed and developing countries. Countries are allowed to meet local needs as long as there is a legitimate showing of local need. Further, this is a process that is inherently dialogic in nature and continuing. Rather than the finality of a rigid substantive provision imposed on all member nations by fiat, regardless of local need, a process whereby countries are ensured that their concerns are communicated, considered, and transformed into concession will provide a framework that maximises global welfare.

Disclaimer: The views expressed in this paper are the opinions and not the legal advice of the author and do not represent the views of Hunton & Williams, its clients, or its affiliates.

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2. Maskus, K. E. & Ganslandt, M. (2004). Parallel imports and the pricing of pharmaceutical products: Evidence from the European Union. *J. Health Econ.* **23**, 1035–1036.
3. See generally Maskus, *Vertical Distribution, supra*. Also see Abbot, F. M. (1998). First Report (Final) to the Committee on International Trade Law of the International Law Association on the subject of parallel importation. *J. Int. Econ. Law* **1**, 607–608 (stating that the parallel imports question may be ‘succinctly’ stated as follows: ‘To what extent should intellectual property rights (IPRs) holders within particular national/regional territories be entitled to restrict the importation of goods and services into those territories on the basis of local IPRs ownership when the subject goods and services have been placed on the market outside the territory of importation with their consent?’).
4. Abbott, *supra*, at 611.
5. Marrakech Agreement Establishing the World Trade Organization, Annex 1C: Agreement on Trade-Related Aspects of Intellectual Property Rights, 15th April, 1994, 33. I.L.M. 81 (1994) (hereinafter TRIPS Agreement).
6. Also see, WIPO Copyright Treaty, Art. 6(2), 26th December, 1996, 36 I.L.M. 65 (stating: ‘Nothing in this Treaty shall affect the freedom of Contracting Parties to determine the conditions, if any, under which the exhaustion of the right in paragraph (1) applies after the first sale or other transfer of ownership of the original or a copy of the work with the authorization of the author’; NAFTA does not address the exhaustion issue).
7. TRIPS Agreement, Art. 6.
8. See Chiapetta, V. (2000). The desirability of agreeing to disagree: The WTO, TRIPS, International IPR exhaustion and a few other things. *Mich. J. Int. Law* **21**, 333, 335–336 (raising substantially the same question).
9. TRIPS Agreement, Preamble. See also Chiapetta, *supra*, at 336 (asking substantially the same question).
10. Chiapetta, *supra*, at 336.
11. See Maskus, K. E. & Li, C. (2006). The impact of parallel imports on investments in cost-reducing research and development. *J. Int. Econ.* **68**, 443–444 and Maskus, *Vertical Distribution*, at 321.
12. See Maskus, *Vertical Distribution*, at 321.
13. Of course, the weights attached to any one determinant are critical. Thus, if social need is high but weighted low, then even a small effect on incentives to innovate may dominate. See generally, Maskus, *Investments, supra* (discussing the effect parallel imports have on incentives to innovate in pharmaceuticals).
14. National exhaustion implies that the sale of a good within a territory ‘exhausts’, that is dispels, the IPRs in the good *in the country of sale*. International exhaustion implies that IPRs are dispelled *worldwide* upon a sale anywhere. Therefore, a country with a uniform national exhaustion rule would allow a person who (with authority of the IPR holder) buys a good in country *A* embodying IPRs to resell that good in country *A* without interference from the original IPR holder. See Chiapetta, *supra*, at 340–343.
15. See Maskus, *Vertical Distribution*, at 323 (stating: ‘In general, few developing countries restrict parallel imports in any field of protection’).
16. *Ibid.*
17. *Ibid.* at 319.
18. See *infra*.
19. But see Maskus, K. E. & Chen, Y. (2005). Vertical pricing and parallel imports. *J. Int. Trade Econ. Dev.* **14**, 1–2 (stating ‘many developing countries prefer to maintain openness to parallel imports in the belief that this policy permits them to source goods at lowest cost.... However, the position taken by poor countries in this regard is curious because *standard economic analysis of market segmentation would suggest that a policy of preventing parallel imports would generate low prices in those nations*’) (emphasis added). This paper will later argue that market segmentation best addresses developing countries concerns. While developed countries would most likely benefit from the flexibility in the proposed rule, the appearance of flexibility will induce developing countries to

- accede to a uniform rule that is arguably in their best interest.
20. The need for a uniform rule is discussed in the section 'An economic perspective on exhaustion and parallel imports'.
 21. A uniform rule is here defined as being uniform if the rule's requirements are applied equally to all member countries. The rule need not be purely pro or anti-parallel imports but can provide defined circumstances under which any country may (or must) adopt one variant of the rule over another. In essence, the rule is predominantly procedurally uniform but only generally uniform substantively.
 22. Regional exhaustion would be allowed in certain circumstances as discussed later.
 23. A possible procedural framework is disclosed in the final part. In general, the framework allows a country to independently list and value its policy justifications for an exhaustion regime with respect to certain IPR rights and goods before a tribunal. Substantively, the tribunal would then assure that countries deviate from the ideal rule via narrowly tailored exceptions only insofar as the deviation is legitimate and necessary to meet particularised local needs. The tribunal would also ensure that to the extent that particular needs change, then the resulting allowed policy deviation would also change.
 24. As the later economic analysis discloses, in certain situations, for example linked economies with low trading costs, regional exhaustion is likely to raise the general welfare. Further, the EU strongly favours a system of regional exhaustion. As such, the proposed uniform rule would make allowance for linked economies to incorporate, permissively, regional exhaustion rules.
 25. This section delineates in part some of the most commonly accepted principles of exhaustion rights. To the extent that law is ever evolving, it is beyond the scope of this paper to address issues such as exhaustion rights in the digital age. For example, an interesting question, worthy of its own examination in another paper, is whether the digital transfer of an online text exhausts IPRs in that text. Unlike traditional chattels, the good is not sold and transported but copied and transported. This paper aims at general principles related to traditional exhaustion doctrine. Undoubtedly, those principles – in application – would need to be refined in line with developing law.
 26. See generally O'Riordan, A. (2003). Are you exhausted? The rights of trademark holders within the EU. *Cork Online Law Rev.* 2. Also See Maskus, *Vertical Distribution, supra*, at 320. Published online <http://colr.ucc.ie/review03.html>.
 27. See Chiapetta, *supra*, at 340–343.
 28. *Ibid.* at 341.
 29. See Maskus, *Vertical Distribution, supra*, at 323.
 30. Kobak, J. (2005). Exhaustion of intellectual property rights and international trade. *Global Econ. J.* 1, 1.
 31. Dinwoodie, G. B. & Janus, M. D. (2004). Trademarks and unfair competition: Law and policy. 714.
 32. For arguments favouring global exhaustion, see *The Case for re-introducing Global Trademark Exhaustion in EU Legislation* (2001) http://www.europarl.europa.eu/hearings/20010410/juri/5_frenkel.pdf. For arguments against see Harlander, L. (2000). Exhaustion of trademark rights beyond the European Union in light of *Silhouette International Schmeid v. Harlauer Handelsgesellschaft*: Toward stronger protection of trademark rights and eliminating the grey-market. *Ga. J. Int. Comp. Law* 28, 267. For arguments both for and against see *Examination of Witnesses (Questions 221–237)*, Select Committee on Trade and Industry of the English Parliament (1999).
 33. Personal communication with Professor Rochelle Cooper Dreyfuss, NYU School of Law.
 34. See Dinwoodie and Janus, *supra*, at 713–715.
 35. *Ibid.*
 36. *Ibid.*
 37. Reed, K. (2002). *Levi Strauss v. Tesco and E.U. trademark exhaustion: A proposal for change.* *NW J. Int. Law Bus.* 23, 139–141.
 38. *Ibid.* at 140–142.
 39. The broadest scope of exhaustion is international, in which sale anywhere in the world exhausts an IP owner's rights.
 40. Reed, *supra*, at 142–143.
 41. *Ibid.* at 159.
 42. See *Davidoff & Cie, S.A. v PLD Int'l Corp.* 263 F.3d 1297 (11th Cir. 2001) (discussing the 'genuine' good requirement).
 43. *Ibid.*
 44. *Enesco Corp. v Price/Costco Inc.*, 146 F.3d 1083 (9th Cir. 1998).
 45. *Ibid.*
 46. Reed, *supra*, at 141–142.
 47. *Ibid.*
 48. Maskus, *Pharmaceutical Products, supra*, at 446.
 49. Although to some extent, treaties such as the Berne Convention did.
 50. See, for example, Berne Convention for the Protection of Literary and Artistic Works, 9th September, 1886, as revised at Paris on 24th July, 1971 and amended in 1979, S. Treaty Doc. No. 99–27 (1986) (stating in Art. 5(1): 'Authors shall enjoy, in respect of works for which they are

- protected under this Convention, in countries of the Union other than the country of origin, the rights which their respective laws do now or may hereafter grant to their nationals, as well as the rights specially granted by this Convention'). Also, TRIPS included provisions for basis minimum standards which countries were generally allowed to exceed. For example, the United States has a copyright term that is longer than that required by TRIPS.
51. For example, the United States as a major net exporter of IP favours substantive protections limiting parallel imports and providing strong enforcement mechanisms.
 52. Maskus, *Vertical Distribution, supra*, at 322–323.
 53. Maskus, *Investments, supra*, at 454.
 54. See TRIPS Preamble and Art. 3 [National treatment].
 55. Bradley, C. A. (1997). Territorial intellectual property rights in an age of globalism. *Va. J. Int. Law* **37**, 505, 584–585.
 56. *Ibid.* (Internal footnotes omitted) (Emphasis in original).
 57. A treaty implementing such a plan would require members to negotiate not only the determinants of global benefit but also the weight-factor given to such determinants.
 58. *Parallel Trade – Consumer Benefit or Consumer Loss?*, Association Des Industries De Marque 1–11 (1999).
 59. Maskus, K. E. (2000). Parallel imports. *Global Trade Policy* **23**, 1269–1284.
 60. Maskus, *Pharmaceutical Products, supra*, at 444.
 61. Barry, P. & Basler, B. (2004). *Battle Lines Drawn on Rx Imports*, AARP Bulletin (July/August 2004).
 62. Abbot, *supra*, at 619–622.
 63. *Ibid.*
 64. *Ibid.*
 65. Maskus, *Investments, supra*.
 66. *Ibid.* at 446.
 67. *Ibid.*
 68. *Ibid.*
 69. *Ibid.* (Also noting that there are other sources of parallel imports 'including free riding on market investments and the existence of varying price controls across nations').
 70. *Ibid.* at 454.
 71. *Ibid.*
 72. *Ibid.*
 73. Personal communication with Professor Rochelle Cooper Dreyfuss.
 74. See Abbot, *supra*, at 607. Also see, Maskus, *Vertical Distribution, supra*, at 320 (noting that 'there is a significant linkage between declining trading costs and the gains from parallel imports, with such trade becoming more likely to improve welfare as trade barriers are reduced').
 75. Maskus, *Investments, supra*, at 334.
 76. *Ibid.* At 446.
 77. *Ibid.*
 78. *Ibid.*
 79. Case, K. E. & Fair, R. C. (1999). Principles of economics. 109.
 80. *Ibid.*
 81. An example of a perfectly inelastic good would be an organ. Someone requiring a necessary organ would pay any price but a person not requiring an organ would not pay any price whatsoever.
 82. An example of a perfectly elastic item is money. A (rational) person will never pay more than the value of a bank-note but will always pay less than the value of the bank-note.
 83. Professor Maskus has noted that the desirability of regulation of parallel imports may be determined empirically from three main determinants: the elasticity of demand, the incentives to innovation, and market structure (Maskus, *Vertical Distribution, supra*, at 322). Such an analysis correctly deconstructs the issues behind parallel imports. TRIPS, in attempting to harmonise IPRs, attempted to construct broad principles regarding patents, copyrights, and trade marks. By analysing exhaustion in such broad terms, without analysing various countries specific demand elasticities, normative and market views concerning innovation, and their specific market structures, resulted in fundamental disagreement. TRIPS attempted to harmonise market structures partly by coercing developing countries into signing onto major provisions that were not beneficial to such countries. When confronted with parallel imports, countries with unique market economies and needs resisted. The United States, for example, is a large IP producer and requires profit margins sufficient to subsidise on-going innovation, that is R&D.
 84. Maskus, *Vertical Distribution, supra*, at 321.
 85. *Ibid.*
 86. *Ibid.*
 87. Abbot, *supra*, at 620.
 88. Maskus, *Vertical Distribution, supra*, at 321.
 89. Maskus, *Vertical Distribution, supra*, at 323 (stating '[G]overnment enforcement of territorial rights invites rent-seeking' and 'The claim that buttressing territorial restraints with restrictions against parallel imports could generate collusion is consistent with past evidence in the US').
 90. *Ibid.* A country's parallel import policy is not binding on other countries. Nonetheless, countries that can benefit from markets which allow parallel

imports would likely push for international exhaustion of rights, that is pro-parallel imports.

91. *Ibid.*
92. Chiappetta, *supra*, at 336.
93. See Abbot, *supra*, at 619–622.
94. The parallel import policy might also be further subdivided among types of IPRs such as trade marks, patents, and copyrights. In general, this paper posits that a uniform rule without distinction as to the IPR is acceptable as long as distinctions with respect to certain IPRs are allowed (possibly required) when a country wishes to deviate from the international norm.
95. *Ibid.* at 323.
96. Personal communication with Professor Rochelle Cooper Dreyfuss.
97. See generally, Maskus, *Investments, supra* (discussing the effect parallel imports have on incentives to innovate in pharmaceuticals).
98. Self-interested behaviour is here defined as behaviour that produces negative externalities on other countries.
99. See Maskus, *supra* (all references).
100. Merges, R. P. & Duffy, J. F. (2002). Patent law and policy: Cases and materials. 48. See also 35 U.S.C. §154(a)(1) which grants patent holders ‘the right to exclude others from making, using, offering for sale, or selling the invention throughout the United States or importing the invention into the United States’..
101. See generally, Maskus, *Vertical Distribution, supra*.
102. Usually 70 years after the death of the author and in some cases the shorter of 95 years from publication or 120 years from creation.
103. Abbot, *supra*, at 612.
104. Trade marks protect the value that product goodwill affords and as such provide tangential incentives to create goodwill. Personal communication with Professor Rochelle Cooper Dreyfuss.
105. Abbot, *supra*, at 612. See generally, Dinwoodie, *supra*.
106. *Ibid.*
107. See Reed, *supra* (arguing in favour of the hybrid US exhaustion system of trademark rights).
108. Reselling a good that is ‘a materially different product’ is considered infringement. See 19 C.F.R. 133.2(e) (2002). In addition, the quality-control exception recognises that if the reseller does not adhere to the trademark holder’s quality control standards, then the reseller will be liable for the resulting tarnishment of the trade mark’s image. In other words, the trade mark is no longer a genuine good. Additionally, a repackager of a good must identify that it has repackaged the goods and not the product’s original maker. In one of the earliest cases on the subject of parallel importers, *A. Bourjois & Co., Inc. v Katzel*, 260 US 689 (1923), the Supreme Court determined many of the important precedents of trademark law in the United States, establishing early on that trade marks were generally territorial in nature. Prior to *Katzel*, trade marks were considered as following the chattel in the stream of commerce, thereby barring infringement if the chattel traveled to a country where the exclusive rights to the trade mark was held by someone other than the owner of the good. *Silhouette International*, 1998 E.C.R. I-4831. This theory of universality of trade marks, while consonant with a view that trade marks function to protect consumers against confusion, did not, in the court’s opinion, adequately address trade mark’s function in protecting an owner’s investment in their business.
109. An example of a sumptuary good includes designer clothing that is often priced far beyond margin.
110. In 2001, members of the World Trade Organization enacted the ‘Doha Declaration on the TRIPS Agreement and Public Health’. The agreement was intended to affirm that IPRs should not restrict government attempts to protect the public health. Nonetheless, the United States has negotiated numerous bilateral and regional free trade agreements imposing ‘TRIPS-plus’ IPRs weakening the public health provisions of TRIPS. See generally, *Patents versus Patients: Five years after the Doha Declaration*, 95 Oxfam Briefing Paper 1 (2006).
111. Maskus, *Pharmaceutical Products, supra*.
112. For example, medicines can be specially marked and shaped so their status as low-cost medicines for a single market are identified.
113. Of course, if negotiators to TRIPS intended no-rule, this paper argues that such a determination was flawed.
114. *Centrapharm v Winthrop*, E.C.R. 1183 (1974).
115. EU Council Directive 89/104/EEC (1988).
116. Reed, *supra*, at 139.
117. Maskus, *Vertical Distribution, supra*, at 333–334.
118. Price – essentially money – is a proxy for the value of a good relative to other goods. To the extent that something, like happiness, is intangible and putatively unquantifiable, a proxy can usually be found. For example, the number of smiles a person gives per day could measure happiness. Like any proxy, they are unlikely to be accurate but are arguably precise.
119. See Maskus, *supra* (all references).
120. If the transport costs with respect to the good are also high, then the country might nonetheless be unable to receive its desired medicines since the added price may be above what local consumers can afford. In such situations, countries may have to rely on charity.