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The Court of Appeal Adds a Few More Shades to Canada's Grey Market

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In Canada, as elsewhere in the world, intellectual property owners have made numerous attempts to control their distribution channels through trademark law, copyright law, or exclusive contracts, without much success.

However, in a recent decision (*Costco Wholesale Canada Ltd.* c. *Simms Sigal & Co. Ltd*.,[1] hereinafter referred to as "***Costco***"), the Court of Appeal of Quebec found that Costco Wholesale Canada Ltd. had committed the fault of contractual interference in a situation involving the grey market, also known as "grey marketing." This decision calls into question a long series of decisions on the legality of the grey market and the principle of free competition, which is well established in Quebec law.[2]

The grey market is defined as follows:

> Goods that are imported contrary to the wishes of the copyright holder or an authorized importer in a specific territory. It refers to goods which, as a general rule, are legitimately marketed in the foreign market, but whose presence in the local market is clouded by allegations of infringement. For this reason it is referred to as the 'grey market' in contrast to the black market, in which copyright is infringed, and the white market, where there is no copyright infringement.[1]

The Court of Appeal for Ontario recently confirmed that grey marketing is a legal way of buying genuine branded products abroad and reselling them in competition with a local distributor of the foreign manufacturer.[3]

In *Costco*, Simms Sigal & Co. Ltd. ("**Simms**") imported and distributed high-end clothing to retailers in Canada. In 2006, Simms entered into an exclusive distribution agreement with Rock & Republic Enterprise Inc. ("**R & R**") for the distribution of R & R's denim line, ready-to-wear clothing, and accessories. R & R jeans were not only high-end; they were also in high demand, selling for between $250 and $325 a pair.

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In November 2009, Costco Wholesale Canada Ltd. ("**Costco**") was approached by a distributor who offered to sell it R & R jeans at a very low price. The evidence shows that R & R knew that those jeans would end up in the Canadian market— R & R would sell to a first distributor who would then sell to a second distributor, who would in turn sell to Costco. Thus, Costco bought R & R jeans through two intermediaries and offered them to its customers for $98.99.

Simms sent a formal notice to Costco demanding that it cease selling the R & R jeans, alleging that it was the exclusive distributor and that the jeans Costco was selling were counterfeit. After checking with its distributor, Costco received a letter from R & R confirming that the jeans were genuine products. Costco's distributor added that R & R "are already dealing with the mad distributor" and asked Costco to "please [not] release this letter to the distributor".[4]

With this letter in hand, Costco answered Simms that the jeans were genuine products acquired on the grey market, and that it was entitled to sell them in Canada. In July 2010, Simms sent a second formal notice to Costco, reiterating that it had exclusive distribution rights to R & R jeans in Canada. Simms then instituted proceedings against R & R and Costco, but R & R filed for bankruptcy.

At trial, the Superior Court judge held Costco liable for damage caused to Simms as of November 2009, when it had received the first formal notice.[5] According to the judge, Costco chose to ignore the existence of the exclusive distribution agreement between Simms and R & R, adopting a position of wilful blindness, whereas it should have inferred, based on its distributor's behaviour, that an exclusive distribution agreement did indeed exist and that R & R was breaching it.

Costco was ordered to pay the sum of $361,005.44 in damages to Simms. Costco was also ordered to pay exemplary punitive damages of $500,000.00 as a result of the gravity of its fault of contractual interference and the effect on Simms' reputation on the Canadian market.

The Court of Appeal of Quebec upheld the Superior Court's decision and held Costco liable.

Contractual interference and the notion of fault

In Quebec civil law, under the principle of relativity of contracts, contractual obligations and undertakings may bind only the contracting parties. The fault of contractual interference is an exception to this principle.

In the 1975 decision *Trudel v. Clairol,*[6] which dealt with a form of grey market, the Supreme Court of Canada defined the fault of contractual interference as "an act of dishonesty to be associated knowingly with a breach of contract."[7] Simply put, to justify granting remedy for contractual interference, a plaintiff must show:

1. "The existence of a contract and valid contractual obligations that the third party allegedly contravened";[8]
2. "The constituent elements of the fault of a third party," which are:

> "the third party's knowledge of the contractual rights;
> incitement to or participation in the breach of the contractual obligations; and
> bad faith or disregard for the interests of others."[9]

In *Costco,* the Court of Appeal specified that "receipt of a copy of the contract by the third party or even that the exclusivity clause was read by the third party"[10] is not required to find that the third party committed a fault, and that the analysis of the third party's knowledge of the contract is contextual.[11]

In this regard, the Court of Appeal confirmed that the formal notice of November 2009 was not ambiguous, given that Simms' assertion that it was the exclusive distributor of R & R products was "clear and require[d] no interpretation".[12] It added that Costco's conduct was not that of a normally

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prudent and diligent person, and that it had adopted a position of wilful blindness by continuing to sell R & R jeans even though R & R's letter concerning its rights was not signed and predated the request for confirmation. In the Court of Appeal's opinion, these facts combined with the formal notice should have been sufficient to conclude that there was indeed a breach of contract.[13]

Although the Court of Appeal concluded that the trial judge did not impose an additional burden on Costco to inform itself,[14] the introduction of the notion of "wilful blindness" makes the situation highly subjective.

The Superior Court judge wrote:

> [186] Costco relies on the fact that they were dealing with a trusted intermediary. Costco has filed no evidence that it was ever advised that, in fact, R & R had "resolved promptly" the matter with Simms. Accordingly, there was no reason for Costco to believe it could ignore the cease and desist letters.
>
> [187] Costco allowed itself to limit its focus to the issue of authenticity of the Product despite being put on notice by Simms that the up-front issue with Simms was the EDA (Exclusive Distribution Agreement). If Costco was not prepared to deal directly with Simms to resolve the issue, it needed to have the issue of the EDA asked and answered by R & R. Costco failed to do either.
>
> [188] […] Ms. Janek on behalf of Costco was at fault in not seeking: (a) some confirmation emanating from R & R that they knew the goods were being sold in Canada by Costco and (b) that there was no Simms EDA that would prevent such sales. […] [15]
>
> [Our emphasis]

The Court of Appeal appears to agree with the trial judge's reasoning. Echoing the Superior Court's analysis quoted above, the Court explained:

> [61] Not only did Costco not obtain the confirmations demanded by Ms. Janek, it also chose to ignore information it received indicating that Simms was the exclusive Canadian distributor of R & R products [...].[16]

Even though no duty to inquire exists, Costco was criticized for having settled for questionable answers to its request for confirmation from the distributor and R & R that the goods were genuine **and that they could be sold in Canada.**

Would the ruling have been different if Costco had only asked R & R to confirm that the goods in question were genuine, while also asking its distributor whether it was bound by a contractual obligation not to sell in Canada? If the answer is yes, the Court of Appeal's conclusions make little sense.

If, as the Court of Appeal stated, Costco had no duty to inquire, its mistake was to have inquired to R & R directly about Costo's right to sell the jeans in Canada and it actually would have been preferable for it to ask as few questions as possible.

If a minimal duty to inquire had indeed existed, what should Costco have done? The Superior Court judge concluded on the basis of facts proven at trial that Costco should have obtained a letter signed by the owner of the trademarks in question confirming or denying Simms' exclusive rights. The Court of Appeal appears to agree, adding that:

> [66] There is no question here of ambiguity or interpretation regarding Simms' exclusivity that would have prevented Costco from understanding its scope or extent, but only of Costco's

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knowledge of its existence.[17]

Thus, the Costco decision seems to create a duty to inquire that must be fulfilled to avoid a fault of contractual interference. However, the scope of this duty remains vague.

Free competition and the grey market

If such duty to inquire is interpreted broadly, it would be possible for an intellectual property right holder to arrange its distribution network in such a way as to make it difficult for a third party to claim ignorance of contractual restrictions with respect to exclusivity in a given territory.

At trial, Costco alleged that the R & R jeans that it was selling at a low price had been legitimately acquired on the grey market and that it was entitled to sell them. With respect to the grey market, in *Consumers Distributing Co.* v. *Seiko*[18] the Supreme Court explained that "[t]he concepts of restraint of trade and free competition [...] would be battered because of an implied recognition of a right of an individual marketing a product to entail and control the sale of identical personal property, however legitimately acquired, of another person."[19]

In the present case, the Superior Court determined that Costco could not exonerate itself by alleging its right to purchase and resell grey market goods, as the contract between R & R and Simms was a juridical fact that was opposable to Costco.[20]

Did the particular facts of this case affect both the outcomes in Superior Court and the Court of Appeal? Certainly, but given that a contract is a juridical fact that is opposable to third parties; that such third parties have a form of duty to inquire about such juridical facts; and that one cannot be wilfully blind, the combination of these decisions seems to give greater weight to honouring contracts than to the principle of free competition.[21]

Is this a particularity of Quebec civil law (as opposed to common law)? How far does the duty to inquire go following the receipt of a formal notice? What degree of ambiguity is required for a party to claim that it has no knowledge of contractual obligations? The Canadian Courts will likely have to shed more light on the various legal shades of grey in the coming years.

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1. 2020 QCCA 1331.
2. Free competition is a well-established principle in civil law. In *Excelsior (L'), compagnie d'assurance-vie* c. *Mutuelle du Canada (La), compagnie d'assurance vie,* the Court of Appeal recognized free competition as [TRANSLATION] "a fundamental principle to the organization of economic activities [...] subject to its legislative or regulatory framework." Thus, competition is unique in that it can voluntarily cause harm to others without constituting a fault. Competition is only considered a fault if it is illicit or unfair; that is, if dishonest practices are used. *Excelsior (L'), compagnie d'assurance-vie* c. *Mutuelle du Canada (La), compagnie d'assurance vie*, [1992] R.J.Q. 2666 (C.A.), p. 30.
3. *Mars Canada Inc*. v. *Bemco Cash & Carry Inc*., 2016 ONSC 7201, para. 7; conf. 2018 ONCA 239.
4. *Costco Wholesale Canada Ltd.* c. *Simms Sigal & Co. Ltd.*, supra note 1, para. 18.
5. *Simms Sigal & Co. Ltd.* c. *Costco Wholesale Canada Ltd*., 2017 QCCS 5058.
6. [1975] 2 SCR 236.
7. *Id.*, p. 241.
8. *Costco Wholesale Canada Ltd.* c. *Simms Sigal & Co. Ltd.*, supra note 1, para. 51.
9. *Id.* para. 50.
10. *Costco Wholesale Canada Ltd.* c. *Simms Sigal & Co. Ltd.*, supra note 1, para. 57.
11. *Id.*
12. *Id.* para. 58.
13. *Id.* para. 64; *Simms Sigal & Co. Ltd.* c. *Costco Wholesale Canada Ltd*., supra, note 6, para. 181 to 183.
14. *Costco Wholesale Canada Ltd.* c. *Simms Sigal & Co. Ltd.*, supra note 1, para. 64.
15. *Simms Sigal & Co. Ltd.* c. *Costco Wholesale Canada Ltd*., supra note 6, para. 186–188.
16. *Costco Wholesale Canada Ltd.* c. *Simms Sigal & Co. Ltd.*, supra note 1, para. 61.
17. *Costco Wholesale Canada Ltd.* c. *Simms Sigal & Co. Ltd.*, supra note 1, para. 66.
18. 1984 1 SCC 583.
19. *Id.*, p. 584.

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20. *Simms Sigal & Co. Ltd.* c. *Costco Wholesale Canada Ltd*., supra note 6, para. 94 and 214.
21. *Excelsior (L'), compagnie d'assurance-vie* c. *Mutuelle du Canada (La), compagnie d'assurance vie*, [1992] R.J.Q. 2666 (C.A.), p. 30.

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