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The Exhaustion Principle and the "Silhouette" Case

I. History of Exhaustion Rule

The exhaustion principle of industrial property rights has become part of European patent, trade mark and copyright law since its conception. This legal rule existed in German case law before, 1) and it was derived by the European Court of Justice from Arts. 30 and 36 EC Treaty. The ECJ had interpreted these articles as guaranteeing the free movement of goods and services within the European Community. Since it was the aim of the Treaty to abolish barriers between member states, the exercise of industrial property rights should not lead to interference with free trade.

Therefore the definition found by the ECJ was that a sale with approval of the right holder precludes any interference with the further distribution of the same products in another member state. In trade mark law the most important cases involved *Centrafarm v. American Home* 2) which was the first in a series of repackaging cases. 3) The most recent cases concerning repackaging issues were decided by the ECJ in 1997. 4)

A classic definition of the principle of exhaustion can be found in a patent case, namely the *Sterling Drug* case 5) where the ECJ stated:

A derogation from the principle of free movement of goods is not justified where the product has been put on the market in a legal manner, by the patentee himself or with his consent, in the Member State from which it has been imported, in particular in the case of the proprietor of a parallel patent.

This rule was extended in the *Merck* case 6) where the patentee had marketed his products in a member state without patent protection for pharmaceuticals (Italy). The ECJ confirmed that the decisive criterion is not the existence of patent protection in the country of first sale but the consent of the patent owner to the marketing of the product in question.

The exhaustion rule in patent law was later confirmed in another *Merck* case (*Merck v. Primecrown*) where it was stated by the ECJ that the "old" *Merck* rule is still valid law. Therefore the ECJ confirmed that the first marketing of a product within a member state with the consent of the patent owner will lead to exhaustion independent of the fact whether price regulations in the first country had impeded the marketing possibilities and thereby the remuneration of the patentee. 7) The ECJ reminded the patent owner that it is clearly his choice if he wants to market his products in such a country in the first place.

II. Facts of "Silhouette"

The *Silhouette* case was referred to the ECJ by the Austrian Supreme Court for a preliminary ruling under Art. 177 on the interpretation of Art. 7 of the Harmonization Directive. 8) Article 7 provides for an exhaustion of rights for goods that have been marketed by the

proprietor or with his consent in the European Community or in the European Economic Area.

Silhouette manufactures high-price spectacles that are marketed worldwide and normally sold by the producer to opticians. Hartlauer, the defendant in this case, is a low-price chain of distributors, which is not supplied by Silhouette because of its low-price policy.

In 1995 Silhouette sold approximately 20,000 out-of-fashion spectacle frames to Bulgaria for export in that country or in the countries of the former Soviet Union. The agreement with the Bulgarian company contained an export prohibition to the European Union. Hartlauer then apparently had purchased those spectacles directly from the Bulgarian company and re-imported them into Austria. Silhouette brought action requesting a preliminary injunction before the Austrian courts arguing that these spectacles had been commercialized within the EU without the consent of the trade mark owner.

Silhouette lost in two instances and filed an appeal on the law to the Austrian Supreme Court. The Supreme Court acknowledged that no consent of the trade mark proprietor was in fact given. It examined the scope of Art. 7 of the Harmonization Directive and its implementation into Austrian law by Art. 10a of the Trade Mark Act. It noted that the explanatory memorandum of the Austrian legislators indicated that in view of the former principle of international exhaustion in Austrian law it was intended to leave the interpretation as to whether the European-wide exhaustion excluded the recognition of international exhaustion under Austrian law to judicial decision. The Austrian Supreme Court therefore stayed the proceedings and referred the case to the ECJ. 9)

III. First Question

With its first question, the Austrian Supreme Court wanted to know whether national rules that provide for international exhaustion are contrary to Art. 7 of the Directive. With respect to the European-wide exhaustion of trade mark law, a number of authors were of the opinion that Art. 7 of the Directive pronounces a minimum standard that leaves room for national legislators or courts to apply international exhaustion. 10) Most of these authors overlooked that it could not have been the intent of the European legislators to leave this question to national law. The application of an international exhaustion rule in one country would immediately have European impact, since products sold outside the Community would come back through that country flooding the Community. 11) If one or a few countries apply the principle of international exhaustion within the Community, internal barriers would be established which were intended to be abolished by the Trade Mark Directive. 12)

In the case before the ECJ, the Austrian, French, German, Italian and the UK governments, together with the Commission, all argued that such an interpretation of Art. 7 must be rejected. The only government that took a different view was the Swedish one which referred to Art. 100 of the Treaty under which the Directive had been adopted and which allegedly excludes a rule governing relations among member countries and non-member countries of the Union. This argument was rejected by the ECJ. 13)

The ECJ agreed with the majority and the opinion of the Advocate-General and argued that it is the purpose of the Directive to safeguard the functioning of the internal market, and that different exhaustion rules would give rise to barriers to the free movement of goods.

IV. Second Question

With its second question, the Austrian Supreme Court was not asking for a clarification of the procedural consequences of an international exhaustion principle as such, but limited the question to the interpretation of Art. 7 of the Directive, namely whether Art. 7 can alone constitute the basis for the grant of an injunction against parallel imports.

Austrian trade mark law normally allows prohibitory injunctions only if, in addition to a trade mark infringement, there is also a breach of unfair competition law, namely the existence of a risk of confusion as to the origin of the products. This of course is not given if the original products of the trade mark proprietor are concerned, and not even a difference in quality - as would be the case in production by a licensee - can be alleged as in some of the earlier exhaustion cases, e.g., the Cinzano decision of the German Supreme Court. 14) Therefore, the Austrian Supreme Court wished to know in its second question whether Art. 7 of the Directive constitutes a right in itself for granting an injunction, since the Austrian legislators had implemented Art. 7 into Austrian law in virtually identical terms, but did not implement Art. 5 (1)(a) of the Directive.

The ECJ argued that the Directive normally does not have direct effect and therefore does not of itself impose obligations on an individual. However, as the Advocate-General had already stated, this was not the question asked by the Austrian Supreme Court. The ECJ then continued that the rights for restraining someone from making use of a third party's trade mark must be derived from Art. 5 of the Directive. It is not clear whether the Court wanted to take the position that Art. 5 provides for prohibition rights only against third party marks, but not against use of a trade mark by a third party if the mark has been affixed to the product by the proprietor himself. This would mean that if there is no violation of Art. 5, additional circumstances must be given for the grant of an injunction, and it is up to the national courts or the legislators to define the prerequisites for such a prohibition. The Court did not follow the suggestion of the Advocate-General that Art. 5 should be read into national law with the aim to interpret national law in conformity with the goal of the Directive. This is surprising, since according to the ECJ's very own case law, national courts must provide effective remedies for the enforcement of Community rights. Such enforcement must not be rendered impossible in practice or excessively difficult. 15)

Therefore one would have expected that the Court would interpret Art. 5 by telling the Austrian legislators that they had perhaps wrongly implemented the Directive into national law, and that a restrictive interpretation of Art. 7 would make its enforcement practically moot. Denying an injunction to the trade mark owner means taking back with the right hand what the ECJ had first given with its left hand in respect to Question 1. If indeed a national law requires confusion as to the origin of the respective products for the grant of an injunction, trade mark owners will have a problem, since in a situation of re-importation of original products neither a risk of confusion as to source nor as to the quality of the products normally exists. This would mean that the exhaustion principle as contained in Art. 7 is limited to the enforcement of contractual rights in a license agreement, i.e., the allowability of an export prohibition, so that the trade mark owner could not file an action for trade mark infringement against third parties that are not bound by contractual obligations. If one leaves the enforcement to national law, a distortion of the free movement of goods within the Community would still be inevitable.

In the Advocate-General's opinion, he agreed with the Court on the first question and had also rejected the principle of international exhaustion, indicating a possible price difference with

respect to identical goods between a country allowing international exhaustion and other countries in the Union. As already mentioned, he was however of the opinion that the trade mark owner could enjoy, on the basis of Art. 7, the use of his trade mark by third parties for products coming from outside the EU.

V. Critical Remarks

The decision of the ECJ must be criticized for several reasons.

a) It must first be remembered that without an exhaustion rule the trade mark owner enjoys exclusive rights within a certain territory, and he therefore is normally entitled to stop goods at the borders of the respective territory bearing an identical mark to his own. This right exists against all third parties as an absolute right under trade mark law. The German legislators therefore correctly explained in the government notes on Sec. 24 - the rule implementing Art. 7 into the German Trade Mark Act - that the trade mark owner enjoys "rights based on trade mark law" (markenrechtliche Ansprüche) as opposed to contractual rights.

Therefore Art. 5 is the general rule for the granting of an injunction, and Art. 7 defines an exception or limitation to this right. If that is the case, the right to an injunction remains, if the conditions of Art. 7, the exception, do not exist, i.e., if exhaustion must be denied. 16) While the argument of the ECJ might be acceptable that an individual cannot directly rely on Art. 7 for the grant of such a prohibition, in its hint to Art. 5 it should have been more specific in order to make it clear that in such a case there are no restrictions that exclude the enforcement of trade mark rights against parallel imports. If Art. 7 does not contain a mechanism for the grant of an injunction, Art. 5 does. This clarification has not been given by the ECJ which apparently felt obliged to interpret the question of the Austrian Supreme Court very restrictively, thereby leaving all other points open.

b) This clarification would have been more appropriate since the application of Art. 5 to situations where no confusion as to origin is given was the very issue of the Silhouette case. It is therefore surprising that one does not find a confirmation in the decision that Art. 5 does not require confusion, as far as identical marks and identical products are concerned.

Article 5(1)(a) reads: "The proprietor shall be entitled to prevent all third parties not having his consent from using in the course of trade: a) Any sign which is identical with the trade mark in relation to goods or services which are identical with those for which the trade mark is registered."

Only in paragraph (b) where similar marks and services are dealt with, can one find the condition of likelihood of confusion as an additional requirement. This provision has been taken over from the Directive by the German legislators in Sec. 14(1) Trade Mark Act, and German scholars and practitioners are unanimous in their view that no risk of confusion is necessary in case of identity of marks and identity of goods. 17)

In fact, this author was of the opinion so far that it was one of the basic elements of the new harmonized European trade mark law that indication as to origin is no longer the only function of a trade mark and has been extended to other functions like quality and advertisement, 18) so that the confusion as to origin is no longer a necessity for being able to enforce trade mark rights. In fact, in most countries the harmonized trade mark laws do not require likelihood of confusion if there is identity of marks and identity of goods and/or

services. 19) If therefore a country did not recognize the significance of Art. 5 and did not properly implement this rule into national law, the ECJ should have corrected this mistake.

c) Were the view to be taken with respect to Art. 7 that the enforcement of trade mark rights by way of a trade mark infringement action is excluded, this article would be limited - if at all - to a "white clause" in trademark licensing agreements that would allow parties to agree on a prohibition as to the re-importation of goods but not give the trade mark owner the necessary weapon to stop re-imported products on the market that are no longer in the hands of the licensee.

The distinction between contractual and absolute rights is of primary importance in licensing practice. Under the laws of many countries a licensee who exceeds the rights granted to him by the license agreement commits patent or trade mark infringement. This means that products sold by the licensee in violation of the agreement are infringing products and can be stopped even after they have been sold on the market. This is the logical result of the definition of an absolute right of which the licensee has only received a part that he has been allowed to exploit while the trade mark owner, i.e. the licensor, has retained all other rights.

In the past this interpretation had been applied in Germany only to patents. Under the new Trade Mark Act, trade marks are also regarded as absolute rights with the same consequences as described before. The additional result of a violation of an absolute right in contrast to contractual violations is that the licensor is not limited to requesting royalties, but he can also ask for damages calculated as in any other trade mark or patent infringement suit.

Does this mean that the ECJ does not regard a trade mark as an absolute right with respect to Art. 7? This would be in contradiction to the Puma decision where the Court had confirmed that no risk of confusion must be proven if the marks are identical. 20) A limitation of the enforcement of trade marks would also mean that those who had hoped that licenses to countries outside the EU could be granted without any risks, and therefore more generously, have been deceived. Who will take the risk of granting licenses to developing countries if it must be feared that "original" products can so easily be brought into the Community, as was the case with the Silhouette products?

It is indeed regrettable that when answering the two questions asked by the Austrian Supreme Court the ECJ has tried to answer the trade mark part of the problem without considering the commercial implications and ramifications that a more difficult enforcement of re-importation clauses in license agreements will have. The ECJ is certainly aware that practitioners have repeatedly demonstrated that licensing of technology and licensing of trade marks have an enormously beneficial effect on international trade. Many more license agreements would be concluded if the licensor could effectively limit a license outside the Community to a certain territory and if he could rely on clear and safe rules against re-importation. 21)

Where a licensor, himself, produces in a market with high production costs and high safety standards, environmental restrictions and so forth, he has a general commercial interest in being protected against the re-importation of "his" products manufactured in a different environment, with lower wages, lower safety standards and less environmental protection in regard to the manufacturing process. No one can force all governments in developing countries to raise the safety and environmental standards to the level of that in Europe and the US. No developing country could afford to raise wages to western standards, and Germany has experienced that even raising the wages in East Germany without improving productivity at the same time can lead to high unemployment because of lack of competitiveness.

Therefore, it makes sense to manufacture products in other parts of the world, with know-how from industrialized countries but at lower prices, and distribute them under trade marks that guarantee the same quality, or at least the quality that satisfies the needs of the local market. If there is a high risk that those products come back through gray trade channels without the possibility of stopping them at the borders of the EU, licensing will certainly not increase and probably even be reduced - not only in the trade mark field, but also in regard to patents. The view that a limitation of the exhaustion principle would only benefit multinational companies 22) can therefore not be shared. Licensing is a chance for small and medium-size companies; multinationals can manufacture themselves. The limitation of the exhaustion principle in copyright law therefore has the primary goal of protecting the individual author by allowing him to apply a selective pricing and distribution policy. 23)

VI. Practical Cases

While the economic and political principles are far from being reconciled, the legal rules of what constitutes exhaustion in a given case might even pose more problems.

One case was recently decided by the Cologne Court of Appeals that concerned the sale of the famous Mercedes star which the cars of that manufacturer proudly carry on the front of the automobile and which are very often the object of souvenir collectors. While the original star is fixed to the car by a roller bearing joint, but easily breaks if one turns it beyond a certain point, the stars of the defendant who had marketed them without authorization of Daimler Benz could be easily removed by the owner with a bayonet joint so that he could always take it off when parking the car. The court of appeals decided that the modification of the original construction principle can be enjoined by the trade mark owner, and exhaustion of his trade mark right must be denied. The general admissibility of the reproduction of spare parts has its limits where absolute rights like a trade mark are infringed.

Some cases go even further. The German Supreme Court decided the case of a towel dispenser normally installed in bathrooms of restaurants, airports etc. The container for the paper towels carried a particular trade mark for which a third party had delivered paper towels in violation of the delivery agreement between the manufacturer of the dispenser and the restaurant. The Supreme Court affirmed the existence of an infringement and that no exhaustion of the trade mark on the dispenser had occurred.

A similar case was later decided by lower courts for soap dispensers. If the dispenser shows a particular trade mark, the consumer must assume, according to the court, that the product within the dispenser has been produced by the trade mark owner. The trade mark right of the proprietor is not exhausted, independently of the fact whether he had given the dispenser for free to the restaurant or whether it was sold. 24) Similarly a number of cases have been decided in the context of the repair of patented or trade marked products. Normally the courts consider whether a repair comes close to being a new manufacture and must therefore be subject to the authorization of the trade mark or patent owner. 25)

From the above considerations it becomes clear that it was certainly premature to argue, as some commentators did, that parallel import cases in the future will easily be dealt with by preliminary injunctions. In this author's view, the interesting part of the discussion, as to what the Silhouette case actually means, has only started.

In particular, the following questions will have to be examined:

- What does consent mean? Is express consent required or is also implied consent sufficient? What if the consent is limited to a certain territory, but the importer has no contractual relations with the trade mark proprietor?
 - What does putting on the market mean? If the products are still in the hands of distributors, are they already on the market? What if the distributor is contractually linked with the trade mark proprietor who has made a reservation as to a certain form or territory of sale?
 - Is there a difference between parallel imports (source outside of the EU) and re-importation (source within the EU with subsequent exportation and re-importation)?
 - What is the relationship with Art. 85? Does Art. 7 of the Directive allow prohibition of re-importation? Can the *Javico/Yves Saint Laurent* (26) decision of the ECJ be interpreted as allowing a re-importation prohibition if it concerns a territory outside the Community, or would Art. 85(1) EC Treaty be also applicable in such a case? Should one keep silent about re-importation in a sales agreement? Is a clause "To be sold in country X" to be preferred to an express prohibition?
- It remains to be seen whether the other exhaustion cases that are still pending before the ECJ might answer some of these questions.

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- 1) For the history of German case law see Loewenheim, 1996 GRUR Int. 307.
- 2) ECJ, *Hoffmann Laroche v. Centrafarm* - 10 IIC 231 (1979).
- 3) ECJ, 9 IIC 580 (1978).
- 4) Three consolidated decisions *Bristol-Myers Squibb/Boehringer/Bayer v. Paranova, Eurim Pharm v. Beiersdorf/Boehringer/Farmitalia and MPA Pharma v. Rhône-Poulenc* - 28 IIC 715 (1997).
- 5) ECJ, 6 IIC 102 (1975).
- 6) ECJ, 13 IIC 70 (1982).
- 7) ECJ, December 5, 1996, *Exhaustion of Rights* - 29 IIC 184 (1998).
- 8) Art. 7: "(1) The 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 trade mark by the proprietor or with his consent. (2) Paragraph (1) shall not apply where there exist legitimate reasons for the proprietor to oppose further commercialization of the goods, especially where the condition of the goods is changed or impaired after they have been put on the market." (First Council Directive of December 21, 1988, to Approximate the Laws of the Member States Relating to Trade Marks (89/104/EEC)).
- 9) The questions submitted to the ECJ by the Austrian Supreme Court read: "1. Is Article 7(1) of the First Council Directive of 21 December 1988 to approximate the laws of the member states relating to trade marks to be interpreted as meaning that the trade mark entitles its proprietor to prohibit a third party from using the mark for goods which have been put on the market under that mark in a state which is not a contracting state? 2. May the proprietor of the trade mark on the basis of Art. 7(1) of the Trade Mark Directive alone seek an order that the third party cease using the trade mark goods which have been put on the market under that mark in a state which is not a contracting state?"
- 10) Cf. *Albert & Heath*, 1996 GRUR 275, 28 IIC 24 (1997).
- 11) *Accord, Beckmann*, 1998 GRUR Int. 836, 839.
- 12) This view had already been taken by the German Supreme Court in the *Dyed Jeans* case, 28 IIC 131 (1997); see also Munich Court of Appeals, 1996 GRUR 137 - *GT All Terra*; contra, *Albert & Heath*, supra note 10.
- 13) For this argument, see also Loewenheim, 1996 GRUR Int. 307, 314.
- 14) Federal Supreme Court, 4 IIC 432 (1973).
- 15) *Accord Grauel*, 1998 MA 55, 56.
- 16) For discussion of the exhaustion rule under former German law, id.
- 17) This view can also be found in the 10th recital of the preamble to the Directive.
- 18) *Accord, Beckmann*, 1998 GRUR Int. 836, 840; *Grauel*, 1998 MA 55, 56.
- 19) Cf., for France, Art. 713(2), *Code de la propriété intellectuelle*; for the Netherlands, Art. 10a *Trade Mark Act*; see also *van Bunnem*, 1998 GRUR Int. 942.
- 20) ECJ 29 IIC 54 (1998) - *Sabèl*, 9th. recital.



21) This "property function" of the trade mark is also underlined by Beckmann, 1998 GRUR Int. 840; also Loewenheim, 1996 GRUR Int. 315, points out that limitation of the exhaustion principle serves to improve the value of the trade mark for its owner and could therefore be regarded as a consequence of the recognition of the broader protection of famous marks.

22) Cf. Albert & Heath, 1996 GRUR 275, 279, 28 IIC 24 (1997).

23) See Loewenheim, 1996 GRUR Int. 307, 316.

24) Federal Supreme Court, 1987 GRUR 438, 20 IIC 228 (1989) - Towel Dispenser.

25) Cf. Kunz-Hallstein, "Zur Frage der Parallelimporte," in "Festschrift Krieger," 1998 GRUR 268, 282, with further references.

26) 29 IIC 798 (1998). For a discussion of these questions see also Joller, 1998 GRUR Int. 751, 760.