Quality control in trade mark licensing
- a privilege or an obligation?

With a law and economic perspective it is examined how EU trade mark law deals with quality control within trade mark licensing.

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Many thanks to my supervisor Stojan Arnerståhl for valuable help.
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Abbreviations

CFR  Charter of Fundamental Rights of the European Union

CJEU Court of Justice of the European Union

EEC Treaty Treaty establishing the European Economic Community

E.I.P.R. European Intellectual Property Review

EU European Union

EUIPO European Union Intellectual Property Office

EUTM European Union Trade Mark


NIR Nordiskt Immateriellt Rättskydd

Paris Convention Paris Convention for the Protection of Industrial Property of March 20, 1883

TCE Transaction Cost Economics

TEU Treaty of the European Union
<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
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<tr>
<td>TFEU</td>
<td>Treaty on the Functioning of the European Union</td>
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<tr>
<td>TRIPS Agreement</td>
<td>The Agreement on Trade-Related Aspects of Intellectual Property Rights (1994)</td>
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<tr>
<td>UK</td>
<td>United Kingdom</td>
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<td>US</td>
<td>United States of America</td>
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Abstract

Licensing agreements are commonly used when, for instance, exploiting new areas or countries. Trade mark licences are one such example. A trade mark licence gives the proprietor the opportunity to keep its exclusive rights at the same time as another party uses the trade mark in commercial purposes. When licensing an EUTM to a third party, it is possible to include quality control clauses in the agreement in order for the licensor to control that the licensee uses the trade mark correctly. The possibility to include quality control implies that there is no such obligation within EU trade mark law. Yet, in the US, quality control is not only a possibility but also an obligation in order to keep the trade mark registered. Therefore, it is of interest to examine European trade mark law in relation to quality control in licensing. The American view of quality control is examined for illustrative purposes. Within the EU, the essential function of an EUTM means the ability to identify the origin. In addition, one single undertaking is responsible for the quality that is needed for the trade mark to fulfil its essential role in the system of undistorted system. Quality is seen as an economic function of the trade mark and therefore it should not be an obligation to include quality control in trade mark licences. The proprietor should bear the responsibility him- or herself when not including quality control. As a contrast, in the US, the consumers must be protected from deception and therefore it is a requirement for the proprietor to control and maintain the quality by including quality control in trade mark licences. If a trade mark licence does not include quality controls, the licence is considered invalid and the trade mark is considered abandoned. Furthermore, a law and economics perspective is included in the thesis and specifically the theory of TCE and the belonging terms or bounded rationality, opportunism, uncertainty and trust. While the EU seems to value trust more when settling licence agreements, the US seems to value opportunism and uncertainty more due to de facto that consumers must be protected from the proprietors. Since quality control within trade mark licensing appears to lock the proprietor into a situation where it is difficult to differentiate and change the direction of the trade mark, it should not be an obligation to include quality controls in trade mark licences. It should be a privilege for the proprietor to decide on whether to use or not and bear the consequences of that choice.
1. Introduction

1.1 Background

Trade mark law nowadays is a principal factor regarding the marketing and advertising of a business. In the commercial scene of free competition there are different interests among the trader, competitive trader and the consumer. The trader wants to protect its reputation and earns a sort of a monopolistic behaviour when registering a trade mark while the competitive trader seeks to compete with that position. At the same time, the consumer wishes to associate a certain quality with a certain business in order to make a purchase without being confused. In other words, the trade mark should be able to identify as to origin. Furthermore, the increased globalisation of businesses makes the trade mark holders influenced into outsourcing due to limitations of doing it by themselves.

A trade mark licence is often part of another licence such as franchising licences or patent licences. In recent years the phenomenon brand stretching has increased, which is when the trade mark proprietor begins to use the trade mark on behalf of new products either by themselves or by licensing to a third party. With a trade mark licence, the trade mark rights are licensed to a licensee in order for the licensee to use the trade mark without the risk of infringing the trade mark holder’s rights. The positive aspect of outsourcing is for example the opportunity to increase sales and knowledge about the company. The negative aspect of outsourcing though is de facto the loss in control of the trade mark that the proprietor faces. For every added intermediary, the connection between the proprietor and the consumer increases, and as a consequence, it could affect how the trade mark and belonging products are portrayed commercially.

A person or business that decides to register a trade mark could either register a national trade mark only protected in a certain territory or register an EUTM. When registering an EUTM, the proprietor seeks protection in the whole EU

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4 Arnerstål, S. Varumärket som kontraktsföremål, p. 45-46.; C-376/11 (Pie Optiek), para. 47.
directly instead of selected EU Member States. One of the legal aspects of EUTM licensing is making it applicable with the EUTMR. From article 25(2) EUTMR it is possible for the licensor to invoke the licence if the licensee does not fulfil the provisions stated in the article. The indent (e) expresses that a licensor can end the licence if “the quality of the goods manufactured or of the services provided by the licensee” contravenes the licence. In combination with the essential function of a trade mark, which is the ability to identify the origin, it could be assumed to be important for the proprietor to control that the licensee uses the trade mark correctly. The licensor has the possibility to include requirements on how the licensee must use the trade mark and belonging products or services. Furthermore, there is no requirement for the licensor to actually control that the licensee respects and follows the stated requirements. If comparing to American trade mark law, US-based trade mark licence agreements must include quality control. If there is no control, there is no valid licensing agreement since the licensor then assumes to have abandoned his or her own rights. In other words, the trade mark would then not be considered as genuine.

Quality control within trade mark licensing implies that quality is a part of the trade mark law. Depending on whether one is looking at European or American trade mark law, there are different approaches towards how the quality criteria is viewed at. The European approach is that in the system of undistorted competition the trade mark is used as a guarantee of indicating that the belonging goods and services holds the same quality and are controlled by the proprietor. This means that quality is only a function and not an essential function of a trade mark. The American approach indicates that quality has a more central role in the scope of trade mark law since a consumer uses the trade mark in the purchase stage as an assurance to quality. These different approaches generate different standpoints when it comes to licensing agreements and it is therefore interesting to examine how and why there is a difference.

8 C-299/99 (Philips), para. 30.; C-206/01 (Arsenal), para. 48.
Nevertheless, trade marks are not important solely as a legal instrument. There are also economic functions of having a trade mark that are of value for the proprietor. The value, or goodwill, that a trade mark develops is used in order to influence consumers and affect consumer behaviour.\(^\text{10}\) In turn this affects, inter alia, sales and market shares. As described above, it is possible to strengthen the business and belonging trade mark even more if licensing some of the business to another party. As an economic perspective to the addressed legal issue, it is interesting to examine how the different standpoints in the EU and in the US regarding whether forced quality control is important or not, correlate to the economic theory TCE. The theory states that it is sometimes better to continue with in-house production due to the costs that comes with every transaction the business do with another business.\(^\text{11}\) Every agreement includes both monetary costs and non-monetary costs such as time spent and depending on having a trade mark licence in the EU or in the US, it could be assumed that TCE is viewed differently.

### 1.2 Purpose and Research questions

The purpose of this thesis is to examine European trade mark law in relation to quality control in licensing. To be able to have a discussion about quality control, the definition of quality needs to be addressed. In order to get a more thorough understanding, a smaller comparative study will be made including American trade mark law and its view on quality control. Since trade marks are an important part of the business environment and competition between companies, it is also interesting to have a law and economic perspective included in the thesis. This perspective appears to be more developed within American trade mark law compared to European trade mark law and could perhaps affect the outcome on how to construct trade mark licences. The thesis will have a TCE perspective in order to understand the legal approach from an economic perspective. As Cooter and Ulen describe, an economic analysis of law connects two major subject fields and make it easier for people to understand the different areas.\(^\text{12}\) Law and economics affect, as well as depend on, each other and it is therefore of

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\(^{10}\) Griffiths, A. *An Economic Perspective on Trade Mark Law*, p. 5.


impotance to combine these two areas in the discussion about trade mark licensing and quality control.

In order to fulfil the purpose of the thesis the following questions will be answered:

- How is quality control dealt with within European trade mark licensing?
- How is quality control dealt with within American trade mark licensing?
- How does quality control affect the transaction cost economics?

1.3 Method and Material

To be able to answer the purpose and questions of the thesis, different method approaches have to be taken into consideration. The general method throughout the thesis is a traditional legal dogmatic method. In addition, EU law method, comparative law as well as an economic analysis of law will be used for the more specific areas of investigation. Below the different methods will be explained more thoroughly.

Firstly, to be able to make an examination of the legal approach towards quality control in the EU it is necessary to use the EU law method. The method is based on a teleological approach, which means that the provisions should be interpreted from its purpose rather than as an isolated provision.13 The primary sources of EU law outline the function of the EU and could be found in the Treaties and in the Charter.14 Also, primary sources of EU law include the general principles developed by the CJEU, which the EU Member States must follow. Case law from the CJEU is also binding. EU Regulations and Directives are secondary sources of EU law. International law such as the TRIPS Agreement and Paris Convention are also secondary sources of EU law.15 The two systems have to correlate and since either the EU or the EU Member States have concluded the

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13 Hettne, J. and Otken, Eriksson, I (ed.). EU-rättslig metod, p. 36.
international agreements, the secondary EU legislation cannot contradict international standards.\textsuperscript{16}

The CJEU interprets the EU law and makes preliminary rulings when asked for by the EU Member States.\textsuperscript{17} The case law is classified as secondary sources of EU law and is important to consider when addressing legal issues.\textsuperscript{18} There is not much case law within the EU about the topic of quality control in licensing and therefore the use of doctrine is important to be able to answer the research questions of the thesis. One British case is included in the thesis regarding quality and quality control since it was referred to the CJEU for a preliminary ruling, but was withdrawn before the CJEU delivered its ruling. The case is interesting partly because of de facto that the national judge agreed with earlier EU case law, partly because it shows that the solution of the issues is unclear. Guiding sources of law such as the opinions of Advocate Generals and doctrine will also be used in order get a more comprehensive understanding.\textsuperscript{19}

Secondly, the method of comparative law will be used in the thesis since American trade mark law is included. It will be a smaller comparative study because it is easier to recognise negative and positive critique of the EU trade mark law that otherwise would be difficult to identify.\textsuperscript{20} By comparing different legal systems it is possible to obtain a more thorough understanding of the European legal system and it is therefore of interest to include an American aspect.\textsuperscript{21} The American trade mark law and the inclusion of quality have developed differently compared to EU law, which brings up the interest of comparing the two legal systems. As Zweigert and Kötz discuss, a lot of other different scientific areas such as economics, sociology and medicine are internationally developed and discoveries are shared between scientists across the world. Unlike those areas, law is territorial but when making it more international

\textsuperscript{16} Article 216(2) TFEU.
\textsuperscript{17} Hettne, J. and Otken, Eriksson, I (ed.) EU-rättslig metod, p. 49-50.
\textsuperscript{18} The principle \textit{Stare Decisis} is adressed. The term is latin and means "Let the decision stand".
\textsuperscript{19} Hettne, J. and Otken, Eriksson, I (ed.) EU-rättslig metod, p. 40.
\textsuperscript{20} Sacco, R. \textit{Legal formats: A Dynamic Approach to Comparative Law (Installment II of II)}, p. 385-386.
\textsuperscript{21} Zweigert, K. and Kötz, H. \textit{An Introduction to Comparative Law}, p. 21.
it is beneficial for how knowledge sharing increases.\textsuperscript{22} However, the American view on quality control will not be as deeply described as the EU view since it is for illustrative purposes only.

For the sake of comprehensiveness, the American legal system will be explained briefly. The US is built up on the common law system, which signifies a system with \textit{Stare Decisis}. The precedents are important and the lower courts are bound to follow what the higher courts have decided.\textsuperscript{23} There is state law that is the law in respective American state and there is federal law that is the law for the US as a whole.\textsuperscript{24} The federal court system includes District Courts, at least one in every state, Courts of Appeals that are divided into circuits of several states in each circuit. The Supreme Court is the highest court in the US and with guidance from the Constitution it keeps the internal market in the US legally functional.\textsuperscript{25} Every state has its own constitution as well as laws but those must be consistent with the Constitution of the United States of America in order to give the US a federal structure.\textsuperscript{26} This thesis will use \textit{McCarthy on Trademarks and Unfair Competition} as a starting point in order to understand the American trade mark law and find relevant cases. J. Thomas McCarthy is a well-reputed Senior Professor within intellectual property in the US and balances his analysing texts with case law from both Courts of Appeal and the Supreme Court. Other American doctrine will be used as well due to the importance of being reflective towards McCarthy’s opinions.

Thirdly, since licensing is not only a legal matter the perspective of an economic analysis of law will be used in the thesis. As Griffiths explains, an economic analysis of trade mark law generate valuable impact on the social welfare.\textsuperscript{27} From a quick overview of the subject, it seems as the US has included this perspective more compared to the EU when addressing legal matters such as trade mark law. Thus, it is interesting to, within the method of comparative law, also use an

\begin{flushend}
\textsuperscript{22} Zweigert, K. and Kötz, H. \textit{An Introduction to Comparative Law}, p. 15.
\textsuperscript{23} McAlinn, G., P., Rosen, D., Stern, J., P. \textit{An Introduction to American Law}, p. xxi.
\textsuperscript{24} Ibid., p. 1.
\textsuperscript{25} Zweigert, K. and Kötz, H. \textit{An Introduction to Comparative Law}, p. 250, 253-254.
\textsuperscript{26} Morrison, A., B. (general ed.). \textit{Fundamentals of American Law}, p. 28.; Zweigert, K. and Kötz, H. \textit{An Introduction to Comparative Law}, p. 239.
\textsuperscript{27} Griffiths, A. \textit{An Economic Perspective on Trade Mark Law}, p. 126.
economic perspective. One the one hand, it could be assumed that some of the answers to why there is a difference between the EU and the US derives from a more profound economic perspective in the US. On the other hand, the EU could, regardless the less visualised link between law and economics, have interpreted the economic perspective in a different way and thereof have a different legal outcome when addressing quality control within trade mark licensing. An economic perspective could develop a more thorough understanding when speaking about effects in society that are caused by legal decisions.28

For simplifying and narrowing the economic perspective, the economic theory TCE will be used. TCE is often used when comparing costs for in-house production respective outsourcing. The issue addressed in this thesis concerning quality control does not include the question whether a company should license the trade mark or not. Despite this, TCE is a useful tool in order to examine the differences between the EU and the US and to acknowledge the economic effects of either decision. The social and cultural differences between the two continents may, or may not, have affected the legal outcome differently depending on how the different behavioural assumptions are interpreted. It could also be easier to acknowledge the differences between the European and American system by referencing towards a more concrete aspect such as TCE.

1.4 Delimitations

Trade mark licensing also involves legal fields other than trade mark law and is important to acknowledge, such as contract law competition law etc. However, due to the scope of the thesis no other legal fields than trade mark law will be recognised in this thesis. Furthermore, international conventions and agreements will not be discussed more than necessary to explain the area when comparing EU and US trade mark law. Due to time as well as space constraints, national law within the EU will not be included more than necessary to get a more comprehensive understanding of the topic. UK trade mark law has a more extended case law on the topic compared to the EU and therefore will one case be included in the thesis. The TCE includes relation-specific assets but will be

excluded in this thesis due to time and space limitations as well as no distinct connection to the topic of the thesis.

1.5 Outline

In order to fulfil the purpose of the thesis and answer the questions, the thesis is divided into different sections as described. Chapter 1 includes information for the reader to receive a basic understanding of the structure and topic of the thesis. The following Chapter 2 will present the economic theory TCE and how it could be connected to trade mark licensing and quality control. Chapter 3 will discuss EUTM licensing and its relation to quality control. The following chapter 4 will include American trade mark law and its definition of quality control within trade mark licensing. In Chapter 5, there will be a comparison between EUTM licensing and American trade mark licensing in order to understand the differences in the definition of quality control and why there is a difference. This will be followed by a conclusion in chapter 6. Reflections will be made continuously throughout the thesis.
2. Economic perspective – Transaction Cost Economics theory

2.1 TCE

All activities and decisions in life include costs. The costs could be monetary but also non-monetary such as time and mental activity spent on the activity. For instance, misunderstandings and conflicts affect how and when an agreement is settled. Furthermore, an activity has different phases; preparations, the activity itself as well as supplementary work. These costs are called transaction costs within the economics field. In the early 1930’s, Commons described how transactions affect the governance structure. Later on, Coase developed the TCE and through time others have developed it further.

When a company considers outsourcing either the whole business or parts of it to a third party, there are often discussions and other activities made in beforehand, during and after the agreement. Coase described that resource allocation not only is decided due to price mechanisms, there are also non-economic transaction costs that should be taken into consideration when deciding on outsourcing a production or not. As a contrast to earlier studies, Coase stated that it is not always the cheapest option to license a production to a third party. Even though the actual production price could be lower. There are always transaction costs related to contracts even when keeping the production in-house, but according to Coase, those are highly reduced if not outsourcing. Furthermore, Coase described that every contract is unique and develops new transaction costs. As a consequence, it is not always a better option to outsource the business or parts of it compared to keep it in-house.

32 Ibid., p. 396.
33 Ibid., p. 404.
However, it took almost 50 years for the TCE to become more important due to the research of Williamson. He stressed how vertical integration could decrease the transaction costs that come along with outsourcing production and marketing. According to Williamson, transaction costs are based on the level of uncertainty, how regularly the relevant transaction is made as well as the degree of successful transaction-specific investments. Also, TCE is based on two major behavioural assumptions, namely that individuals are subject to bounded rationality as well as that some of the individuals are opportunistic. If individuals were subject to bounded rationality but without opportunistic behaviour, comprehensive contracts would be possible. When dishonest, or opportunistic, behaviour is occurring, it is a higher possibility to create incomplete contracts. Williamson’s definition of opportunism is “self-interest seeking with guile” and will be explained further in Chapter 2.2.

Transaction-specific investments, or relationship-specific assets are divided into Site specificity, Physical asset specificity, Human asset specificity and Dedicated assets. A common factor for the different relationship-specific assets is the fact that the made investments will lock the parties into the current relationship. The assets could be human labour and knowledge or specific movables that are bought for the manufacturing. The thesis will refer to transaction-specific investments but will not go into detail on which asset specificity is addressed.

As already described, there are various transaction costs in an exchange where, inter alia, a licence agreement is settled. In order to make the definition of

34 Oliver Eaton Williamson received the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2009 for his "analysis of economic governance, especially the boundaries of the firm". He is an American economist working as a Professor within the field of economic governance.; The Official site of the Nobel Prize. Oliver E. Williamson – Facts (electronic source).
38 Williamson, O., E. The Economic Institutions of Capitalism, p. 47.
exchange more understandable, Cooter and Ulen have divided the exchange into three parts: search costs, bargaining costs and enforcement costs.\textsuperscript{41} It is also common to divide the transaction costs into ex ante and ex post types where the signing of the agreement is the frame of reference. According to Williamson, ex ante transaction costs include the costs of drafting, negotiating and safeguarding the agreement. In contrast to this, ex post transaction costs occur after the agreement is signed and indicates the costs of supervision of agreed commitments and governance structure.\textsuperscript{42} As seen, Williamson as well as Cooter and Ulen use different definitions to divide the transaction costs. Considering that all phases are important for the understanding of how transaction costs are integrated in licensing, search costs, negotiating costs and enforcement costs include all the relevant aspects and will be used ahead. Below is a picture explaining how the transaction costs will be used in this thesis.

\begin{center}
\begin{tikzpicture}
    \node[fill=white, rounded corners, text width=2.5cm] (search) at (0,0) {Search costs};
    \node[fill=white, rounded corners, text width=2.5cm] (negotiate) at (0,-3) {Negotiating costs};
    \node[fill=white, rounded corners, text width=2.5cm] (enforce) at (0,-6) {Enforcement costs};
    \node[fill=white, rounded corners, text width=2.5cm] (ex_ante) at (2,-0.5) {Ex ante transaction costs (before signing)};
    \node[fill=white, rounded corners, text width=2.5cm] (ex_post) at (2,-3.5) {Ex post transaction costs (after signing)};
    \draw (search) -- (ex_ante);
    \draw (negotiate) -- (ex_ante);
    \draw (enforce) -- (ex_post);
\end{tikzpicture}
\end{center}

This thesis will focus on the transaction costs related to quality control in a licence agreement. Aspects of quality control can be found in both ex ante phase and ex post phase. In the ex ante phase, the costs developed in relation to quality control is important when searching for a partner to collaborate with. When referring to negotiating costs, there are costs relevant for the quality control that should to be taken into consideration. The negotiating costs could increase if the licensor discusses and includes quality control in the licence. As an effect, the

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{41} Cooter, R. and Ulen, T. \textit{Law and Economics}, p. 88.
\item \textsuperscript{42} Williamson, O., E. \textit{The Economic Institutions of Capitalism}, p. 20-21.
\end{itemize}
\end{footnotesize}
enforcement costs could increase as well since there will be a possibility to control the licensee. This will be discussed further in Chapter 2.3.

2.2 The behavioural assumptions of TCE

2.2.1 Bounded rationality
Williamson’s definition of bounded rationality derives from Simon who stated that a person subject to bounded rationality is “intendedly rational, but only limitedly so”\(^\text{43}\). It is described as a semi strong form of rationality since both directions of being rational should be reflected on.\(^\text{44}\) Being rational means acting and making methodological and conscious decisions whereas irrationality means the opposite.\(^\text{45}\)

2.2.2 Opportunism
As previously mentioned, Williamson explains opportunistic behaviour as when a person acts with guile for self-interest. Reflecting on ex ante versus ex post transaction costs, opportunism is included in both. Information asymmetry is derived from opportunism since there is disclosure of information, distortion or general confusion. As Williamson states, with stronger opportunism in the ex ante phase, it is more difficult to confront the issues in the ex post phase since there is much hidden information. In other words, the transactions made in the ex post phase will benefit from already made protective measures in the ex ante stage.\(^\text{46}\) Opportunism goes hand in hand with uncertainty since uncertainty emphasises an opportunistic behaviour and vice versa.\(^\text{47}\)

2.2.3 Trust
As explained earlier, the levels of uncertainty and opportunism are connected to each other. By natural causes they are also connected to trust that the parties have in each other when contracting. As Gambetta explains, there is trust when A and


\(^{44}\) Williamson, O., E. *The Economic Institutions of Capitalism*, p. 45.

\(^{45}\) NE. Rationalitét, (electronic source).


\(^{47}\) Ibid., p. 49.
B have an agreement and A trusts that B will perform in a way that is beneficial, in other words not harmful, for A.\textsuperscript{48} However, Williamson has not focused on trust as a division in the TCE even though he considered it to be important for the business-related strategic decisions.\textsuperscript{49}

Other researchers have developed trust as a component within the TCE. Bromiley and Cummings have stated that transaction costs are reduced by trust since the costs, for example monitoring the agreement will decrease when the parties are trustworthy to each other.\textsuperscript{50}

\subsection*{2.3 How is this connected with Trade Mark Law and quality control?}

As Posner explains, there is an interesting relationship between law and economics that should be addressed.\textsuperscript{51} Licensing as well as the effects of controlling the licensee, include both legal and economic difficulties. It is therefore valuable to address the issue from both perspectives in order to receive well thought through results. As will be explained in Chapter 3, the CJEU has stated that indication of quality is more of an economic function of the trade mark rather than a legally protected function. Thus, it is valuable to study how quality control is viewed at in an economic perspective.

According to Posner, the economic function of trade marks is to “economize on consumer search costs by providing an assurance of uniform quality”\textsuperscript{52}. Trade mark A that has put a lot of effort in marketing has normally a higher cost compared to the less marketed trade mark B. Nonetheless, when a consumer knows about trade mark A and its quality, the total cost could be lower compared to if purchasing trade mark B due to the consumer search costs.\textsuperscript{53} If the business

\textsuperscript{49} Williamson, O., E. Markets and Hierarchies: Analysis and Antitrust Implications, p. 108.
\textsuperscript{50} Bromiley, P. and Cummings, L., L. Transaction Costs in Organizations with Trust, p. 220.
\textsuperscript{51} Posner, R., A. Economic Analysis of Law, p. 31.
\textsuperscript{52} Ibid., p. 419.
\textsuperscript{53} Posner, R., A. Economic Analysis of Law, p. 419.
continuously changes its level of quality, the search costs will increase since the consumer cannot rely on previous experiences.\textsuperscript{54}

According to Griffiths, different stages of the purchase affect the view on the trade mark as well as the consumer search costs. He allocates the different stages on how to use the trade mark to reduce consumer search costs into \textit{search}, \textit{experience} and \textit{credence}.\textsuperscript{55} These stages can be compared to the described stages of TCE; \textit{search costs}, \textit{negotiating costs} and \textit{enforcement costs}. Since the concept of TCE derives from whether outsourcing or not, it is based on the proprietor’s costs and could therefore be put in relation to the groups described by Griffiths. 

Assume that an EUTM is licensed together with a specific product within the territory of the EU. The transaction costs \textit{search} and \textit{negotiating} occur before the consumer \textit{searches} and \textit{experiences}. Depending on how productive the proprietor has been in its development of an agreement or licence with a licensee, the transaction costs, monetary as well as non-monetary, could either be quite high or low. When discussing certain quality control clauses in the agreement, it will most likely increase the \textit{negotiating costs}, which generates a higher “starting cost” when the consumer begins his or her search for the wanted trade mark and product. The \textit{consumer experience} depends on how the trade mark and product is perceived by the consumer. The quality is most certainly an aspect that the consumer considers in this situation and depending on how the quality is perceived, the \textit{consumer credence} to the trade mark will be either higher or lower.

If the \textit{consumer credence} is low and the licensor and the licensee have agreed on some sort of quality control, it could be relatively easy for the licensor to either adjust the quality level or stop the agreement from continuing with reference to article 25(2)(e) EUTMR.\textsuperscript{56} Yet, if there are no quality control clauses in the licence agreement, the licensor must bear the responsibility.\textsuperscript{57} So, if there is quality control, the proprietor’s \textit{enforcement costs} increase but if the possibility to control does not even exist, the \textit{enforcement costs} will be very low. However, if the trade mark licence would be US based the \textit{negotiation costs} would not be

\textsuperscript{54} Griffiths, A. \textit{An Economic Perspective on Trade Mark Law}, p. 132.

\textsuperscript{55} Ibid., p. 136.

\textsuperscript{56} Article 25(2)(e) EUTMR states that if there are quality provisions in the agreement which are not followed by the licensee, the licensor has the possibility to invoke the rights transferred.

\textsuperscript{57} This is explained further in Chapter 3.5.
possible to avoid regarding quality control since it is a requirement to include those in a trade mark licence as described in Chapter 4. As a consequence, there would also be *enforcement costs* since the possibility to control will always be there.

In addition, *bounded rationality, opportunism* and *trust* also affect how the situation develops through time. If one party is more opportunistic than the other, *uncertainty* and *trust* will be affected negatively. Furthermore, since individuals are subject to *bounded rationality* as well there will be incomplete contracts no matter the perhaps shared willingness to cooperate.

Reflecting on the above described, most of the costs, transaction costs, could either be laid upon the proprietor or the consumer. It will depend on how the licence agreement is constructed as well as in which legal territory the licence is agreed on. The following chapters will examine the EU and the US respectively in order to understand why there is a difference and its connection to TCE.
3. European view on quality control

3.1 Why EUTM licensing?

The idea of licensing derives from the limitations that companies face concerning for example lack of geographical access or lack of manufacturing possibilities. A vertically integrated company that decides to, on their own, market and distribute the trade mark and the related products or services, could restrain the value of the trade mark and stop its potential value creation due to limited resources.\(^{58}\) With a licence agreement, it is possible for the licensor to keep the intellectual property rights and still be able to outsource the exploitation of the trade mark and the products or services at the same time as the licensee is able to exploit the trade mark and belonging products without any risk of infringing the original right’s holder.\(^{59}\) The exclusive rights held by the proprietor are thereby extended to another party and includes “commercial use of that mark in a manner consistent with its functions, in particular the essential function of guaranteeing to consumers the origin of the goods or services concerned”\(^{60}\). Previous statements declared that licensing was not compatible with the function of the trade mark since it became more difficult for the consumer to identify the origin of the trade mark.\(^{61}\)

When deciding on the nature of the trade mark licence, it could either be an exclusive licence or a non-exclusive licence. With an exclusive licence, the trade mark holder becomes prohibited from granting other licences with other parties within the decided scope of the licence. On the one hand, as Pila and Torremans discuss, this could be problematic due to that the trade mark holder, whom has received a “valid” monopoly, only transfers it to another party.\(^{62}\) As a consequence, it will lead to continued monopoly and in a sense inhibitory for the


\(^{59}\) Arnerståhl, S. *Varumärket som kontraktsföremål*, p. 45-46.; C-376/11 (Pie Optiek), para. 47. Pie Optiek dealt with Internet domains. On behalf of an American company, a European company was assigned to register the domain name “lensworld.eu”. However the licence was not considered to be a licence since the only assignment was to register the domain name. Instead it was considered to be a contract for services because the licensee was never supposed to use the domain name himself or herself.

\(^{60}\) C-376/11 (Pie Optiek), para. 47.

\(^{61}\) Wilkof, N., J. and Burkitt, D. *Trade Mark Licensing*, p. 25.

free competition. The licensee may also not put as much effort as needed into keeping the trade mark as it should be. On the other hand, an exclusive licence could generate an increased willingness for the licensee to produce and use the licensed trade mark in a good manner. By having an exclusive licence, there is a great financial opportunity for the licensee and why risk that opportunity by handling differently from how the proprietor would?

The risk for deceiving the public exists even if the proprietor commercialises the trade mark end belonging products on their own. However, if there is a licence agreement involved, some activities could happen without the knowledge or approval from the licensor. According to article 7(1)(g) EUTMR, deceiving the public is an absolute ground for refusal of a trade mark and the mark could thereby be invalidated. The requisite for revoking a trade mark due to deception is, as stated in the Emanuel case, when a trade mark is facing an “existence of actual deceit or a sufficiently serious risk that the consumer will be deceived”\textsuperscript{63}.

The Emanuel case concerned an assignment of the registered trade mark Elizabeth Emanuel. Elizabeth Emanuel was a fashion designer in the UK whom particularly gained reputation for her wedding dresses. She begun to commercialise under her own name Elizabeth Emanuel and a couple of years later Emanuel started to cooperate with another company and founded Elizabeth Emanuel Plc. The individual Elizabeth Emanuel later assigned her trade mark and business to an additional company and instead she became an employee.\textsuperscript{64} Emanuel quit working for the company and the registered trade mark was again assigned to another company. However, the mark was changed in its graphic appearance. Later, the person Elizabeth Emanuel filed for the trade mark to be revoked since the trade mark no longer had a connection with the person Elizabeth Emanuel.\textsuperscript{65}

Despite that the case did not deal with licensing issues, it is an interesting case due to the fact that the name, Elizabeth Emanuel, represents a certain origin that does not exist anymore, as well as the connection to the qualitative clothing that

\textsuperscript{63} C-259/04 (Emanuel), para. 47.
\textsuperscript{64} C-259/04 (Opinion of Advocate General Colomer, Emanuel), para. 13-15.
\textsuperscript{65} Ibid., para. 16-18.
Emanuel produced. On the one hand, The United Kingdom Government stated that the average consumer\(^\text{66}\) cannot be deceived when the proprietor is changed to another person since the standard of the goods could vary even though the proprietor is the same person. The trade mark does not itself represent a certain standard but instead it is a guarantee that a single undertaking is responsible for the product’s standard.\(^\text{67}\) On the other hand, the Commission held that a name as a trade mark does not imply that there is a connection with the person holding that specific name. If however the sales strategy implies such connection, it is deceptive to the average consumer.\(^\text{68}\) As explained earlier, the CJEU held that there must be existence of deception or a sufficiently serious risk that a possible consumer would be a victim of deception in order for refusing a trade mark registration by referring to article 7(1)(g) EUTMR.\(^\text{69}\) The Court further explained that the average consumer could be misled when viewing the trade mark since the company still produced the same products as when Elizabeth Emanuel was involved. It is however the undertaking that owns the trade mark that is responsible for the quality and characteristics. The name Elizabeth Emanuel could therefore not be seen as deceiving the public with reference to quality.\(^\text{70}\) If the proprietor of the mark intended to make the consumers think that Elizabeth Emanuel is still engaged with the business, the situation could be seen as fraudulent but not deceiving.\(^\text{71}\)

When a product or service is licensed together with the trade mark to another party, the guarantee of quality could be jeopardised due to the prolonging of trade mark use. Article 25 EUTMR describes the ruling regarding EUTM licensing. In article 25 TMD 2015, the rulings on how to license national trade marks are described. Moreover, according to Recital 34 TMD 2015, the licensing routines for national trade marks must be coherent with the EUTM licensing due to making the commercial exploitation easier. The respective provisions are thereby identical.

\(^{66}\) The average consumer is reasonably observant and circumvent and reasonably well informed. See for example C-104/01 (Libertel), para. 46 and C-252/07 (Intel), para. 34.
\(^{67}\) C-259/04 (Emanuel), para. 35-36.
\(^{68}\) Ibid., para. 40-41.
\(^{69}\) Ibid., para. 47.
\(^{70}\) Ibid., para. 48-50.
\(^{71}\) Ibid., para. 51.
A relevant question to ask is what actually is included in the *risk of deception*. Is it only the risk of not being able to distinguish the product as indication of origin, or is it also the risk of deceiving the consumer that refers to the trade mark as a certain level of quality? Advocate General Colomer described the primary purpose as “distinguishing [...] from those originating elsewhere” while the indication of quality was described as “and thereby provide a guarantee that they have been manufactured or provided by a single undertaking, which bears responsibility for their quality”.  

He continued by explaining that there are other purposes, in particular the indication of quality. By how Colomer expressed himself, the indication and guarantee of quality does not appear to be as important as the indication and guarantee of origin without saying it is a less important purpose of the scope of a trade mark.

### 3.2 Why trade mark registration – rights and responsibilities

With a trade mark registration, the proprietor is given exclusive rights to prohibit others from using the trade mark. Furthermore, the exclusive rights are given to the proprietor in order to protect the specific interests of the proprietor. The specific interests include guaranteeing that the trade mark fulfils its functions, which is the essential function as well as guaranteeing that the goods or services hold a quality. The essential function of a trade mark is for the consumer to be able identifying the origin of the purchased product or service without being confused and it is therefore a value for the proprietor to protect. In other words, the consumer should have the possibility to distinguish one product from another company’s product and recognise the quality of the product. The trade mark as such should thereby be distinctive. The rights also include a protection for the trade mark holder due to the prohibition of others taking advantage of the up built

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72 C-259/04 (Opinion of Advocate General Colomer, Emanuel), para. 42.
73 Ibid., para. 44.
74 Article 9(1) EUTMR.
75 Joined cases C-236/08 to C-238/08 (Google-Louis Vuitton), para. 75-77.
76 C-10/89 (HAG II), para. 13-14.; C-39/97 (Canon), para. 28.; C-299/99 (Philips), para 30.; C-206/01 (Arsenal), para. 48.; C-487/07 (L’Oréal), para. 58.
reputation. As a consequence, the trade mark registration guarantees the proprietor the exclusive rights of using the trade mark. Another advantage of registering a trade mark is the fact that the proprietor can renew the registration as many times as wanted. Each registration is valid for ten years.

One advantage of having an EUTM instead of a national trade mark registration, is the fact that the rights’ holder has the exclusive rights in the whole of the EU and not only in selected EU Member States where a national trade mark registration may exist. The fundamental requirements for being able to register a trade mark have the same content in both the TMD and EUTMR, namely distinctiveness and the ability to register the sign in a register. The distinctiveness could either be acquired by use through time or by how the sign is portrayed originally. Being able to register indicates that the sign, which could be for example a word or a colour, is able to find in a common used register in order for others to understand the sign and determine the precise and clear subject matter.

3.3 Guarantee of origin

In order to discuss the quality responsibility, it is necessary to first have a discussion about the guarantee of origin. As stated before, the essential function of a trade mark is to be able to guarantee the origin by making it possible for the consumer to distinguish the mark from others without any confusion. Furthermore, one single undertaking is responsible for the quality that is needed for the trade mark to fulfil its essential role in the system of undistorted system. Moreover, both the EUTMR and the TMD state that the function of the trade mark is “in particular to guarantee that the trade mark is an indication of origin.” As Wilkof and Burkitt discuss, this could indicate that the essential function,

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78 C-10/89 (HAG II), para. 14.
79 Ibid.
80 Article 52 EUTMR.
81 Article 4 EUTMR respective Article 3 TMD 2015.
84 EUTMR, recital (11); TMD 2008, recital (11); TMD 2015, recital (16).
guarantee of origin, of the trade mark is unfulfilled with no exercised quality control of the products made by the licensee.\textsuperscript{85} Thereof, the guarantee of quality and quality control is an important aspect of trade mark licensing.

Advocate General Colomer held in the opinion of the Arsenal case that it is a “simplistic reductionism”\textsuperscript{86} when restricting the trade mark’s function to only having it as an indication of origin. It is possible that consumers do not see the origin when looking at the trade mark; instead they see the trade mark as a guarantee of quality. Moreover, the indication of origin gets even more abstract when trade mark licensing is involved.\textsuperscript{87} However, in the actual case the CJEU stayed with the previous standpoint that the indication of origin is the essential function of the trade mark whereas the quality indication is important in the system of undistorted competition.\textsuperscript{88}

According to Davis, the Court included the importance of consumer interest when speaking about usage of trade marks. However, it is not included enough and therefore there is a risk of marginalising the public interest in relation to trade mark law.\textsuperscript{89} The facts of the Arsenal case included the famous UK-based football team Arsenal FC and one individual, Matthew Reed, whom were selling Arsenal souvenirs since 1970. Arsenal FC had for a long time used the emblems cannon device as well as shield device and registered those emblems along with the words Arsenal and Arsenal Gunners as trade marks in 1989. Furthermore did Arsenal FC produce and sell products via approved retailers in order to decrease the non-official products sold by others, including Matthew Reed.\textsuperscript{90} Reed sold both official and unofficial products and the unofficial products were labelled as unofficial.\textsuperscript{91} The case ended up in the High Court of Justice of England and Wales, Chancery Division and the case was then referred to the CJEU. The referred questions concerned if a third party is allowed to sell goods without

\textsuperscript{85} Wilkof, N., J. and Burkitt, D. Trade Mark Licensing, p. 34-35.
\textsuperscript{86} C-206/01 (Arsenal), para. 46.
\textsuperscript{87} C-206/01 (Opinion of Advocate General Colomer, Arsenal), para. 46-47.
\textsuperscript{88} C-299/99 (Philips), para. 30.; C-206/01 (Arsenal), para. 48.
\textsuperscript{89} Davis, J. To protect or serve? European trade mark law and the decline of the public interest. p. 180.
\textsuperscript{90} C-206/01 (Arsenal), para. 12-15.
\textsuperscript{91} Ibid., para. 15-16.
infringing when the use of the trade mark does not indicate a connection between the business and the proprietor.\textsuperscript{92}

Davis also highlights the different standpoints on whether quality should have a stronger position within the scope of trade mark or not by using Advocate General Colomer and Lord Nicholls in the UK as examples. While Advocate General Colomer argued that quality as such and other qualities should be a bigger part of the protected trade mark, Lord Nicholls did in the national British case Scandecor argue as the CJEU, namely that the primary function of trade marks is to identify the origin and the quality is hence not represented by the trade mark.\textsuperscript{93}

### 3.4 Guarantee of quality

As already mentioned, the CJEU has declared that in the system of undistorted competition, the trade mark is a guarantee of that the products or services sold under the trade mark have the same quality and that it is controlled by the trade mark holder.\textsuperscript{94} Within the exclusive rights of a trade mark, the guarantee of origin is the essential function of the trade mark.\textsuperscript{95} However, the guarantee of quality could in some aspects be seen as equally important.\textsuperscript{96} As mentioned earlier in chapter 3.3, this statement of the CJEU could indicate that if there are no quality controls, the essential function is not fulfilled. However, before discussing quality control in chapter 3.5, the definition of what quality and guarantee of quality must be sorted out.

Advocate General Jacobs did, in his opinion of the HAG II case, highlight that a trade mark does not stipulate any legal guarantee of quality. There are though within the economic terms of a trade mark such a guarantee since consumers include quality when deciding on which trade mark and product to purchase. It

\textsuperscript{92} C-206/01 (Arsenal), para 27.

\textsuperscript{93} Davis, J. To protect or serve? European trade mark law and the decline of the public interest. p. 180.; Scandecor UKHL 21, para. 19.

\textsuperscript{94} C-299/99 (Philips), para. 30.; C-206/01 (Arsenal), para. 48.

\textsuperscript{95} C-487/07 (L’Oréal), para. 58.

\textsuperscript{96} Ibid., para. 58-59.; Joined cases C-236/08 to C-238/08 (Google-Louis Vuitton), para. 77.; Arnerståhl, S. Marknadsidentitet, irrationella konsumenter och varumärket som en kvalitetsgaranti. p. 400.; Guidelines for Examination of European Union Trade Marks. European Union Intellectual Property Office (EUIPO) Part C Opposition Section 2 Double Identity and Likelihood of confusion Chapter 1 General Principles, p. 3.
stimulates economic progress for the individual company as well as the market. Companies would recognise few incentives for maintaining the quality if the trade mark protection opportunities did not exist. According to Jacobs, there is a seemingly low risk that proprietors will change the quality of the products bearing under the trade mark since it could, for instance, generate change in consumer behaviour.\(^97\) Jacobs continued by explaining “the function of a trade mark is to signify to the consumer that all goods sold under that mark have been produced by, or under the control of, the same person and will, in all probability, be of uniform quality”\(^98\).

In the opinion of the Ideal Standard case, Advocate General Gulmann referred to Jacobs and the HAG II case and explained the relationship between identity of origin and quality as a distinguishing function. The function as such is not protected but the proprietor’s possibility to maintain the function is protectable. The quality factor is an economic value of a trade mark. Moreover, Gulmann described that the economic value of a trade mark has a strong connection to a trade mark’s distinguishing function.\(^99\) The different opinions seem to come to the same conclusion, namely that quality is an important aspect of the trade mark. According to some, it is not however up to legal measurements to make the proprietors keep the standard. In 2009, the CJEU began confirming that other functions, such as quality, were economic functions performing parallel with the essential function.\(^100\) Griffiths explains this as an indication that these functions should be protected under trade mark law as well.\(^101\) Yet, as described in chapter 3.3, Advocate General Colomer held that it is an “simplistic reductionism”\(^102\) to reduce the function of a trade mark to solely indicate origin.

Within the guarantee function, when hearing or viewing the trade mark, the consumer responds in the following order: “a decided mark \(\rightarrow\) a decided origin \(\rightarrow\) a decided quality”\(^103\). Despite the old source, it includes functions that are still

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97 C-10/89 (Opinion of Mr Advocate General Jacobs, HAG II), para. 18.
98 Ibid., para. 24.
100 C-487/07 (L’Oréal), para. 58.
101 Griffiths, A. An Economic Perspective on Trade Mark Law, p. 5.
102 C-206/01 (Arsenal), para. 46.; See chapter 3.3.
103 Tiili, V. Om varumärkets funktioner, p. 242.
very important when discussing the foundations of a trade mark. In the 1960’s, Schelup did divide the quality into objective quality and subjective quality. The objective quality corresponds to the quality that could be measured by different tests in order to see if the materials have the same standard as before whereas the subjective quality indicates how the consumer’s needs are satisfied. The two different qualities are also dependent on each other.\textsuperscript{104}

The relevance of subjective quality was also dealt with in the Copad case\textsuperscript{105} concerning distribution of corsetry goods belonging to the trade mark Christian Dior. Dior was the owner of the trade mark Christian Dior and established a trade mark licence agreement with SIL including manufacturing and distributing.\textsuperscript{106} One of the contractual requirements in the licence was that “in order to maintain the repute and prestige of the trade mark the licensee agrees not to sell to wholesalers, buyer’s collectives, discount stores […]”\textsuperscript{107}. Due to financial difficulties SIL decided, despite the rejected request, to sell goods outside the selective distribution network namely to the discount store Copad.\textsuperscript{108} Dior did of course bring action against Copad as well as SIL and held infringement of trade mark rights. The French Court of Appeals stated that neither did any infringement of rights occur nor were the products exhausted. Copad therefore appealed the judgement and later the Court of Cassation referred the case to the CJEU asking how the grounds of a trade mark’s prestige affects a possible licence breach.\textsuperscript{109}

The CJEU as well as the assigned Advocate General Kokott, held that the objective characteristics are not the only characteristics affecting the quality. The allure and prestigious image that generate the luxury feeling of the Dior brand is also affecting the quality, which in turn guides the consumer to distinguish the products from other undertakings.\textsuperscript{110} Kokott further discussed that not every subjective aspect could affect the quality and thereby the reputation of the trade

\textsuperscript{104} Tiili, V. \textit{Om varumärkets funktioner}, p. 242-243. See further references.
\textsuperscript{105} C-59/08 (Copad).
\textsuperscript{106} Ibid., para. 7.
\textsuperscript{107} Ibid., para. 8.
\textsuperscript{108} Ibid., para. 9-10.
\textsuperscript{109} Ibid., para. 11-13.
\textsuperscript{110} Ibid., para. 24-26.; C-59/08 (Opinion of the Advocate General Kokott, Copad), para. 31.
Nevertheless, in the Copad case the discussed distribution channels were of importance concerning how the trade mark could be perceived.\textsuperscript{111}

With this in mind, it is easy to consider the questions \textit{What does quality include?} As well as \textit{What level of quality should be guaranteed and controlled?} It seems to be a general opinion that quality is a part of trade marks but not in the sense that it should be included with a more distinctive legal approach. Indication of origin is the essential function of the trade mark and thereby holds a stronger position compared to the guarantee of quality which is “barely” a function of the trade mark. Nevertheless, since the indication of quality is such an important aspect of how the trade mark stays competitive on the market, it seems a bit contradictory to not include it in the scope of the trade mark as an essential function. According to this, Advocate General Colomer had a relevant approach to the issue when he argued that simplifying the essential function to identification or origin is not correct. At the same time, it is understandable that quality does not get “upgraded” to become an essential function of the trade mark since it is already a part of it due to its connection to the already existing essential function, identity of origin.

Also, an inclusion of quality would probably stipulate that the quality should be maintained. That would perhaps be beneficial for the consumer but not for the trade mark proprietor. On the one hand, it could be more problematic for the proprietor if the quality requirement is embedded in the scope of the trade mark in a different way compared to now, since it then would be more difficult to change the quality in the future, either to worse or better. The way the functions are formed today does indicate a risk for the consumer whom could purchase products that should not, but do, vary in quality. As a consequence, the consumer changes supplier and the proprietor loses sales and possibly reputation. On the other hand, it is also a freedom for the proprietor to be able differentiating the trade mark and products whenever wished for. Determination of quality within the scope of trade mark law would in a sense lock the trade mark holder into deciding what to do with its own trade mark. That does not correspond with the definition

\textsuperscript{111} C-59/08 (Opinion of the Advocate General Kokott, Copad), para. 32.
\textsuperscript{112} C-59/08 (Copad), para. 37.
of exclusive rights, which is protecting the proprietor from others taking advantage of the reputation that comes with the trade mark. It is obvious that when the quality begins to diminish, the trade mark’s reputation will decrease. However, a declining reputation does not have to affect the identity of origin, which currently is the only essential function. If the proprietor acts with a well thought through strategy, a declined reputation does not have to affect the other criteria for keeping the mark registered as a trade mark.

3.5 Trade mark licences and quality control

As mentioned in the introduction chapter, there is not much case law from the CJEU concerning quality control within trade mark licensing. However, the case law that exists is quite clear on how quality control within trade mark licensing is dealt with. In 1994, the CJEU held that the licensor have the possibility to control the quality of the products made by the licensee by including quality clauses into the agreement. The statement was described in the Ideal Standard case that addressed a dispute between two companies, Ideal-Standard GmbH and IHT (Internationale Heiztechnik), and their respective trade mark use when selling heating equipment manufactured in France by the parent company to IHT, CIC (Compagnie Internationale de Chauffage). The American Standard group had, by its subsidiaries in several EU Member States, the registered trade mark Ideal-Standard in, inter alia, Germany (Ideal-Standard GmbH) and France (Ideal-Standard SA). The French subsidiary, Ideal-Standard SA, did however sell its trade mark for the heating equipment segment to SGF (Société Générale de Fonderie), an external company based in France. The transfer included the trade mark and belonging business in France, Tunisia and Algeria. The reason for this was as followed; Ideal-Standard SA begun having financial difficulties a couple of years before the transfer and therefore did insolvency proceedings begin. A management agreement between Ideal-Standard SA and another French company which was owned by, among others, SGF. The agreement included outsourcing production and sales. When the situation was not improved, Ideal-Standard SA assigned the heating equipment business together with the trade mark in 1984 to

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113 C-9/93 (Ideal Standard), para. 37.
114 Ibid., para. 2.
115 Ibid., para. 1, 3.
SGF. Later, SGF did assign the trade mark to CICh, which was part of the same corporate group and with no connections with the American Standard group.\textsuperscript{116} Thereafter, the German subsidiary Ideal-Standard GmbH brought proceedings against IHT for the infringement of the trade mark and belonging heating equipment business that were made by CICh in France in Germany. Though, Ideal-Standard GmbH had been neither manufacturing nor selling heating equipment since 1976. The purpose was to prevent IHT using the trade mark Ideal-Standard in Germany.\textsuperscript{117} The case was referred to the CJEU with a question regarding if it is possible to prevent such business in relation to articles 30 and 36 of the EEC Treaty.\textsuperscript{118} These articles are now updated to be articles 34 and 36 of the TFEU. The case is not interesting in relation to the articles of the TFEU but instead in relation to made discussions concerning licensing and its possibilities to control the licensee.

In terms of licensing agreements, the CJEU did state that the licensor have the possibility to control the quality of the products made by the licensee. The licensor could then develop clauses demanding the licensee to fulfil certain requirements in order for the trade mark to hold the same quality as the licensor wants. The licensor also has the possibility to include activities that could be made by the licensor in order to control that the licensee actually follows the specific quality requirements. The reason for this is that the origin is connected to the proprietor of the trade mark and not to the actual producer of the products and marketing.\textsuperscript{119} It was further stated that the actual exercise of control is not as important as the possibility to exercise control. If the licensee does not follow the contracted requirements and the licensor does not use his or hers contractual means to prevent the deteriorated quality, the licensor is accountable for the outcome whether the trade mark is still a valid trade mark or not.\textsuperscript{120} As the Court later held, also Advocate General Gulmann described that if the proprietor agrees on a licence agreement without any quality controlling systems, he or she must

\textsuperscript{116} C-9/93 (Ideal Standard), para. 4-5.
\textsuperscript{117} Ibid., para. 6-7.
\textsuperscript{118} Ibid., para. 12.
\textsuperscript{119} Ibid., para. 37.
\textsuperscript{120} Ibid., para. 38.; This was also later stated in C-259/04 (Emanuel), para. 48.
bear the consequences of that choice.\textsuperscript{121} The CJEU also illuminated that a regular contract of assignment does not constitute any rights for the licensor to control the licensee regarding the quality of the products.\textsuperscript{122} Concerning the referred question, the CJEU stated that, in relation to articles 30 and 36 of the EEC Treaty (articles 34 and 36 of the TFEU) it is not unlawful to restrict a business as described in the case.\textsuperscript{123}

For a long time, the Ideal Standard case was the only case concerning quality control within trade mark licensing. In 2001, some questions regarding quality control were referred to the CJEU from the UK. However, the British case Scandecor was never dealt with by the CJEU due to successful domestic settlements. Despite this, the case includes interesting aspects on quality control.

The case concerned a conflict between Sandecor Developments AB and Scandecor Marketing AB. Two art students founded an equally shared company, later known as Scandecor International AB, with a business to publish and market art posters and related goods. Scandecor was the brand name. The business grew and with the help of subsidiaries in various countries, the work could be distributed. In the UK, there were a registered word mark and a registered logo mark including the word \textit{Scandecor}. The word mark was registered first by Scandecor Ltd and a couple of years later in 1976, the logo mark was registered by Scandecor International AB. In 1978 Scandecor Ltd assigned the word mark to Scandecor International AB.\textsuperscript{124}

The two founders of Scandecor International AB had shared the subsidiaries between themselves. One party, Hjert, was responsible for the continental countries while the other party, Huldgren, was responsible for inter alia UK.\textsuperscript{125} Scandecor International AB was the parent company of the group and in 1979 the company sold several subsidiaries to its founders as well as Hjert and Huldgren. The Swedish subsidiary was sold to Huldgren whom also acquired the

\textsuperscript{121} C-9/93 (Opinion of Advocate General Gulmann, Ideal Standard), para. 72, 75.
\textsuperscript{122} C-9/93 (Ideal Standard), para. 41.
\textsuperscript{123} Ibid., para. 60.
\textsuperscript{124} Scandecor UKHL 21, para. 1-2.
\textsuperscript{125} Ibid., para. 2.
subsidiaries in the countries where Huldtgren already had responsibility, for example the UK and Scandecor Ltd. However, Scandecor International AB continued to be co-owned and remained to be the proprietor of the registered trade marks in the affected countries.126

A couple of years later, Huldtgren sold his shares in Scandecor International AB to the other party Hjert. However, Scandecor International AB was still registered as proprietor of the UK registered trade marks. Scandecor International AB licensed Scandecor Marketing as distributor in the countries where Huldtgren earlier had responsibility. Scandecor International AB ended up with insolvency and even though the licence agreement was terminated, orders and supplies did continue interimisticly. With time the cooperation ceased and Scandecor Marketing intended to continue selling posters made within the company as well as external products.127 In the UK, retailers cooperated with Scandecor Ltd rather than another Scandecor company and linked Scandecor Ltd with the name Scandecor. Despite this, Scandecor Marketing did inform the buyer of the connection with Scandecor International AB, namely the origin.128

The situation lead to a situation where the trade marks were considered to be deceptive and therefore a case for the British court system. The raised question dealt with whether a bare exclusive licence as such is deceiving potential consumers. A bare licence indicates a licence with no possibility for the proprietor to control the quality of the products made by the licensee.129 As stated by the CJEU and mentioned above in chapter 3.3, Lord Nicholls explained that the indication of origin is the essential function and in order for the trade mark to perform its function, “it must offer a guarantee that all the goods bearing it have originated under the control of a single undertaking which is responsible for their quality.”130 The quality aspect is considered to be of economic importance rather than legal importance.131 Lord Nicholls explained that a consumer is agreed upon

126 Scandecor UKHL 21, para. 5-6.
127 Ibid., para. 7-8.
128 Ibid., para. 9.
129 Ibid., para. 14.
130 Ibid., para. 17.
131 Ibid., para. 19.
the business changes that might occur and relies on that maintenance of quality is
in the proprietor’s self interest.\textsuperscript{132}

The case is not guiding in the same way as a decision from the CJEU, but it shows
how the question is dealt with in one EU Member State. Namely that quality is
seen as an economic function rather than an essential function.

In 2017, the CJEU published a preliminary ruling concerning trade mark licensing
and genuine use. The dispute was between the German company “Gözze” (Gözze
Frottierweberei GmbH) and VBB (Verein Bremer Baumwollbörse), which is an
association working with activities related to cotton. VBB has a registered EUTM
and cotton companies use the mark as an indication about a certain cotton quality
verified by the VBB.\textsuperscript{133} Gözze does not belong to the association and has
therefore no licence agreement with VBB even though the company for years
have had the verification sign on its products.\textsuperscript{134} With a licence, the VBB has the
possibility to make quality controls. Because of this, VBB brought infringement
proceedings against Gözze in Germany, which lead to a counterclaim by Gözze
claiming that the trade mark is descriptive and not distinctive.\textsuperscript{135} The case went to
Oberlandsgericht Düsseldorf, which decided to refer the case to the CJEU with
one of the questions concerning invalidation of the trade mark if there are no
frequent quality controls made by the licensor, both in relation to genuine use and
deception.\textsuperscript{136}

Likewise previous case law, the essential function of a trade mark was stated as
identifying the origin by distinguishing one product from another. In order to
fulfil this function in the system of undistorted competition the trade mark must
guarantee that the products are manufactured and distributed under the control of
one undertaking responsible for the quality.\textsuperscript{137} The case dealt with a label of
quality and the CJEU specifically wrote that the essential function should not be

\textsuperscript{132} Scandecor UKHL 21, para. 22, 39.
\textsuperscript{133} C-689/15 (VBB), para. 18-20.
\textsuperscript{134} Ibid., para. 21.
\textsuperscript{135} Ibid., para. 22-24.
\textsuperscript{136} Ibid., para. 32.
\textsuperscript{137} Ibid., para. 41.
confused with the other functions, such as guarantee of quality. Oberlandsgericht Düsseldorf discussed that if a trade mark, which is licensed and does not carry on any quality controls, could be seen as not fulfilling the requisite genuine use. Genuine use is to be found in article 18 EUTMR. A trade mark must have been used genuinely in the EU within five years after the trade mark registration to stay registered. From case law it is stated that when a trade mark is used in consistence with the essential function, it is being used genuinely. Nevertheless did the CJEU held that even though the proprietor does not carry out periodic quality controls in order to control the quality, it is not enough for declaring the trade mark invalid, neither according to genuine use nor deception. Genuine use is relating to the essential function, which only per se includes indication of origin and not indication of quality. It does not either fulfil the requirement set in the Emanuel case, namely that there must be existence of deception or a sufficiently serious risk that a potential consumer would be deceived.

From this case it is clear that quality control is only an option for the licensor to include and not an obligation. Furthermore, the CJEU does not value the guarantee of quality in the same way as guarantee of origin. At least not in relation to how the case law and general principles are explaining the issue as of today. As mentioned above and seen in this chapter, there are not much case law related to the issue of quality control within trade mark licensing. It is however more case law concerning the definition of quality, which of course affects the view on quality control. New questions arise when reading the statement in the Emanuel case concerning what is meant by, inter alia, “by sufficiently serious risk”. Yet, those questions will not be dealt with in this thesis but are of importance for the issue. The proprietor could lose the trade mark if the requirement is fulfilled. There is however no regulation within trade mark licensing that could prevent it from happening more than the possibility to include quality controls in the licensing agreement.

138 C-689/15 (VBB), para. 43-44.
139 See C-40/01 (Minimax), para. 37.
140 C-689/15 (VBB), para. 57.
141 C-259/04 (Emanuel), para. 47.; C-689/15 (VBB), para. 54.; See chapter 3.1.
142 “[…] existence of actual deceit or a sufficiently serious risk that the consumer will be deceived”, see C-259/04 (Emanuel), para. 47.
As a contrast, Levin claims that quality control within trade mark licensing is a
general principle within the EU law and refers to the Ideal Standard case and the
Emanuel case.\textsuperscript{143} In other words, the opposite to what is explained above. Levin
refers to the HAG II case, which stated “for the trade mark to be able to fulfil this
role, it must offer a guarantee that all goods bearing it have been produced under
the control of a single undertaking which is accountable for their quality”\textsuperscript{144} and
reaches the conclusion of forced quality control. Due to how the CJEU in the
HAG II case explained the importance of quality, it is understandable that she
comes to this conclusion. The only way for a licensor to be able to become the
single undertaking that controls the quality when outsourcing is when quality
control is a requirement in the agreement. Yet, it is not a general principle within
the EU law at the moment, and with the VBB case that is explained one more
time. It is for the licensors themselves to decide whether wanting to fulfil the role
stated in the HAG II case or not.

\textbf{3.6 Reflection towards control as a transaction cost}

From a European point of view, the cost of controlling is up to the licensor, or
licensor and licensee, to decide. If the licence includes quality control clauses,
there are costs related to quality in \textit{search costs, negotiating costs} as well as
\textit{enforcement costs}. It is highly possible that the licensor \textit{searches} for a business
partner that has similar quality standards themselves; this would ease the coming
work of negotiating since there already is a mutual \textit{trust} towards each other.
When negotiating begins and the licensor decides to include quality control in the
license, there will be costs related to this aspect, monetary as well as non-
monetary costs. Depending on how \textit{opportunistic, uncertain} and \textit{trustworthy} the
parties are to each other, the outcome of the agreement will be affected. Both in
relating to the relationship partners in between and costs. It seems as the EU
values \textit{trust} more than \textit{opportunistic} behaviour in its decisions on how to
incorporate forced quality control in trade mark licensing. The licensor bears the
responsibility him- or herself if the trade mark and belonging products are
affected, either to worse or better. If the EU would have perceived companies and

\textsuperscript{143} Levin, M. \textit{Lärobok i immaterialrätt}, p. 552.
\textsuperscript{144} Ibid., p. 417-418.; C-10/89 (HAG II), para.13.; C-9/93 (Ideal Standard), para. 37.
proprietors as *opportunistic*, there would perhaps been a different standpoint in this issue. If you perceive someone as opportunistic it is important to balance different aspects from the beginning, possibly through regulations.

The *enforcement costs* will vary as well depending on the agreement itself and on the behavioural assumptions. However, reflecting on how the European system is built up, the behavioural assumptions and the transaction costs depend on how the market itself deals with the issue. At least regarding whether one is keeping the rights to your trade mark or not.

All the discussed case law has in one way or another stated that the indication of origin is the essential function and the indication of quality is merely an economic function and can never be an essential function. Some of the doctrine has reflected on the opposite but as long as the CJEU does not, the situation will remain as settled.
4. American view on quality control

4.1 Why trade mark licensing?
As explained in the introduction chapter, the American view on quality control within trade mark licensing will be explained more briefly compared to the previous chapter, which described the European view on quality control within trade mark licensing. In general, quality control is more developed in the US and therefore there is a lot of information on the topic. This thesis includes only the required information for understanding that there is a difference, and what the difference is, between the EU and the US.

Likewise the EU, American trade mark licensing derives from the increased opportunities to exploit businesses and value of trade marks. A single undertaking has often not the opportunity to manufacture as well as market the trade mark and belonging products across the world by themselves.\(^\text{145}\) Furthermore, if trade mark protection only is possible for companies with vertically integrated protection, trade marks “would be of much less value to the society”\(^\text{146}\).

Yet, this has not always been the ruling in the US. Historically, licensing opportunities did not exist in the US. Since the trade mark at that time was designed to identify the physical source of the service or good together with the use of the sign, there were no possibilities to license the trade mark to another party. In other words, it was assumed to be not possible for the consumer to identify the physical source if the trade mark was licensed to a third party.\(^\text{147}\) In at the time leading case, the Supreme Court stated that the “the primary and proper function of a trademark is to identify the origin or ownership of the article to which it is affixed”\(^\text{148}\). Thus, the trade mark was considered to be abandoned if the

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\(^{145}\) Calboli, I. The Sunset of Quality Control in Modern Trademark Licensing, p. 343-344.


trade mark owner approved another party to use the relevant trade mark with an agreement. 149

The rulings began to change in the 1930’s and when the new Trade Mark Act, Lanham Act, was adopted in 1946, trade mark licences became allowed in the written law as well. It was approved along with a reservation, namely that the licensor must control the products manufactured by the licensee since a trade mark also gives the consumer an indication about the quality of the manufactured products. 150 A licence without such control was deemed to be a naked licence, which indicated an invalid licence. 151 A trade mark that is object for a naked licence is also seen as not genuine, and therefore it is not longer a trade mark with the right to protection. 152

The modification of allowing trade mark licences derives from a change in how to view at trade marks. McKenna refers to Schechter, whom began to discuss this change by explaining how a trade mark cannot only be seen as simply something that is used in order for the consumer to connect a “vehicle with its producer”. A trade mark is also a source for the visualised value created by manufacturing certain goods or services. 153

Due to the update of the Lanham Act, section 5 of the Lanham Act states that related companies could justifiably use the trade mark if there are no deceiving of the public. 154 Continuing to section 45 of the Lanham Act, the definition of related company is “any person whose use of a mark is controlled by the owner of the mark with respect to the nature and quality of the goods or services on or in connection with which the mark is used”. 155

150 Ibid., part IV fifth paragraph.; Calboli, I. The Sunset of Quality Control in Modern Trademark Licensing, p. 344.
151 Calboli, I. The Sunset of Quality Control in Modern Trademark Licensing, p. 345.
4.2 Why trade mark registration? – rights and responsibilities

Like the EUTM, the American trade mark is also designed to identify and distinguish the goods sold from other undertakings. Furthermore, the trade mark should be a guarantee to the consumer that the goods belonging to the trade mark share the same level of quality. On the one hand, some state that the trade mark law in the US was developed in order to protect consumers from deception and confusion. On the other hand, it was more important to protect the trade mark holder’s rights. McCarthy explains that in his opinion, the trade mark law has two goals namely to protect consumers from deception and confusion as well as protecting the trade mark as property. In addition, the Supreme Court held this in 1982. Nevertheless, since the source of the trade mark should be traceable, the trade mark inquires a responsibility from the rights’ holder. When registered, the trade mark is valid for 10 years and can be renewed as many times as wished for.

McCarthy discusses quality and its relation to distinctiveness. He refers to a case from the Court of Appeals and explains “without achieving the quality called distinctiveness, either inherently or through the acquisition of secondary meaning, then a designation does not have the legal status of a trademark or service mark. No distinctiveness - no validity - no mark.” However, it could be read as in order to achieve distinctiveness, the mark must have a certain quality to be able to receive trade mark protection. As a consequence, this would mean that without a certain quality, there is no distinctiveness.

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162 Tana v. Dantanna’s, 611 F.3d 767, 96 U.S.P.Q2d 1001 (11th Cir. 2010), p. 773.
### 4.3 Source identification

Under section 45 of the Lanham Act, it is stated that a trade mark functions “to identify and distinguish his or her goods, including a unique product, from those manufactured or sold by others and to indicate the source of the goods, even if that source is unknown”\(^\text{164}\). As explained in chapter 4.1, the historical definition of identifying the source was stricter. There had to be a visual connection between the product and the company that was responsible for the product and trade mark. In other words, the source had to be physical.\(^\text{165}\) As McCarthy explains, nowadays there are a lot of corporate groups that lead to the fact that a consumer cannot always be assumed to know the source for a specific trade mark.\(^\text{166}\) As a consequence, the previous definition of a single source has been developed into “single, though anonymous source”\(^\text{167}\).

Likewise EU trade mark law, the source identification is the primary function of trade marks. When the source is identified, it helps the consumer to recognise the estimated quality of the product. This is an important factor within the role of the free market economic system. As a consequence, the search costs for consumers are reduced since it becomes easier to make a purchase decision.\(^\text{168}\) This indicates that the quality theory is something separated from the actual purpose of the trade mark namely source identification. If that is the case, could the requirement of quality control descend from solely economic aspects rather than legal aspects? The source identification is then, likewise the EU, the essential function of the scope of the trade mark. Yet, when examining the quality identification and quality control within American trade mark law, this theory seems to be incorrect if essential means *only* or *main purpose*.

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\(^\text{166}\) McCarthy, T., J. *McCarthy on Trademarks and Unfair Competition*, § 3:12.

\(^\text{167}\) Ibid.; Restatement Third, Unfair Competition (1995), §9 comment c.

\(^\text{168}\) McCarthy, T., J. *McCarthy on Trademarks and Unfair Competition*, § 2:3. See further references.
4.4 Quality identification

As frequently mentioned, the scope of American trade mark law developed into not only including identification of the source but also an indication of quality standards. As McCarthy describes, the quality aspect is a supplement to the traditional source identification that originally was the main purpose of the trade mark.\(^\text{169}\) He refers to an opinion made by Posner whom stated that “[…] The purpose of a trade mark, after all, is to identify a good or service to the consumer, and identity implies consistency and a correlative duty to make sure that the good or service really is of consistent quality, i.e., really is the same good or service.”\(^\text{170}\)

When referring to quality standards and indication of quality, there is no requirement regarding which sort or level of quality that the trade mark should indicate. The scope of protection is the same, regardless high or low quality. Instead, the important aspect is the consistent quality that the trade mark should represent. For this reason, the licensor is obligated to control the quality.\(^\text{171}\) In 1985, the Supreme Court stated that trade marks “desirably promote competition and the maintenance of product quality”\(^\text{172}\). In other words, there is both a legal point of view and an economic point of view of using a trade mark when examine the importance of maintaining quality. Also, it is important to highlight that the level of quality is never discussed in relation to legal restrictions. A higher quality could affect the economic functions with the result of, for instance, higher sales. However, a higher quality does not affect the legal functions of a trade mark. There are several companies that, from a consumer perspective, perhaps not represent the highest quality but yet have a strong reputation among consumers.

With this in mind, the question What is actually meant by “maintenance of product quality?” arises. If the trade mark must maintain a certain quality as stated by the Supreme Court, it is difficult to change the product, no matter if the

\(^{169}\) McCarthy, T., J. McCarthy on Trademarks and Unfair Competition, § 18:40.


\(^{171}\) McCarthy, T., J. McCarthy on Trademarks and Unfair Competition, § 18:40.

proprietor succeeds to keep the consumer’s idea of how the trade mark should be portrayed commercially or not. *Should it not be for the proprietor to decide what to do with the quality his- or herself?*

In 1986, the Court of Appeals in the second Circuit declared that if there are no quality standards stated by the proprietor in the licence, the trade mark would not be considered genuine.\(^{173}\) The decision was later appealed to the Supreme Court but was not dealt with, which indicate that the decision was correct. Nonetheless, this indicates that quality itself is a highly important factor within American trade mark law. The effects on quality control will be discussed in chapter 4.5.

### 4.5 Trade mark licences and quality control

As Wilkof and Burkitt express, quality control within trade mark licences is a fundamental part of American trade mark law.\(^{174}\) By including quality control clauses into the agreement, the licensee is forced to make the production and marketing of products consistent with those clauses. As previously mentioned, legalising trade mark licensing was allowed as long as the licence agreement included quality clauses. The clauses functioned, and still function, as a warrant to make the trade mark holder responsible for quality control of the products or services belonging to the trade mark. Historically, if the quality control clauses were left behind, the licence was considered naked and not valid. As a consequence, the trade mark was considered to be abandoned by the proprietor due to the fact that the trade mark was no longer considered as being *genuine*. This ruling is still used and the control made by proprietors is a non-negotiable requisite when licensing.\(^{175}\)

The relationship between quality control and genuineness has been explained in different decisions from the Courts of Appeals. As previously mentioned, the concept of *genuine* implies that the proprietor controls the quality.\(^{176}\) Therefore,

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\(^{174}\) Wilkof, N., J. and Burkitt, D. *Trade Mark Licensing*, p. 113.

\(^{175}\) Calboli, I. *The Sunset of Quality Control in Modern Trademark Licensing*, p. 355.

the trade mark is not genuine if there are no quality controls. The referred case concerned a licence agreement between a licensor and licensee within the shoe business. The shoe company El Greco licensed a shoe factory to produce and distribute shoes. Yet, El Greco was not satisfied with the results and refused further distribution. The shoe factory disregarded the decision and sold the shoes. 177 Judge Pratt stated, “as long as the goods are manufactured under the direction of the trade mark owner, bear the trade mark registered and issued by the trade mark owner, and are not of an inferior quality, the products are considered genuine.” 178 Thus, this means that if the licensee does not manufacture the products according to the requirements stated in the agreement, the products and trade mark seen and purchased by the consumers are not considered to be genuine. This is also discussed in another case from another Circuit a few years later. The outcome of that case was the same. 179

While deciding on the importance of quality control, it remained unclear concerning how much quality control was needed in order for the trade mark licence to be valid. Due to inconsistent decisions, it has through time been continuously difficult to interpret what is considered to be sufficient quality control within the American trade mark law. 180 According to case law, the amount of needed control must be put in perspective to aspects such as consumer expectations as well as the nature of the business. 181 Quality control should be reasonable in relation to how much is required to avoid consumer deception. 182 Moreover, while some court decisions have declared that contractual provisions concerning quality control is enough to fulfil the requirement, others have stated that the control have to be actively made with the trade mark holder as the leading figure. 183

178 Ibid., p. 398.
180 Calboli, I. The Sunset of Quality Control in Modern Trademark Licensing, p. 345-346.
Historically, there have been trade mark holders arguing against such quality control since the licence agreement is made in order to increase production and at the same time reduce the costs.\(^{184}\) Parks argues that it is nothing bad with a naked licence. If, regardless the quality of the manufactured products, the trade mark is able to identify, it should not be considered abandoned. If the licensor desires to control the quality it should be possible. In other words, quality control in a trade mark licence should be a privilege and not an obligation in order to keep the trade mark valid and registered. According to Parks, it is furthermore a requirement that contradicts the essential function of the trade mark, which is the source indication. It is beneficial for neither the licensor nor the consumers.\(^{185}\) By leaving the quality control requirements behind, the quality can differ according to relevant “business judgement”. Such an economically important activity, as trade mark licensing is, should not be made unruly merely because of a requirement to include quality control in the licence.\(^{186}\) Consumers do not suffer any legal defaults but rather just the choice to change brand, which will generate a lack of sales for the licensor and proprietor as well as the licensee.\(^{187}\) Parks concluded the discussion by declaring that consumers can be affected negatively by, inter alia, being injured by a poorly made product. That is however something connected to warranty, which is not a part of the scope of trade mark law.\(^{188}\) Calboli has also aligned with this discussion.\(^{189}\)

McKenna argues that the consumer focus never was supposed to become such a focus within trade mark law. Instead, it was the protection for proprietors that was intended to be the main purpose. However, in the discussion of unfair competition and risk of deception, the consumer aspect became an important factor.\(^{190}\) This brings up the question whether the consumer aspect has affected the legal outcome of today or not, especially concerning quality control.

\(^{185}\) Parks, K. “Naked” is Not a Four-Letter Word: Debunking the Myth of the Quality Control Requirement in Trademark Licensing, p. 557-558.
\(^{186}\) Ibid., p. 558.
\(^{187}\) Ibid., p. 560.
\(^{188}\) Ibid., p. 560-561.
\(^{189}\) Calboli, I. The Sunset of Quality Control in Modern Trademark Licensing, p. 396.
4.6 Reflection towards control as a transaction cost

From an American point of view, the cost of controlling is not for the licensor to decide as freely as in the EU. When the licence includes clauses with quality control, there are related costs in search costs, negotiating costs and enforcement costs. Even though it is possible for the licensor to influence the licensee later on, it could be assumed that the proprietor spends time and money on the search to find a business partner with comparable quality standards. Since a continuous trade mark protection is connected to the source and quality indication, there should not be that high negotiating costs. There are of course a lot of other aspects when negotiating that generates both monetary and non-monetary costs. Yet, on behalf of the quality control, the licensor probably has most of the power. The licensor must keep its trade mark intact and if agreeing on loosening up on the quality, the problems with genuineness and deception could probably occur sooner than first anticipated. The opportunistic behaviour of the licensor must be quiet high in this situation due to the abovementioned. Furthermore, an opportunistic behaviour is based on uncertainty. However, the problem with opportunistic behaviour is de facto that the licensee acts in the same manner. Therefore, the level of trust is low, both regarding the need for trust and how it is activated within the relationship. It could be assumed that there is no need for trust more than in how the licensor trusts that the licensee follows the instructions.

The enforcement costs would vary depending partly on how much quality control is required in the situation, partly if the quality control must be activated or not. In this phase, there is a strong co-relationship between opportunism, uncertainty and trust. Without actively made quality control, the level of trust between the licensor and licensee must be high. There is probably much uncertainty since the partners must mutually trust each other. Though, the level of opportunistic behaviour is assumed to be lower unless the licensor uses his or her right to control. Of course, with those circumstances opportunism would be higher.

As discussed in 1995, the Supreme Court stated that the microeconomic functions of trade marks are partly encouragement to produce quality products, partly that
trade marks decrease the costs for decision making and shopping made by consumers.\textsuperscript{191} It is interesting that the quality aspect is in a sense considered to be something else than a legal function, but yet so important that it is a requirement in the agreement.

5. Which direction to take? – Comparison between the EU and the US

5.1 TRIPS Agreement and Paris Convention

The TRIPS Agreement defines minimum restrictions for intellectual property in order to have a globalised protection for the different intellectual property rights.\(^{192}\) Both the EU and the US have signed the agreement and they therefore need to keep the minimum standards for trade mark protection incorporated in their respective legal systems.\(^{193}\) Article 15 states that a sign that is able to be distinguished from other undertakings is eligible to become a trade mark. Furthermore, article 16 states that the owner of the trade mark has exclusive rights and therefore the right to prevent others from using similar or identical signs in the course of trade where there is a possibility of likelihood of confusion. Within licensing, the minimum requirement is that the trade mark owner has the “right to assign the trademark with or without the transfer of the business to which the trademark belongs”\(^{194}\). Also, the article states that the conditions of the licences are for the respective member to decide. In other words, there are no minimum requirements related to trade mark whether there have to be any clauses about quality control or not.

The US, as well as the Member States of the EU, are bound to follow the Paris Convention.\(^{195}\) Since the Member States must work cohesively with the Paris Convention, the EU must do the same in order to have a joint legalisation. Article \(6^{\text{quinquies}}\) describes what a mark has to fulfil in order to become a registered trade mark. For instance, the trade mark has to be distinctive and not only describe e.g. quality or place of origin. Further information regarding licensing cannot be found in the convention.

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\(^{193}\) WIPO. *Other IP Treaties*. (electronic source).
\(^{194}\) Article 21 TRIPS Agreement.
\(^{195}\) WIPO. *WIPO-Administered Treaties*. (electronic source).; TMD 2015, recital (41).
5.2 Licensing

In respective jurisdiction, licensing seems to descend from economic incentives. If a company outsources its production and marketing, the possibilities to exploit the trade mark and belonging products increase. Furthermore, the TRIPS Agreement explicitly states that licensing is allowed. It is a minimum requirement that must be followed by the amended member states. In other words, there is no doubt whether trade mark licensing should be allowed or not. Instead, the issue concerns how the licence should be constructed and as explained in chapter 3 and 4, there is a difference between the EU and the US.

5.3 Rights and responsibilities

When a trade mark is legally protected, the proprietor could take advantage of exclusive rights. This is also stated in the TRIPS Agreement and thereby a right that exists in both the EU and the US. The US seems to consider the consumer aspect more thoroughly in comparison to the EU. Regardless of territory, a trade mark should distinguish goods without making the consumer confused. This is a legal ruling in TRIPS, EUTMR as well as Lanham Act. However, because of the stronger consumer aspect in the US, the responsibilities differ in relation to the EU and the EUTMR. This will be further discussed in the following chapter.

5.4 Source and origin in relation to quality

The respective trade mark laws have always been permeated by the importance of showing the source or origin of the trade mark. As previously mentioned, this was also the reason in the past for not allowing licensing. By natural reasons, there is more information regarding the US and its physical source theory compared to the EU, which constructed its trade mark law during the second half of the 20th century.

In both jurisdictions, the source indication is the main function of the trade mark. Yet, when Advocate General Colomer discussed that restricting the function to only include origin identification is a “simplistic reduction”, he touched on the American view on what to actually include in the main purpose of the trade mark.
As McCarthy expresses, nowadays it is very difficult to identify the single source accountable for the quality. Consumers can only identify that it is one source, but perhaps not which one.\footnote{196 See chapter 4.3.} Thereby, the quality of the trade mark is an important factor for the consumer when distinguishing products. When the consumer identifies a trade mark, it is possible for that person to also recognise the quality and make a decision. In other words, quality is an effect resulting from knowledge about the origin or source. Furthermore, the definition of objective and subjective quality could be assumed to be the same in the EU and the US. Schechter began this discussion when questioning the \textit{physical source theory}. With the Copad case, the CJEU held that subjective quality is as important as objective quality.\footnote{197 See chapter 3.4.} From this discussion the fundamental differences between the EU and the US are found. While the EU and the CJEU simply see the guarantee of quality as an economic function that the proprietor itself should be able to affect, the US considers it to be an economic function that consumers need to be assured of.

The Supreme Court in the US has stated that trade marks “desirably promote competition and the maintenance of product quality”.\footnote{198 See chapter 4.3.; \textit{Park \textquoteleft N Fly, Inc. v. Dollar Park and Fly, Inc.}, 469 U.S. 189 (1985), part, II.} Furthermore, in a judgement from the Court of Appeals, Posner held that identity in the term of identifying goods also implies consistent quality control.\footnote{199 See chapter 4.4.} The CJEU has stated that one single undertaking is responsible for the quality that is needed for the trade mark to fulfil its role in the system of undistorted system.\footnote{200 See chapter 3.3.; C-39/97 (Canon), para. 28.; C-299/99 (Philips), para. 30.; Guidelines for Examination of European Union Trade Marks. European Union Intellectual Property Office (EUIPO) Part C Opposition Section 2 Double Identity and Likelihood of confusion Chapter 1 General Principles, p. 3.} At same time as there is no difference between the statements, two different systems have been developed. The requisite “responsible for the quality” in the European definition does not imply anything regarding the responsibility; is it responsibility when the quality declines or is it responsibility in the sense of preventing an inferior quality? It could be difficult to answer the question but according to how the EU law and case law is established, the responsibility seems to be referring to the first option. If responsibility would be equal to preventing an inferior quality, the
responsibility would be perceived as something forced and then quality control within trade mark licensing would be an obligation in the EU as well.

5.5 Quality control

In chapter 5.4, it is established that guarantee of quality is important in both jurisdictions. Nonetheless, it differs how quality is put in relation to quality control. On the one hand, if an American trade mark licence does not include quality control it is considered to be naked and invalid. In the EU on the other hand, the licence would not be considered to be naked and invalid as stated in the VBB case\textsuperscript{201} in 2017. The consumer distinguishes a trade mark from another trade mark on the market, which is also the essential function. However, does the essential function generate from the information about the origin or the information about the quality? As the situation is today, the indication of origin implies which sort of quality the trade mark represents but could the indicated quality give information about the origin? Which information pops up first and helps the consumer to find the other information?

Regardless of having a licence or not, the American proprietor must exercise quality control in order to not deceive consumers. In the EU it is optional with the risk to deceive consumers and invalidate the trade mark registration. Though, that would be a consequence of not having quality control and not a situation that a legal system should regulate in beforehand. The US perspective derives from consumer protection aspects, but it could also be seen as something in order to protect proprietors. Reflecting on the TCE, this thesis argues that the EU values trust more while the US values opportunism and uncertainty more.\textsuperscript{202} Put in relation to the above described, it appears that in order to have a functional economic system, the US has to legally control proprietors while the EU reflects back on the four freedoms of the EU, namely freedom of movement of goods, services, capital and people.\textsuperscript{203} Freedom of movement of goods and services could perhaps also indicate freedom of change of goods and services. In other words, there is freedom with responsibility and with responsibility there is a risk of

\textsuperscript{201} C-689/15 (VBB).
\textsuperscript{202} See chapter 2.3.
\textsuperscript{203} Article 26(2) TFEU.
deceiving the public if not using the trade mark correctly. The theory of maintaining quality implies that once a trade mark is registered and promoted, the proprietor is not eligible to change it at all.

As discussed in chapter 4.5, Parks argues that quality control should be a privilege and not an obligation in order to keep the trade mark protection. Most of the time, a consumer is not legally affected by a deceiving trade mark, but is affected economically regarding decisions and consumer search costs. Also, McKenna discusses how much the consumer aspect should affect the scope of the trade mark since it was not intended to be such a strong factor. The American view on quality control appears to be built upon distrust between different parties in order for the economic system and undistorted competition to work at its best. Perhaps, it would be better to base the system on trust instead as the EU does. It is a general reflection that with self interest as a basis, the incentives to do your best increases. The same could be assumed to be accurate within trade mark licensing.

The relationship between genuineness and guarantee of quality has also been discussed in the EU as well as in the US. In the US, the quality control is included in the definition of a genuine trade mark whereas it is not in the EU; at least not to the same extent. 204 Since the European definition of genuine use refers to the essential function, which itself does not include guarantee of quality, it is difficult to hold a correlation between these two. There are CJEU statements on behalf of consumer deception, but as mentioned earlier it is the proprietor’s responsibility to provide a certain standard.

5.6 Reflection towards control as a transaction cost
Reflecting on the above mentioned, it could be assumed that the EU and the US have different approaches on how law and economics are, and should be, combined. Unlike the EU, the American trade mark law appears to have a more joined cooperation with economic incentives and refers to the trade mark as a part of a greater area. When reading case law from respective jurisdiction, it is easier to acknowledge the American symbiosis of law and economics compared to how

204 See chapter 3.1, 3.5, 4.5.
it is acknowledged in the EU. The European economic functions often seem to be the second part of a legal issue, which also occurs in parallel. This is not as obvious in the American case law where the microeconomic effects of trade marks are outspoken more clearly.205

With licensing, there are both economic and legal aspects taken into consideration. As reflected on in chapter 2.3, 3.6 and 4.6, the TCE is of relevance in all phases of settling a licence agreement. Griffiths explains how a trade mark can reduce consumer costs by dividing them into search, experience and credence.206 While the economic aspect in general seem to have a focus on consumers, the TCE tends to have a stronger focus on the business perspective. This is also interesting to discuss in relation to the previously questioned consumer focus within trade mark law. A consumer should be able to distinguish a product without being confused, but does that mean that the entire economic perspective should be based on how to reduce consumer costs? It is a mutual exchange between proprietors and consumers, legally as well as economically, which should be represented. This could also be the reason for, as McKenna argues, a too strong consumer focus within the American trade mark law. With this in mind, it is easier to understand why the EU not includes quality control as an obligation within trade mark licensing.

Building on the opportunism and trust discussion in chapter 5.5, the different behavioural assumptions, together with bounded rationality, affects how the transaction costs develop during a licensing settlement. From chapters 3.6 and 4.6, it is understood that depending on whether there is forced quality control or not as well as cultural differences, the search, negotiating and enforcement costs will differ. The best case scenario would probably be a European agreement where the parties trust each other. Even if quality control is included in the licence, a European contract will be the cheapest option because of the lack of strong opportunism. There is of course opportunism in the EU but most likely not as strong as in the US. This is perhaps also the reason for still keeping the guarantee

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205 See chapter 4.5.
206 See chapter 2.3.
of quality as a separated function from the guarantee of origin. It is possible to keep a good standard anyway.
6. Closing remarks

The purpose of this thesis was to examine the EU trade mark law in relation to quality control in licensing with the help from a method of comparative law as well as a law and economics perspective. In order to answer the purpose, three questions were stated; *How is quality control dealt with within European trade mark licensing? How is quality control dealt with within American trade mark licensing? How does quality control affect the transaction cost economics?*

In the EU, an EUTM have one essential function, which is to ensure that goods and services are possible to distinguish without the risk of consumers being confused. For the trade mark to fulfil its role in the system of undistorted competition, one single undertaking is responsible for the quality. The quality is often seen as an economic function rather than a legal function of trade mark rights. Therefore, quality control is not a requirement when agreeing on an EUTM licence. According to case law, the proprietor has the possibility to control the quality by including clauses into the agreement but it is not mandatory. If the licensee manufactures inferior products or markets the trade mark that is not cohesive with how the proprietor wants it to be marketed, the proprietor is responsible and should bear the consequences of his or her decision. A possible consequence could be that the trade mark is decisive to consumers or not genuine if the essential function is not fulfilled, which in turn could lead to invalidation of trade mark registration. In other words, quality control is a privilege you as a proprietor could use when licensing the trade mark to a third party.

American trade mark law also emphasises the main purpose of distinguishing products without confusing consumers. Furthermore, the proprietor is responsible for the maintenance of quality and for the trade mark to stay genuine. In other words, there have to be quality controls. The reason for this is to protect consumers from deception. As an effect, American trade mark licensing must include quality control clauses. If they are not included, the licence is considered naked and invalid. The trade mark is not considered to be genuine and therefore abandoned by its proprietor. In comparison to the EU, quality control is an obligation in order for the trade mark to keep its protection rights.
In an economic perspective, quality control affect how the transaction costs are divided between the different phases, search costs, negotiating costs and enforcement costs. The behavioural assumptions bounded rationality, opportunism, uncertainty as well as trust also affect how the relationship between the licensor and licensee develops as well as how the licence is constructed. According to how the systems are developed, it appears that the EU focus more on trust between parties and therefore is able to have quality control as a privilege instead of an obligation. If the quality is not as it should be, it is on the responsibility of the proprietor. The US seems to presume that persons are opportunistic and the quality therefore has to be regulated by law. However, it could be an issue with the requirement of how a trade mark holder should maintain the quality. In an environment of free competition, it should be available for the proprietor to change the quality on its own products. With the requirement of quality control within trade mark licences, the proprietor is locked into a position without the possibility to develop. Even if the consumers are not deceived.

To summarize, the differences between the EU and the US derive from different views on what to protect and how to protect it. Considering that the EU has a younger joint system, it is possible that it is more comparable to how society is built up today. Businesses are changing and should have the possibility to differentiate its trade mark as well as belonging products. Therefore, quality control in my opinion should not be an obligation. It should be a privilege that the proprietor wants to use in order to fulfil its role in the system of undistorted competition.
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