K&L GATES

FASHION LAW

"Fashion is the armor to survive the reality of everyday life"

Bill Cunningham

NOVEMBER 2021

WELCOME

WELCOME

As the world recalibrates in the wake of COVID-19, we continue to see new trends emerge and evolve in the retail, luxury goods and fashion sectors.

One such trend is the acceleration during the pandemic of **brands' move to direct to consumer (D2C) e-commerce**. In Part 1 of this edition, we flag the top 10 tips for fashion brands establishing or growing their e-commerce operation, to retain their allure whilst navigating potential legal pitfalls. There are also some important practical reminders as a brand manages this transition to D2C, such as when terminating distribution partners and when competing with its own retail customers. With fashion brands exploring new online models, we cover how brands can maximise the full potential of an "e-concession" to leverage the technology and reach of a partner's website, whilst avoiding antitrust risk.

Fashion companies doing business in Europe should be aware that major changes are afoot. In Part 2, we flag a proposed new European Union (EU) directive which will introduce mandatory obligations on many brands to carry out due diligence, report on, and take measures to address, potential adverse impacts on human rights, the environment, and good governance in their supply chains.

The EU is also revamping the competition law rules that will govern how a brand can structure its distribution arrangements and control the resale of its goods in Europe from May 2022 for the next decade. We summarise the key opportunities for fashion brands in the draft rules, as well as areas where systems and agreements may need revision. Some recent cases, including against Caudalie and major eyewear brands, provide a stark reminder of how the competition rules are strictly enforced.

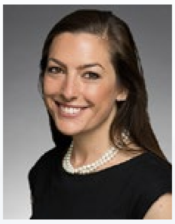
Keeping the lens on supply chains, in Part 3 our U.S. colleagues provide a useful step-by-step guide for how brands can weather the current storm of no supplies in the chain to meet surging demand. We also consider how California's new recyclability law could create liability associated with labelling and packaging issues for product suppliers. From a policy perspective, we provide an update on the "Made In America" Executive Order, which aims to ensure that the U.S. federal government is spending taxpayer money on American-made goods, by American workers, and with American-made component parts.

In Australia, where we turn to in Part 4, consumer law is heating up. This edition summarises reforms to the unfair contract terms laws that will materially increase the risk profile for larger businesses that engage business to business (B2B) and business to consumer (B2C) via standard form contracts. We also consider a case where an active-wear manufacturer has been fined for making false and misleading claims about the "anti-virus" properties of its garments; and see these same laws being used in interesting ways, including in a case brought by Mike Tyson to challenge third parties' use of his name, nicknames and likeness to sell t-shirts. Additionally, similar to inquiries elsewhere in the world, the Australian authority is examining competition and consumer concerns with general online retail marketplaces.

In Part 5, we discuss recent movements in the fashion intellectual property space, including whether 3D shaped packaging can be a registered trade mark; a key U.S. case on copyright registration validity challenges; and the recently enacted U.S. Trademark Modernisation Act.

Finally, looking to the future, we explore the rise in NFTs—or non-fungible tokens—an emerging form of technology akin to cryptocurrencies but in the art and music space. Our U.S. Fintech team explores the pros and cons of NFTs from a legal perspective and sets out considerations for those looking to issue or purchase NFTs, against the backdrop of potential future regulation.

We hope you find this edition insightful. If we can be of any assistance, no matter where you are in the world, please contact us.



GABRIELA DA COSTA

Special Counsel
London
+44 20 7360 8115
gabriela.dacosta@klgates.com

CATHERINE ADAM

Partner
London
+44 20 7360 8214
catherine.adam@klgates.com

FRANCESCO CARLONI

Partner
Brussels and Milan
+32 2 336 1908
+39 02 3030 0291
francesco.carloni@klgates.com

SUSAN KAYSER

Partner
Washington, D.C. and New York
+1 202 778 9421
+1 212 536 4053
susan.kayser@klgates.com

IN THIS ISSUE

NAVIGATING A FASHION BRAND'S TRANSITION TO D2C

OPTIMISING YOUR D2C E-COMMERCE FASHION OPERATION—TOP 10 TIPS

By Gabriela da Costa, Georgina Rigg, and Kira Green

The COVID-19 pandemic accelerated most brands' plans to grow their own D2C e-commerce presence. For many brands, this has become essential to their continued survival and competitiveness. However, how does a fashion brand run a successful e-commerce site whilst retaining the exclusive allure and personal feel of its designer stores? What are the key legal pitfalls it should be looking out for as it navigates this changing landscape? We've pulled together 10 lessons learnt over the past 18 months.

1. Remember Your App and the Basics

First things first, the brand will need a website and a mobile app. Both of these should consistently reflect the brand identity not just in look and feel, but in function. Check for bugs and make sure both work intuitively so as not to irritate users (consider consumer market testing before launch). Don't forget to ensure that your relationship with the website/app developer is governed by an agreement with strong intellectual property (IP) provisions. Also, make sure that where the site is owned or operated by a third party, your partnership is properly structured as a D2C arrangement to avoid competition/antitrust law risk when it comes to setting product prices (for more detail, go to page 12 for our section on structuring a D2C partnership model). When it comes to functionality, the ease of the customer journey from product selection to purchase is essential to avoid baskets being left behind, but you should also be aware that certain steps in this journey may be required by law. When developing your site, make sure the user experience (otherwise known as UX) is reviewed for legal compliance.

2. Dot Your I's and Cross Your T's

Next, a brand will need consumer-friendly online terms and conditions readily available on its website and app. This area of law is highly regulated in most countries and special care should be taken. The terms should be clear and easy to understand for all users and contain any mandatory provisions required by the applicable law (normally where the consumer is located). Applicable rules relating to customer returns for distance selling may also have an operational impact, which you will need to keep in mind. Other online policies you will typically need to have in place include a cookie policy, privacy policy, and acceptable use policy.

3. Check Your Products

If entering a new market or country, be aware that local product compliance requirements may vary, e.g., packaging, recycling and recovery obligations, or labelling requirements. Conscientious consumers will be interested in understanding a brand's ethical sourcing and sustainability policies but you must be conscious not to "greenwash" or exaggerate any claims. Make sure to also keep on top of evolving environmental, social, and governance laws—see our alert **here** for an overview of the proposed new EU Supply Chain Due Diligence Directive.

4. Get Techy

This is where we have seen fashion brands set themselves apart from their competition—through technological innovation. At the most advanced end of the spectrum, augmented reality technologies can now allow users to virtually try on products before they buy them, bridging the gap between the digital and physical marketplace. However, as a minimum, the consumer should be able to examine the products in detail, such as being able to zoom and rotate images to make up for the lack of physical interaction.

5. Minimise Back-End Logistics Risk

Providing fast delivery and convenient returns typically requires a network of suppliers. Where you use third party logistics providers for warehousing or fulfilment, make sure your third-party logistics (3PL) agreement is carefully negotiated to ensure you have the right levers to drive required performance. Although apportioning risk by way of insurance, indemnities, and liability provisions is essential, you may also wish to consider contractual mechanisms to "focus your 3PL's attention" on actually providing contractual volumes. Although termination rights for non-performance are standard, they are unlikely to achieve your commercial requirements (i.e., fulfilment of customer orders) and this is where some creativity in the commercial contract could come to the rescue.

Remember that if you transfer a logistics supply arrangement between providers or in-source the logistics, there may be employee transfer points to consider, such as the Transfer of Undertakings (Protection of Employment) regulations (TUPE) in the United Kingdom (UK). Also, if you wish to be fairly hands on in overseeing/shaping operations, you will need to be mindful of possible co-employment risk. As there is now a hard border between the EU and the UK, brands selling across these territories should also think about how they intend to address customs requirements.

6. Beware Geo-Blocking

If a fashion company is intending to supply products to customers in the EU, it cannot unjustifiably discriminate against them based on their location or nationality. This means that an e-commerce business within the EU cannot unjustifiably refuse to deliver products to customers in other countries simply because of their location. Examples of geo-blocking which can raise risk include automatically redirecting website users to a local country site without their consent, refusing to accept foreign credit cards, and charging delivery surcharges not based on actual costs. A similar provision applies within the UK borders as well.

7. Protect Your IP

A brand's website and app should clearly set out that IP on the website and app belong to the brand (to the extent that is true) to help prevent data scraping and copyright infringement, and to increase the likelihood of successful enforcement against infringers. Additionally, some fashion brands have been using blockchain to prevent counterfeiting, help deter theft, and authenticate goods as genuine.

8. Data is King—But Exercise Caution

A transactional site will have access to a large amount of consumer personal data (names, addresses, contact details, banking information, and so on). The brand should therefore understand what it is collecting, how and where it is being processed, and what mandatory data protection requirements apply. Brands may wish to consider techniques to limit privacy policy fatigue, for instance including appropriate terms to limit email notifications for policy changes and streamlining cookie preference click-throughs.

To limit the risk and negative connotations of possible data breaches, a company should ensure it has adequate cybersecurity protections and a disaster-recovery plan in place. At the same time, a brand can obviously benefit from collecting user data to understand trends, spot opportunities, and improve the user experience through personalisation and targeted recommendations—a data strategy is always recommended to strike the right balance for a particular business between protection and capitalisation of personal data.

9. Getting Marketing Right

Social media platforms have become a critical tool for engaging with consumers and conveying a consistent story about a brand and its products. However, a company should be mindful of applicable influencer marketing rules and advertising regulations—regulators are currently very interested in ensuring paid relationships (which includes providing free products) are communicated clearly to consumers. Ensure relationships with brand ambassadors are also well-documented in influencer marketing agreements or endorsement/collaboration agreements. Marketing teams should also be trained in the key local marketing and consumer law requirements to ensure compliant product claims and price presentations, while at the same time successfully growing the brand's appeal and presence online.

10. Maintain Premium Support

Last but not least, consumers accustomed to the high quality customer support given at fashion boutiques will expect the same from their online experience. Brands should ensure that customer support is available quickly and efficiently, and in the consumer's language. A brand should familiarise itself with applicable rules around cooling off periods for returns as well as mandatory consumer warranties.

We have also seen clients introducing key performance indicators for waiting times and common support issues, such as returns, refunds, and exchanges. Finally, a dedicated resource for responding to social media commentary promptly has become a must—make sure they feel adequately equipped with appropriate training.

AUTHORS

Gabriela da Costa
Special Counsel
London
gabriela.dacosta@klgates.com

Georgina Rigg
Associate
London
georgina.rigg@klgates.com

Kira Green
Trainee Solicitor
London
kira.green@klgates.com

Gabi works in our Antitrust, Competition, and Trade Regulation practice group across the UK and Europe. For more information about this practice, please visit our **website**.

Georgina and Kira work in our Intellectual Property practice group in London. For more information about this practice, please visit our **website**.

TERMINATING PARTNERS? KEEP THESE POINTS IN MIND

By Michal Kocon

It is not uncommon for a brand to rationalise its distribution or resale network as it moves D2C to better reflect its brand strategy and minimise business costs. However, before letting a partner go, make sure you've run through this checklist to manage legal risk.

1. Check your contract terms—do they say anything on notice period? Note that some local country laws can impose longer mandatory notice.
2. Consider whether your partner could be considered an agent or whether the local laws treat distributors very favourably—some laws entitle terminated partners to compensation payments so you will want to understand and mitigate your potential exposure.
3. Familiarise yourself with the key competition/antitrust law principles in the territory—in many countries both in Europe and elsewhere, a third-party cannot be restricted from reselling products unless a valid selective distribution system is in place. Your market shares may influence the extent to which you can stop someone from selling even if they comply with your authorisation criteria.
4. Consider whether reasons for the termination should be provided to minimise legal risk, and be mindful of the potential consequences of doing so—if you disclose the reason and the partner addresses it, are you willing to continue doing business with them?
5. Be ready to have a discussion about practicalities such as remaining inventory and transition period. Make sure you have strong confidentiality and IP protections in place.

AUTHOR

Michal Kocon
Senior Associate
London
michal.kocon@klgates.com

Michal works in our Antitrust, Competition, and Trade Regulation practice group across the UK and Europe. For more information about this practice, please visit our **website**.

REMINDERS WHERE YOUR CUSTOMERS ARE ALSO YOUR COMPETITORS

By Niall Lavery

As brands move D2C, they should be mindful that their resale customers may start to wear two hats—that of both the customer and competitor. In many territories, "dual distribution" as it's known, introduces some extra rules around the types of information brands can and cannot share with their competing retail network and vice versa. Crossing this line can lead to serious repercussions such as antitrust investigations and fines which fashion brands such as Hugo Boss are starting to discover (see our previous alert **here**).

The rules in this area remain somewhat unclear and in flux, so it is always good practice to have in place appropriate protocols, which will help to mitigate possible risk.

Some key examples include:

1. Keeping the D2C and sales teams separate.
2. Limiting information flows, so that potentially competitively sensitive customer information does not flow to the brand's D2C team, and competitively sensitive information regarding the brand's D2C operation does not flow down to competing customers.
3. Training the sales team to know how to discuss sensitive topics with customers—e.g., future network promotions, minimum discounts, recommend resale prices, and brand or territory strategy. Sales teams should also be trained to avoid "vertical" risks—see our summary in this publication on Caudalie's recent fine for minimum resale prices and unlawful online sales restrictions.

AUTHOR

Niall Lavery
Associate
London
niall.lavery@klgates.com

Niall works in our Antitrust, Competition, and Trade Regulation practice group across the UK and Europe. For more information about this practice, please visit our **website**.

STRUCTURING AN E-CONCESSION THAT DOES NOT FALL FOUL OF THE COMPETITION LAWS

By Jennifer Marsh, Gabriela da Costa, Michal Kocon, Yujing Shu, Dr. Annette Mutschler-Siebert, Christopher Finnerty, Francesco Carloni, Philip Torbøl, Mélanie Bruneau, and Niall Lavery

The events of the COVID-19 pandemic have caused many brands to re-evaluate whether they are fully utilising the internet as a tool to reach out to consumers, with many enhancing and upgrading their own brand websites. Some brands are now also considering whether they are fully harnessing the potential reach and profile of multi-brand websites and platforms to make sales to consumers.

One growing trend is a rise in the popularity of the "e-concession" model. Just like a branded concession in a physical department store, an e-concession allows the brand to have its own "shop within a shop" on one or more digital marketplaces. These showcase a collection of brands in a distinctive setting in which brands can leverage existing investments in enhanced tools such as virtual try-on or matching suggestions performed by artificial intelligence. They are also likely to attract a broader customer set and thereby grow brand awareness.

In order to ensure that an e-concession strategy is an asset rather than a risk, the antitrust and competition issues need to be carefully considered and addressed. In particular, is the brand seeking to control a third-party's pricing to consumers? If so, this can amount to a serious violation of antitrust and competition laws in many jurisdictions, such as the EU, UK, and other countries, and expose the brand to a risk of investigation, large fines, and damages claims.

Resale Pricing and Cross-Border Selling Restrictions

In jurisdictions such as the EU, it is illegal for a brand to dictate the price that a third-party reseller charges to a consumer. For example, the European Commission fined GUESS €40 million for such resale price maintenance (RPM) and other conduct in 2018 (for more detail on the GUESS case and recent RPM developments, see our earlier alerts **here** and **here**). RPM can be a risk in concessions in brick and mortar department stores if the concession is operated by the department store rather than by the brand, such that the department store is the company making the sales to consumers rather than the brand itself. In such a context, the brand may recommend the onsale price but may not dictate it. Much will turn on the factual detail, and the substance rather than the form of the agreement will be decisive.

The same is true in the online context with e-concessions. For example, if the brand itself is making direct sales to consumers via the online marketplace, the brand is entitled to set the price charged to consumers. This may well also be the case where the third-party platform is operating as an agent of the brand and is not itself taking the risk/reward of the sale. However, if the marketplace is operating as an independent third-party and the brand is transferring inventory to it for onward sale, serious concerns may arise.

One option to limit the risk in such scenarios is for the bricks and mortar department stores or the online partner to act as an agent of the brand so that the brand takes the risk of the activities of the "agent," for example the credit risk of customers not paying or the stock risk of lost or damaged stock. In such a scenario, a brand can stipulate the price charged to the customer. Further, the

European Commission has now proposed a helpful clarification in the proposed guidance for such arrangements, due to take effect in May 2022 and discussed in the section "European Distribution Rules Latest" in this publication. Specifically, there is a proposed clarification that a brief temporary passing of title in the products will not in itself preclude an agency agreement if the partner is otherwise not taking on risk.[1]

On the other hand, the European Commission's current stance will make it much more difficult to appoint a platform as an agent regardless of whether title to the products passes to the platform or not. In particular, the proposed guidance suggests that online intermediation service providers cannot qualify as agents of sellers who use the platforms (because the platforms are categorised as suppliers who dictate terms to sellers, rather than the other way around). The Commission sets out that online platforms should therefore be seen as independent economic operators rather than agents.[2]

The operation of e-concessions may also raise issues with respect to cross-border selling. Brands offering their products through e-concession stores may want, for example, to control the regions where certain products are being sold and marketed (e.g., to account for local fashion trends or consumer preferences). In this respect, it is important to bear in mind that EU competition law imposes a number of limitations on the ability of manufacturers to prohibit sales between EU Member States.

[1] See paragraph 31(a) of the draft EU Vertical Guidelines.

[2] See paragraph 44 of the draft EU Vertical Guidelines.

Selective Distribution

Brands operating a selective distribution system in the EU have the advantage of being able to authorize all the resellers (online and bricks and mortar) selling their products to consumers. E-concession stores certainly fall within the category of stores that a brand may want to include in its selective distribution network. However, care should be taken when the brand expands to new channels that the model fits within its criteria for authorisation so that the brand is operating its system in a consistent and objective way.

The International Picture

The question as to which legal system applies is primarily dictated by where the onward sales to consumers are being made. For instance, in the United States, there will be more flexibility when it comes to third-party pricing restrictions. We anticipate that China may be a particular area of focus for the e-concession model as brands look to capture sales from the Chinese consumer in the context of a sustained period of travel disruption. The Chinese rules are still evolving in this area and careful analysis is required (see our previous alert **here**).

AUTHORS

Jennifer Marsh
Partner
London
jennifer.marsh@klgates.com

Gabriela da Costa
Special Counsel
London
gabriela.dacosta@klgates.com

Dr. Annette Mutschler-Siebert
Partner
Berlin
annette.mutschler-siebert@klgates.com

Philip Torbøl
Partner
Melbourne
philip.torbol@klgates.com

Yujing Shu
Partner
Beijing
yujing.shu@klgates.com

Francesco Carloni
Partner
Brussels and Milan
francesco.carloni@klgates.com

Chris Finnerty
Partner
Boston
chris.finnerty@klgates.com

Mélanie Bruneau
Partner
Brussels
melanie.bruneau@klgates.com

Michal Kocon
Senior Associate
London
michal.kocon@klgates.com

Niall Lavery
Associate
London
niall.lavery@klgates.com

Our team above works in our Antitrust, Competition, and Trade Regulation practice group across the UK and Europe. For more information about this practice, please visit our **website**.

IMPORTANT UPDATES FOR BRANDS SELLING GOODS IN EUROPE

EUROPEAN UNION MOVES TOWARDS MANDATORY SUPPLY CHAIN DUE DILIGENCE: START GEARING UP FOR NEW DIRECTIVE

By Gabriela da Costa, Jennifer Marsh, Dr. Annette Mutschler-Siebert, Catherine Adam, and Kate McDermott

There has been a proliferation of new laws concerning ethical sourcing and due diligence in supply chains in various territories in recent years. This trend is being taken to the next level in the European Union with a proposed new law that will introduce far-reaching supply chain due diligence obligations for certain businesses.

On 10 March 2021, the European Parliament considered and adopted an outline proposal for the "EU Directive on Mandatory Human Rights, Environmental and Good Governance Due Diligence" (the Directive). The European Commission was tasked with drafting a formal legislative proposal for the Directive, which is due to be presented to the European Parliament in 2021. Whilst the Directive is not expected to come into force until late 2022 or early 2023, companies falling within its scope will need to start gearing up to ensure they're ready when the new requirements kick in.

Below, we summarise the aims of the Directive, who it will apply to, what they will need to do to comply, and what the risks will be if they don't.

What are the Aims of the Directive?

The Directive aims to introduce far-reaching mandatory due diligence obligations amid concerns that a voluntary regime is insufficient in addressing the potential negative impacts of globalised business activities in various fields of corporate responsibility.

The European Parliament's concern that too little is being done today is corroborated by the European Commission's recent finding that only one business in three is currently conducting appropriate due diligence measures with regards to its value chain.

The Directive is also intended to exclude unfair competitive advantages across the European Union, by harmonising and creating a level playing field in light of different national supply chain laws already, or soon to be, enacted in several member states (such as France, Germany, and the Netherlands).

Who Will Have Obligations Under the Directive?

It is currently expected that the Directive's obligations apply to:

- Large undertakings, defined as businesses operating in the European Union (irrespective of place of registration) with more than:
  - o 250 employees;
  - o €50 million annual turnover; or
  - o a balance sheet total exceeding €43 million.
- Publicly listed or "high-risk" small and medium sized entities; and
- Companies providing financial services and products.

What Will Companies Need to do to Comply?

Companies falling within the scope of the Directive will be obliged to:

- Take measures and make efforts to prevent potential adverse impacts in three fields of corporate responsibility: human rights, the environment, and good governance;
- Put appropriate processes in place; and
- Publicly communicate their approach to due diligence in a due diligence strategy document.

Measures and Efforts to Prevent Adverse Effects

Affected companies will need to take "all proportionate and commensurate measures," and "make efforts within their means," to prevent potential adverse impacts in the following three fields of corporate responsibility:

- **Human rights**: including social, trade union, and labour rights;
- **The environment**: for example, the production of waste, sustainable use of natural resources, pollution, greenhouse gas emissions, deforestation, biodiversity, and ecosystems; and
- **Good governance**: including combatting bribery, corruption, and illegal campaign contributions.

What Does "Proportionate Measures" Mean?

Given the broad scope of affected entities, the obligations will be applied proportionately, meaning not all companies will be required to take the same actions. The necessary actions for each company will depend on factors such as:

- The severity and likelihood of the adverse impacts;
- Sector of activity;
- Size of the undertaking;
- The nature and context of the undertaking's operations (including geography);
- The undertaking's business model;
- Its position in the value chain; and
- The nature of the business's products and services.

Know your customer

Affected companies will need to:

- Make appropriate efforts to identify their suppliers and subcontractors – the due diligence requirements will not be limited to the first tier downstream and upstream in the supply chain, but will encompass any identified as posing "major risks" in any stage of the value chain;
- Take appropriate action to ensure that their business partners put in place governance policies in line with the company's due diligence strategy (e.g., by means of framework agreements, contractual clauses, codes of conduct, or certified and independent audits); and
- Regularly verify that subcontractors and suppliers comply with these obligations.

Appropriate Processes

Affected companies will be obliged to put processes in place in relation to potential adverse impacts in the above areas that:

- Identify;
- Assess;
- Prevent;
- Mitigate;
- Cease;
- Monitor;
- Communicate;
- Account for;
- Address; and
- Remedy.

Due Diligence Strategy

Affected companies will be required to produce a Due Diligence Strategy Document in which they publicly communicate their approach to due diligence, which must be integrated into their overall business strategy.

The Due Diligence Strategy Document, which will need to be evaluated (and revised if necessary) on an annual basis, will need to:

- Specify the company's potential or actual adverse impacts on human rights, the environment and good governance;
- Map the company's value chain;
- Indicate the appropriate policies and measures adopted by the company, with a view to ceasing, preventing, or mitigating the identified potential or actual adverse impacts; and
- Set up the company's prioritisation strategy.

Enforcement

Enforcement of the mandatory regime under the Directive will fall on the competent national authorities of EU member states, who will have the power to carry out investigations into compliance, including by conducting interviews with stakeholders and their representatives, and carrying out on-the-spot checks.

Possible sanctions under the final Directive regime are expected to be serious and may include:

- Large administrative fines (comparable in magnitude to fines currently provided for in competition/antitrust law and data protection law);
- Exclusion from public procurement, state aid, or public support scheme; and
- Import bans in the case of severe human rights violations (such as child labour).

The proposed regime also envisages a system giving victims of a company's actions in third world countries access to a legal remedy in the form of compensation.

When Will the Requirements Kick In?

Based on the usual timeline for legislation adoption at EU level (approximately 19 months), we expect that the Directive will be adopted in late 2022, at the earliest. Following this adoption, EU member states will be given time to transpose the Directive into national law, which is usually a maximum period of two years - meaning binding national laws would not be expected before 2023.

However, given the extent of these obligations, companies expecting to be subject to the new regime under the Directive will need to begin to consider necessary steps to reach compliance and potentially upgrade the measures already implemented under national regimes (such as those in Germany, France and the Netherlands), to ensure all required measures are in place before the Directive comes into force.

AUTHORS

Gabriela da Costa
Senior Associate
London
gabriela.dacosta@klgates.com

Jennifer Marsh
Partner
London
jennifer.marsh@klgates.com

Dr. Annette Mutschler-Siebert
Partner
Berlin
annette.mutschler@klgates.com

Catherine Adam
Partner
London
catherine.adam@klgates.com

Kate McDermott
Trainee Solicitor
London
katherine.mcdermott@klgates.com

Gabriela, Jennifer and Annette work in our Antitrust, Competition, and Trade Regulation practice group across the UK and Europe. For more information about this practice, please visit our **website**.

Catherine works in our Intellectual Property Technology Transactions group in London. For more information about this practice, please visit our **website**.

EUROPEAN DISTRIBUTION RULES LATEST: DUAL PRICING, SHARED EXCLUSIVITY IN; MAP POLICIES STILL OUT

By Jennifer Marsh, Gabriela da Costa, Dr. Annette Mutschler-Siebert, Philip Torbøl, Francesco Carloni, Dr. Jens Steger, Mélanie Bruneau, Michal Kocon, and Katherine McDermott

The European Commission has now published its proposed draft of the new EU rules, which will govern distribution agreements until 2032. These are set to replace the current EU Vertical Block Exemption Regulation (VBER) and Vertical Guidelines, which expire on 31 May 2022.

The draft proposed texts present some positive aspects for brands. These include increased flexibility for structuring their distribution arrangements in Europe, clarity in relation to applying different prices and criteria for online retailers, and welcomed comfort on how price monitoring software, online advertising restrictions, and website e-concession arrangements are likely to be assessed under the law. Conversely, the proposals also introduce some questions and potentially stricter rules for brands who sell directly to consumers in competition with their resellers (notably marketplaces), as well as regarding the extent to which different distribution models at the wholesale and retail level can be combined in the same territory.

Under the Proposals

Resale Price Maintenance

Stipulating the price at which products can be resold continues to be a concern to the Commission (as is the case with national competition authorities in Europe and globally); though there seems to be a greater willingness to accept potential pro-competitive effects in limited instances:

- with respect to minimum advertised prices (MAPs) or minimum advertised pricing policies, it has been made explicit that it is illegal to sanction a customer for selling below MAP or to prohibit customers discounting or communicating that a final price may differ from a MAP;[1]
- it is clarified that the use of price monitoring software is not problematic in and of itself, but only if used as a tool for enforcing concerning RPM behaviours;[2] and
- there is further recognition that RPM could benefit from an individual exemption under certain circumstances (such as a temporary short-term pricing campaign for a new product launch or to prevent free-riding), although the requirement to prove that there is no less anti-competitive alternative to the proposed RPM measure remains a high threshold.

Dual Pricing

In a major departure from previous rules, brands will be able to offer different wholesale prices depending on whether products are going to be sold online or offline, in order to support additional pre-sales services offered by retailers, so long as the differential does not in practice make online sales uneconomic.[3] Similarly, the ability to impose different criteria on online and offline dealers is now more explicit with no reference to the need for "equivalence."[4]

---

[1] Draft Vertical Guidelines, paragraph 174.

[2] Draft Vertical Guidelines, paragraph 175.

[3] Draft Vertical Guidelines, paragraph 195.

[4] Draft Vertical Guidelines, paragraph 221.

Selective Distribution

The possibility to require an authorised reseller to operate a brick and mortar store or to make a certain amount of sales offline remains block exempted where the parties are below the 30 percent market share threshold.[5] However, given the need—in principle—for consistent application of criteria across a retail network, these options may remain impractical for some brands or products (for instance, where the brand itself or key online partners do not have a physical presence or offer equivalent support). The proposals also clarify that selective distribution may be appropriate for any sort of high quality products (not just technical or luxury goods), although the benefit of the safe harbor may be withdrawn if this is not justified.[6] Consistent with the EU courts' decisional practice, it is also confirmed that, in principle, a supplier is allowed to prevent sales on online marketplaces even outside a selective distribution system—though the Vertical Guidelines remind suppliers that where the platform, the supplier itself, or certain authorised resellers are permitted to sell on the platform, a ban on sales on the marketplace for others is unlikely to meet the requirements for exemption; but a supplier is permitted to require compliance with quality criteria for marketplace authorisation.[7]

Shared Exclusivity and Flow-Down of Restrictions

Brands will be able to grant a limited number of distributors (rather than only one distributor, as it is currently) shared exclusivity of a particular territory or customer group. It is also now possible to protect an exclusive territory or customer group from active sales both from the brand's direct customers, as is currently possible, as well as from indirect customers to whom the active sales restriction can be passed down.

Mix and Match

It will become easier for brands to combine different distribution systems within the EU, for instance exclusive or free distribution in one territory and selective distribution in another (where the local conditions might support this model better). It will also be clearly acceptable to prevent customers and indirect customers from selling to unauthorised dealers in a territory where a selective distribution system has been implemented.

However, the rules on combining systems within one territory (for example an exclusive wholesaler and selective retailers) remain somewhat unclear and should be kept under review pending the consultation, in case revisions to agreements might be required. Additionally, whilst the new rules further endorse the need to protect authorised members of a selective distribution system and system objectives (such as brand and consumer protection); they remain silent on how this can be enforced in practice, particularly against third-parties. It will therefore be for national courts to confirm the tools available to suppliers seeking to protect these well-recognised rights.

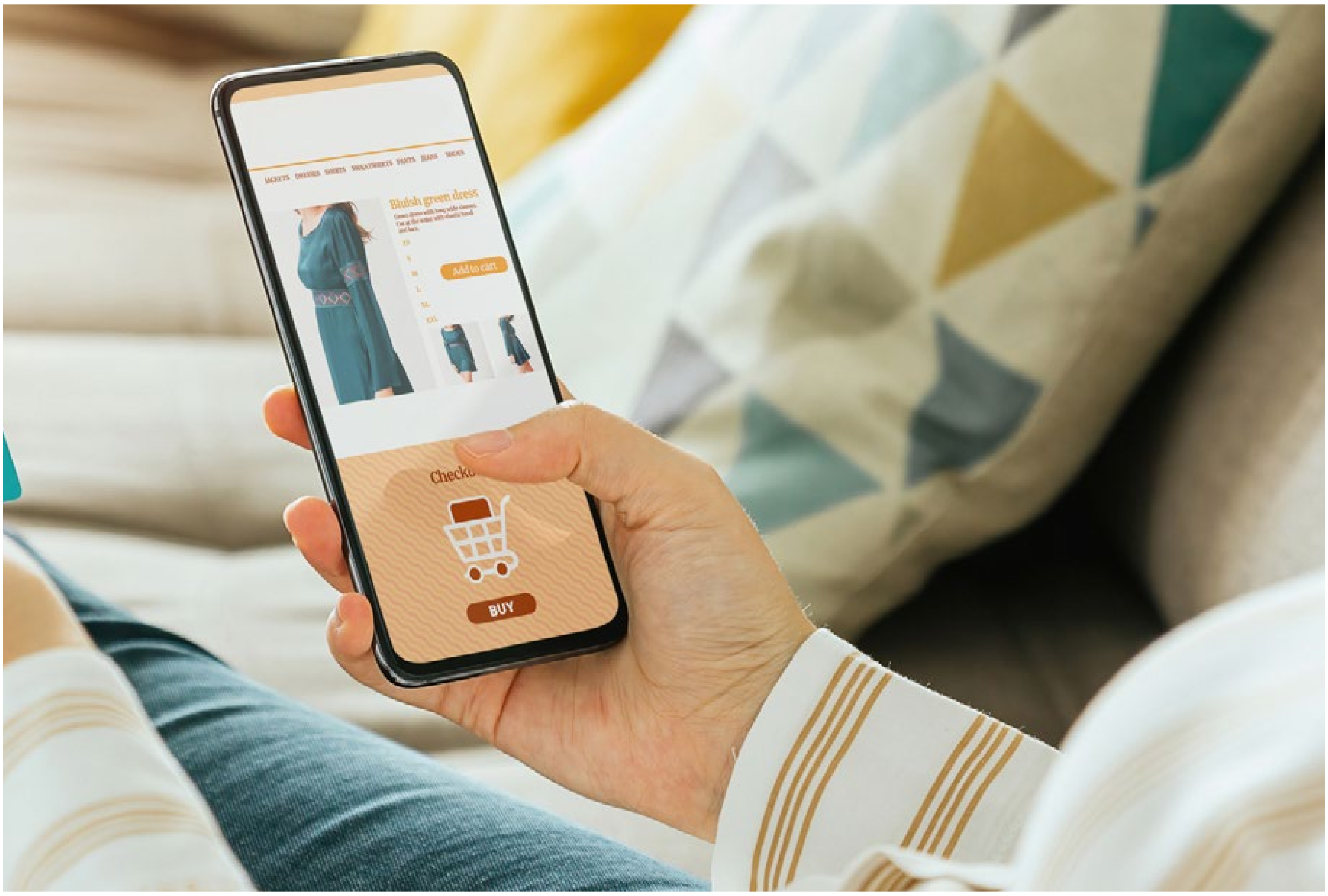
Online Active Sales

Where exclusivity has been granted to a partner, active selling by other distributors or resellers can be prevented. The new rules are clearer around what constitutes "active" selling in the online context and adopts a broader stance more reflective of e-commerce realities. Specifically, the following are now expressly deemed "active" sales efforts: offering language options different to those commonly used in the territory in which the distributor is established (though English is an exception), using price comparison tools not commonly used in the distributor's territory/in a different language, and bidding for search engine terms targeting a territory.

[5] Draft Vertical Guidelines, paragraph 194.

[6] Draft Vertical Guidelines, paragraph 136.

[7] Draft Vertical Guidelines, paragraphs 321 and 322.



Dual Distribution

Where a brand sells products through a distribution network as well as direct to consumers in competition with its partners, the Commission is proposing tougher thresholds for exemption. The arrangement (including information exchanges) will be block exempted where the combined market share of the brand and its dealer does not exceed 10 percent at retail level. However, where it exceeds 10 percent but remains below 30 percent, the parties will be subject to the rules applicable to horizontal agreements concerning competitive information sharing. Strictly speaking, whilst the safe harbor has been narrowed, this broadly mirrors the advice given by competition lawyers for some time.

Nevertheless, the new rules may result in increased complexity when it comes to calculating market shares (for instance where a company owns multiple brands in the same sector). Additionally, more specific guidance on the expected treatment of information exchanges would be welcomed, since certain discussion topics that are essential for the efficient operation of a distribution relationship would be illegal under a pure competitor relationship. Risk management measures might include team separations between sales and D2C divisions, information exchange protocols, and ensuring sales reporting templates do not request customers' competitively sensitive data.

Agency

As before where a dealer is in fact an agent, the relationship is effectively exempt from some of the key limitations on what the seller/brand can require of its dealers, in particular the brand may specify the price at which the agent sells the products. There are some helpful relaxations in the draft proposals, which will assist brands setting up "e-concession" windows or partnerships online, akin to what they might have in a brick and mortar department store. Specifically, it has now been clarified that a brief temporary passing of title will not in itself preclude an agency agreement if the partner is otherwise not taking on risk.[8]

[8] Draft Vertical Guidelines, paragraph 31(a).

Online Intermediation Services

In the light of their growing influence on the European markets, the new VBER will put a special emphasis on online intermediation services (i.e., marketplaces and other sales platforms). On the one hand, these service providers will be treated as "suppliers" in the context of VBER, irrespective of the nature of their participation in the transactions they facilitate. This could further limit some of the conditions larger platforms may put on their business users (e.g., also in their general service terms). In particular, the new VBER expressly excludes from exemption any obligations put on businesses using online intermediate services not to offer their products or services under more favourable conditions via competing services, effectively prohibiting best-price clauses aimed against competing platforms. A major element of the new rules is that the safe harbors for dual distribution (described above) will not apply to online platforms/marketplaces that sell in competition with the suppliers/sellers they host. Additionally, due to their "supplier" designation noted above, providers of online intermediation services (e.g., marketplaces) are in principle excluded from being agents so this should also be closely monitored in the context of brand-marketplace partnerships.[9]

Non-Compete

The proposed rules introduce welcomed clarity that a non-compete obligation which is tacitly renewable beyond five years will benefit from the safe harbor (currently, where such agreements automatically roll-over, they are not exempted).[10]

Potentially Longer Safety Periods for "Successful" Agreements Exempted Under VBER

Finally, since the VBER only applies to businesses with modest market shares, businesses that relied on its terms for exemption were always under a certain risk of becoming "too successful." Under the current VBER, if a market share that is initially not more than 30 percent rises above that level without exceeding 35 percent, the exemption will apply for a further two years. However, this protection is reduced to one year where the market share exceeds 35 percent.

Under the proposed draft, the two year further protection will apply irrespective of the amount by which the market share increases over 30 percent. Note that if the VBER does not apply (due to larger market shares), this does not mean the arrangements are presumed unlawful; however, they are not automatically exempted and an individual assessment of their competitive effects will be required. Additionally, measures such as quantitative criteria and flexibility in the application of terms become less available.

United Kingdom

Following the Brexit process, the revised VBER and Vertical Guidelines will not apply in the UK. However, the UK has retained the existing rules and is considering a revised version under its own consultation process. The UK Competition and Markets Authority has in fact published a consultation document setting out its proposed recommendations to the Secretary of State for the UK approach.

The UK consultation has focused on similar themes to the Commission's and a wholesale parting of ways is not in prospect. For example, on points such as RPM, shared exclusivity, dual pricing, and the possibility of different offline and online criteria, the two regimes are aligned. However, the UK proposed approach to combined selective and exclusive distribution systems appears more coherent. On the other hand, the Commission is taking a more relaxed approach to tacitly renewable non-compete agreements.

[9] Draft Vertical Guidelines, paragraph 44.

[10] Draft Vertical Guidelines, paragraph 234.

This divergence in itself could be problematic for brands who have traditionally been able to adopt a holistic European distribution strategy. Arguably, the greatest divergence is the timeframe—the UK is planning to have its revised verticals regime in place for just six years before renewing it, whereas the Commission is proposing that the new rules will remain in place until 2032.

Next Steps

Our team has been heavily involved in submitting comments and suggestions to the Commission on the proposed rules to ensure clarity, flexibility, and commerciality. We also prepared and submitted comments on behalf of the Camera Nazionale della Moda Italiana (the National Chamber for Italian Fashion) and the Fédération de la Haute Couture et de la Mode (the French Federation of haute couture and fashion) advocating for the interests of their members.

Whilst immediate changes are not necessary pending finalisation of the draft rules, brands, marketplaces, and other players in the distribution chain should begin to assess their distribution structures and policies to flag areas that might need revision or clarification to ensure compliance going forward, as well as to identify opportunities where they can now take advantage of the additional flexibility. Please let us know if we can assist you in planning for the new regime.

AUTHORS

Jennifer Marsh
Partner
London
jennifer.marsh@klgates.com

Gabriela da Costa
Senior Associate
London
gabriela.dacosta@klgates.com

Dr. Annette Mutschler-Siebert
Partner
Berlin
annette.mutschler@klgates.com

Philip Torbøl
Partner
Brussels
philip.torbol@klgates.com

Francesco Carloni
Partner
Brussels and Milan
francesco.carloni@klgates.com

Dr. Jens Steger
Partner
Frankfurt
jens.steger@klgates.com

Mélanie Bruneau
Partner
Brussels
melanie.bruneau@klgates.com

Michal Kocon
Senior Associate
London
michal.kocon@klgates.com

Katherine McDermott
Trainee Solicitor
London
katherine.mcdermott@klgates.com

Our team above work in our Antitrust, Competition, and Trade Regulation practice group across the UK and Europe. For more information about this practice, please visit our **website**.

CAUDALIE FINED IN BELGIUM IN THE CONTEXT OF THE IMPLEMENTATION OF ITS SELECTIVE DISTRIBUTION NETWORK

By Nicolas Hipp

On 6 May 2021, the Belgian Competition Authority (BCA) fined the high-end skincare products supplier Caudalie €859,310 for breaching competition law by imposing to its authorized distributors minimum resale prices and illegal limitations of online sales.

Caudalie submitted commitments to the BCA concerning the conditions that Caudalie can impose on distributors to safeguard the integrity of its distribution network and protect its brand image. The BCA's decision made these commitments legally binding and considered them as mitigating circumstances justifying a decrease of the amount of the fine.

Selective distribution systems (SDS) are agreements between a supplier and one or more distributors that specify selection criteria which have to be met by a company before it can be admitted into the system as "authorized distributors," and prevent the resale of the product to non-authorized distributors.

SDS are considered a restriction of competition under EU competition law (also applicable in Belgium). However, the EU VBER acts as a safe harbor, exempting certain agreements from the application of EU competition law. This exemption applies to SDS, provided that they satisfy the VBER requirements and contain no "hardcore" restrictions. The luxury and fashion industry heavily relies on the provisions of the VBER, as it gives legal certainty when implementing SDS. SDS are a particularly useful tool for brands to preserve the quality of the distribution system and the reputation of the brand.

The SDS of Caudalie could not benefit from the VBER's safe harbor as it imposed hardcore restrictions on its authorized distributors. In particular, Caudalie imposed minimum prices, which are equivalent to fixed prices in terms of severity, and limited passive (i.e., reacting to unsolicited orders) and active sales (i.e., actively approaching potential clients) online. The restriction of cross-border active and passive sales is considered a hardcore restriction of competition, and EU antitrust authorities consider online sales restrictions a form of restriction of passive sales. The presence of hardcore restrictions in an agreement removes the benefit from the VBER to the whole agreement and exposes the breaching company to significant fines.

This decision of the BCA occurs at a pivotal moment where the VBER is being reviewed by the European Commission, the EU antitrust authority. During this review process, stakeholders noted that the VBER should be adapted to reflect current market trends in e-commerce and that the online sales channel does not need the same level of protection as ten years ago, when the VBER was adopted. In that regard, stakeholders notably considered that the concept of active and passive sales should be clarified and that brands should benefit from more flexibility in the context of resale pricing strategies.

As the European Commission published a first draft of a revised VBER on 9 July 2021, it remains to be seen whether the voice of stakeholders, including the luxury and fashion industry, will be properly reflected. In particular, the luxury and fashion industry would like the updated rules to ensure more flexibility for brands and adequate brand protection in order to offer a true omnichannel experience for consumers. This also entails the recognition of the importance of fully preserving the value of the bricks and mortar sales channel against free riding. Once the draft revised VBER is published, the European Commission will again consult stakeholders before the publication of the new rules in May 2022.

AUTHOR

Nicolas Hipp
Associate
Brussels
nicolas.hipp@klgates.com

Nicolas works in our Antitrust, Competition and Trade Regulation practice group in Brussels. For more information about this practice, please visit our **website**.

GLOBAL LUXURY BRANDS' AND EYEWEAR COMPANIES' PRICING AND ONLINE SALES RESTRICTIONS ATTRACT SCRUTINY IN FRANCE

By Nicolas Hipp, Stefano Prinzivalli Castelli, and Francesco Carloni

On 22 July 2021, the French Competition Authority (FCA) fined two luxury brands and a global eyewear manufacturer for having imposed resale prices on their resellers and for having prohibited sales on the Internet. Under both EU and French competition law, RPM and online sales bans are considered hardcore restrictions of competition (i.e., severe restrictions of competition because of the likely harm they cause to consumers). Companies may try to reverse the presumption of illegality by demonstrating that the pro-competitive effects outweigh the negative effects, but in practice, such attempts are rarely successful.

With respect to the RPM practices, between 1999 and 2015, a luxury brand owner (Brand Owner 1)'s licensing contracts for one of its watch brands contained clauses providing for a framework for prices and promotions practiced by opticians. Such clauses also appeared in an eyewear manufacturer's selective distribution contracts (between 2002 and 2015). In addition to the above-mentioned clauses, the FCA relied on a set of evidences including the dissemination of recommended prices and the establishment of monitoring mechanisms.

Between 2005 and 2014, an eyewear manufacturer disseminated so-called "recommended" prices to its distributors and encouraged them to maintain a certain level of retail price for its products (in particular, by prohibiting discounts and promotions in its selective distribution contracts). The eyewear manufacturer has also limited the advertising of its distributors on their prices and has organized a price enforcement system among its distributors.

With respect to the prohibition of online sales, the licensing agreements between another luxury brand owner (Brand Owner 2) and the eyewear manufacturer (between 1999 and 2014) and between Brand Owner 1 and the eyewear manufacturer (between 2004 and 2015) provided for a ban on online sales of sunglasses and eyeglass frames by opticians. The authorized retailer charters concluded between the eyewear manufacturer and its authorized resellers (between 2002 and 2013) also provided for such prohibitions.

The FCA considered that these practices were particularly serious and constituted hardcore restrictions. However, it is worth noting that the FCA took a more lenient approach on the ban on online sales since the contested conduct started before the adoption of the landmark judgment of the European Court of Justice (ECJ) in *Pierre Fabre* (2011). Indeed, it is by this judgment that the ECJ qualified online sales ban (whether *de jure* or *de facto*) as a hardcore restriction.

This decision highlights the strong focus of the European Commission and national competition authorities of the EU Member States (NCAs) over pricing and online practices. Indeed, over the past few years, a significant number of companies have been fined by the Commission and NCAs for RPM (in particular, when conducted online) and online sales bans.

In 2018, the Commission fined a fashion brand €40 million, notably for RPM and online sales restrictions. In 2020, the FCA fined a luxury tea producer €226,000 for imposing sales prices on its resellers selling online. This decision was also issued in the context of the Commission's ongoing review of the Vertical Block Exemption Regulation and the accompanying Vertical Guidelines, which set out the rules for distribution systems throughout Europe.

The new rules are expected to enter into force on 31 May 2022 and will better adapt to the market developments, notably the growth of online sales and its impact on the brick and mortar channel.

AUTHOR

Francesco Carloni
Partner
Brussels and Milan
francesco.carloni@klgates.com

Stefano Prinzivalli Castelli
Associate
Brussels
stefano.prinzivallicastelli@klgates.com

Nicolas Hipp
Associate
Brussels
nicolas.hipp@klgates.com

Francesco, Stefano, and Nicolas work in our Antitrust, Competition, and Trade Regulation practice group across the UK and Europe. For more information about this practice, please visit our **website**.

MANAGING SUPPLY CHAIN RISK—THE U.S. PERSPECTIVE

NO SUPPLIES IN THE CHAIN

By Melissa Tea and Sarah Decker

The world's supply chains are crumbling. Manufacturing companies are struggling to catch up with surging demand as the global economy begins to recover from the pandemic-related impacts on production across all industries. Prices for resources such as magnesium, silicon, and iron ore and other industrial raw materials are skyrocketing as a result of depleting inventories. Shipping container rates have increased fourfold. Ports are congested, trucks are without drivers, and warehouses are empty.

Against this backdrop, suppliers and buyers find themselves facing off over the allocation of risks, including increasing production costs and delivery shortfalls, brought on by persistent delays and disruptions. Commercial terms that might once have been considered to be "boilerplate"—such as force majeure or commercial impracticability—have taken on heightened importance.

Now, as power outages rage across China, manufacturers around the world are bracing for further widespread, indefinite raw material shortages. In this environment, rapid risk assessment and mitigation is a mission-critical exercise.

Assessing Risks

Raw materials are becoming increasingly scarce, and your capacity to fill orders is rapidly declining. What can you do to weather the storm?

First, carefully review and triage your existing contracts. Many commercial contracts contain flexibilities that may allow delayed or minimised production.

Second, keep your customers informed. Informed customers are better positioned to take action to mitigate their downside risk and, in turn, less likely to take action against you.

Finally, know your rights and obligations in the event you cannot deliver. Force majeure provisions and the Uniform Commercial Code (U.C.C.) can guide your business decisions with an eye toward maintaining customer relationships and the proactive avoidance of litigation.[1]

Leveraging Flexibilities

Even if your commercial contracts contain fixed price and volume commitments, there may be options to mitigate your risk. Look to see whether your contracts contain price escalation provisions allowing for periodic equitable increases or adjustments when triggered by a defined event, such as when a particular price index indicates a certain percentage increase. Additionally, your contracts may contain provisions that provide for:

- **Delayed deliveries**. Does the contract provide that schedule or lead times will be determined at the time of the order, or, if specified in the contract, are subject to change based on then-available capacity?

[1] Contract interpretation and available defenses differ across jurisdictions. Many contracts contain choice of law provisions governing all claims arising out of or relating to the contract. The within information should be considered under the law of your governing jurisdiction.

Informed Customers → Risk Mitigation → Less Litigation

- **Limitation of quantities**. Does the contract provide that order acceptance or production quantities are subject to available capacity at the time of the order?
- **Lesser shipments**. Does the contract provide that all orders are subject to a shipping tolerance of +/- a certain percentage?

Importantly, a manufacturer's options under any such contractual provisions may require exercise of commercially reasonable efforts to allocate production capacity among similarly situated customers in a fair and reasonable manner. This is where knowing your rights and obligations before implosion of the supply chain will prove useful.

Knowing Your Rights and Obligations

Commercial Impracticability

Commercial impracticability is a defense to nonperformance where an unexpected event renders performance of the contract commercially impracticable. In most instances, market shifts and increased costs do not support application of the defense, but some courts have allowed it where the price increase was considered severe (e.g., tenfold). Material shortages, on the other hand, more frequently support an impracticability defense.[2]

A manufacturer contemplating nonperformance based on commercial impracticability should be mindful of its obligation under U.C.C. Section 2-615 to fairly and reasonably allocate production among its customers.[3] *Unless* a manufacturer's contracts expressly permit allocation within the seller's sole discretion or based on considerations other than equitable treatment of similarly situated customers, an allocation plan should take account of the following guidelines:[4]

In addition, manufacturers should be careful not to allocate production to high-paying customers to the detriment of others absent supporting contractual grounds.[5] Finally, a manufacturer employing Section 2-615 should provide timely notice to its customers.[6]

Force Majeure

Whereas U.C.C. Section 2-615 is available in the absence of an express contractual defense, a force majeure clause excuses performance in the face of events expressly contemplated by the parties on the face of the contract. Courts typically interpret force majeure provisions narrowly based on a plain reading of the provision. Generally, market shifts and increased costs are not force majeure events. Materials shortages, however, could be a triggering event if expressly included in the force majeure clause.

[2] *See* U.C.C. § 2-615, cmt. 4 (1951) (enacted by statute in most states).

[3] § 2-615(b).

[4] *Id.*; see also § 2-615, cmt. 11.

[5] *See* § 2-615, cmt. 11.

[6] § 2-615(c).

Party	Allocation
Contracted Customers	***must*** receive a fair and reasonable allocation.
Regular spot purchasers	***may***—at the seller's election—receive a fair and reasonable allocation.
The manufacturer	***may*** retain a fair and reasonable allocation to maintain production capacity.
Other parties	***must not*** receive an allocation.

Importantly, a manufacturer's declaration of a force majeure event does not terminate a contract. Rather, it excuses performance until the earlier of (a) resolution of the force majeure event, or (b) expiration or termination of the contract. Manufacturers considering declaration of a force majeure event as to one customer should be mindful of their treatment of similarly situated customers, including avoiding situations where preferential treatment of one customer might lead to a material shortage for another. Remember, a force majeure event is one outside of a party's control.

Future Considerations

Now is the time for manufacturers to consider whether their contracts sufficiently protect them against future supply chain disruptions:

- Can your standard force majeure provision be made stronger by express inclusion of material shortages or commercially unfeasible prices?
- Have you updated your force majeure provision to include pandemics and communicable disease outbreaks, as well as cyber-related disruptions, such as ransomware and other cyberattacks?
- Do you reserve the right to adjust delivery time and production volume based on your capacity at the time the order is placed?
- Is the right to allocate capacity left to your sole discretion?
- Do your contracts contain price escalation provisions triggered by defined market shifts?

With a careful and prompt response to supply chain disruptions, and some proactive prevention steps, manufacturers can better control risks—and even come out stronger on the other side.

AUTHORS

Melissa Tea
Partner
Pittsburgh
melissa.tea@klgates.com

Sarah Decker
Associate
Pittsburgh
sarah.decker@klgates.com

Melissa and Sarah work in our Litigation and Dispute Resolution group in Pittsburgh. For more information about this practice, please visit our **website**.

WHITE HOUSE PROVIDES GUIDANCE ON "MADE IN AMERICA" EXECUTIVE ORDER

By Susan Kayser and Lauren Burke

On 11 June 2021, the White House issued initial guidance on how President Biden's 25 January 2021 "Executive Order on Ensuring the Future Is Made in All of America by All of America's Workers" (Order) will be implemented. The Order aims to ensure that the federal government is spending taxpayer money on American-made goods, by American workers, and with American-made component parts. This is significant considering the nearly US$600 billion the federal government spends annually.

The "Made in America Office" (MIAO) established by the Order is within the Office of Management and Budget (OMB). The MIAO will review any exceptions from, or waivers of, Made in America laws filed by government agencies. The renewed focus on "Made in America" as implemented by the MIAO will likely influence enforcement of Made in America claims as well.

The June White House guidance outlines four areas of implementation and timelines:

1. Senior Accountable Officials

Agencies must designate a Senior Accountable Official to work with the MIAO to implement an approach to advance the policy goals of the Order, including that the U.S. government should "procure goods, products, materials, and services from sources that will help American businesses."

2. Agency Reports

Agencies must provide initial and semi-annual reports on compliance with Made in America laws and the Order. The reports should highlight the steps the agency is or will be taking to increase domestic suppliers, describe the consistency of submitted waivers, analyze whether the agency's waivers accomplish the missions of the Order and the agency, and include the status of any review of the agency's acts inconsistent with the Order's policies.

3. Agency-OMB Waiver Review

Agencies must provide a waiver for any exception from Made in America laws for MIAO review. The guidance specifies the information that agencies must include in waivers such as why the waiver is necessary and any actions that can be taken to avoid the need for the waiver. Agencies are encouraged to keep waiver requests to a minimum.

4. Waiver Transparency

The Administrator General of Services was tasked to develop a public website including all information on proposed agency waivers and whether those waivers have been granted. In October 2021, the MIAO website (**www.MadeinAmerica.gov**) launched, which allows the public to view details of waivers reviewed by the MIAO, and informs U.S. businesses of available federal contract opportunities.

AUTHORS

Susan Kayser
Partner
Washington, D.C. and New York
susan.kayser@klgates.com

Lauren Burke
Associate
Newark
lauren.burke@klgates.com

Susan and Lauren work in our Intellectual Property practice group in the United States. For more information about this practice, please visit our **website**.


made in USA
TURN INSIDE
MACHINE
COLD

SB 343: IS RECYCLING LIABILITY ON THE WAY?

By Buck Endemann, Caitlin Blanche, David Wang, and Damon Pitt

California's new recyclability law could create liability associated with labeling and packaging issues. On 9 September 2021, the California Legislature overwhelmingly passed "The Truth in Labeling for Recyclable Materials" bill (SB 343), which prohibits the use of the "chasing arrows" symbol (or any other indication of recyclability) on products or packaging that are not deemed "recyclable" under criteria to be established by the California Department of Resources Recycling and Recovery (CalRecycle).[1] Governor Gavin Newsom signed the bill into law on 6 October 2021.

SB 343 addresses a longstanding concern that non-recyclable products are often confused for recyclable products due to ambiguous packaging labels. As a result, consumers commingle recyclable and non-recyclable products, which, according to SB 343's sponsor Senator Bob Allen, "contaminate[s] the recycling stream and make[s] it more costly to sort and clean the truly recyclable material."[2] SB 343 aims to remedy this confusion by ensuring "claims related to the recyclability of a product or packaging be truthful" because "consumers deserve accurate and useful information related to how to properly handle the end of life of a product or packaging."[3]

But what exactly do consumers need to make recycling-friendly purchase and disposal decisions?

The law gives CalRecycle until 1 January 2024, to develop a list of commonly recovered materials at recycling facilities in the state.[4] Based on that information, the law provides that a product may only be labeled "recyclable" if:

1. that product is collected in one of the curbside programs that cover at least 60% of the state's population;
2. can be sorted into defined streams; and
3. can be reclaimed at appropriate facilities.[5]

Products collected by non-curbside programs can also be "recyclable," but only if the program "recovers at least 60% of the product or packaging in the program" and the material can be sorted and aggregated in defined streams.[6] Manufacturers would then have 18 months after the list's release (and after each subsequent update to the list) to ensure that their products are in compliance.[7] This means consumers could start seeing changes on products by 2025.

"Chasing Arrows" in State Laws

California wants to eliminate confusion created by a historical dissonance between industry standards and state regulations. The well-known "chasing arrows" symbol (a triangle formed by three clockwise arrows) has long been associated with recycling and has its basis in Resin Identification Codes (RIC) developed originally to identify the specific types of plastic resin used in manufactured products. These RICs originally consisted of a specific number, or code, surrounded by a "chasing arrows" triangle. After the Society of the Plastics Industry (SPI) standardized these RICs, dozens of states enacted legislation incorporating the RIC logo, although its meaning varied from state to state. California, for example, required that "rigid plastic bottles and rigid plastic containers" must be labeled with a RIC that "shall consist of a number placed inside a triangle," which had to be "equilateral" and "formed by three arrows."[8]

SPI revised the RIC standard in 2013, substituting the "chasing arrows" triangle requirement with a solid equilateral triangle encompassing the resin number. But the traditional RIC logo remained in

state statutes and regulations,[9] many of which still require the original "chasing arrows" standard. California, for instance, did not change its regulation to being only "a number placed inside a triangle" until last year.[10]

Potential Impacts of the Law

SB 343 is supported by stakeholders who must physically manage California's bulging and heterogeneous waste stream, including over 70 waste haulers, recyclers, environmental groups, and governmental organizations.

Consumers and retailers, however, have had difficulty evaluating the meaning of the traditional RIC logo where state regulations have either diverged from or not kept up with industry standards. By further distancing the RIC logo from its historical roots, trade groups have argued that the law "create[s] more labeling complexity and increas[es] confusion for consumers."[11] Such confusion could have unintended consequences and result in a larger amount of plastic in landfills. According to SB 343's Senate Floor Analyses, "[b]ased on current trends, the only plastics that would likely be allowed to be labeled with a chasing arrows symbol under the considerations of this [law] would be PET #1 and HDPE #2 plastic bottles and jugs."[12] Hundreds of companies, particularly those with products using resins #3-7, will likely have to make changes to their labeling processes.[13]

In addition to regulatory compliance issues, SB 343's labeling requirements may also spur a new market for litigation akin to the wave of private enforcers suing businesses under California's Proposition 65 (Prop. 65).[14] Prop. 65 allows private California citizens to sue companies directly (in lieu of enforcement action by the California Attorney General's office) for failing to label products that purportedly expose consumers to chemicals known to the State of California to cause cancer or reproductive harm. However, unlike Prop. 65, SB 343 does not include a private right of action. As such, private plaintiffs could not sue companies directly for violations of SB 343.

Notwithstanding the lack of a private right of action, companies could still be subjected to labeling lawsuits arising under other California consumer protection laws. For example, failure to comply with SB 343 could trigger lawsuits arising from California's False Advertising Law (FAL) (Business & Professions Code § 17500), the California Consumers Legal Remedies Act (CLRA) (Civil Code §§ 1750, et seq.), and California's Unfair Competition Laws (UCL) (Business & Professions Code §§ 17200, et seq.).

Collectively, the FAL, CLRA, and UCL prohibit false or deceptive advertising concerning the nature of a product or service (i.e., prohibiting a company from falsely labeling a product "Made in the USA" or "All Natural" if manufactured outside the United States or made with synthetic ingredients, respectively).

The CLRA prohibits unfair competition including unfair or deceptive advertising directed to consumers. It expressly prohibits misrepresenting the certification of goods or representing that a product has approval that it does not have. Under the UCL, a violation of SB 343 could constitute actionable conduct under the "unlawful" prong of the statute, which prohibits any business practice that violates a statute, regulation, or rule.

In addition to litigation risk from alleged statutory violations, manufacturers and retailers may also face common law claims for breach of warranty should a product label misrepresent (intentionally or not) that the product is recyclable when it is not. The key to any of these claims is whether a product's label, as a whole, misleads a reasonable consumer to believe that a product is recyclable when, in fact, it is not. Thus, if a failure to comply with SB 343 misleads a reasonable consumer to believe that a product is recyclable, that could be a factor in analyzing whether the overall labeling was misleading or false under the FAL or CLRA. Given that recyclability is increasingly desired by consumers, companies should consider the risk of civil actions (including class actions) brought either by consumers or competitors if their products fail to satisfy SB 343 or are otherwise misleading with respect to recyclability.

Part of a Trend

SB 343 was one of several recyclability and waste bills considered by the California Assembly in this past legislative session. Others included AB 1201, which addresses the labeling of products as "compostable," "biodegradable," or similar; SB 881, which reclassifies mixed plastics exported from the United States as "disposal" rather than "recycling"; SB 619, which directs CalRecycle to adopt regulations to meet organic waste reduction targets in landfills; and AB 962, which authorizes CalRecycle to establish a beverage container recycling program and certify processors.

Similar legislation is also pending in other states: the New York Assembly, for example, is considering AB A7668/S7375, which would ban products with misleading recycling labels. Oregon passed SB 582, which, in addition to requiring manufacturers to foot the bill for packaging recycling, established a 15-member "Truth in Labelling Task Force" to "study and evaluate misleading or confusing claims regarding the recyclability of products made on a product or product packaging."[15]

These developments follow on the heels of AB 793, a California law passed last year requiring all bottled beverage manufacturers use at least 15 percent postconsumer resin (PCR) in their plastic containers beginning January 2022. A recent report from CalRecycle shows that only seven of the state's 69 bottlers have met this threshold. More regulatory scrutiny across the consumer products industry is expected as manufacturers struggle to transition their supply chains to comply with states' recyclability standards in the coming years.

[1] SB 343, Proposed Cal. Pub. Res. Code § 42355.51(b)(1).

[2] SB 343, Senate Floor Analyses (Sept. 9, 2021).

[3] SB 343, Legislative Counsel's Digest.

[4] SB 343, Proposed Cal. Pub. Res. Code § 42355.51(d)(1).

[5] SB 343, Proposed Cal. Pub. Res. Code § 42355.51(d)(2).

[6] *Id.* at § 42355.51(d)(5). After 1 January 2030, the minimum recovery threshold would increase to 75%.

[7] *Id.* at § 42355.51(b)(2)(A).

[8] Specifically, the triangle had to be "formed by three arrows with the apex of each point of the triangle at the midpoint of each arrow, rounded with a short radius. The pointer (arrowhead) of each arrow shall be at the midpoint of each side of the triangle with a short gap separating the pointer from the base of the adjacent arrow. The triangle, formed by the three arrows curved at their midpoints shall depict a clockwise path around the code number." See Cal. Pub. Res. Code § 18015 (1989).

[9] "It is possible that some states or countries will have incorporated the original SPI practice into state or regulation. In those situations, that statute or regulation takes precedence over this standard."

[10] *See* AB 1583 § 2.

[11] SB 343, Floor Alerts.

[12] The law includes carve-outs for exemptions, including consumer goods that are required to display a chasing arrow symbol under the California Beverage Container Recycling and Litter Reduction Act and the Electronic Waste Recycling Act of 2003. See SB 343, Proposed Bus. & Prof. Code § 17580(e), (g).

[13] SB 343, Senate Floor Analyses (Sept. 9, 2021).

[14] Prop. 65 is officially known as the Safe Drinking Water and Toxic Enforcement Act of 1986, enacted by ballot initiative in 1986.

[15] See SB 582 § 36(3).

AUTHORS

Buck Endemann
Partner
San Francisco
buck.endemann@klgates.com

Caitlin Blanche
Partner
Orange County
caitlin.blanche@klgates.com

David Wang
Associate
Seattle
david.wang@klgates.com

Damon Pitt
Associate
Orange County
damon.pitt@klgates.com

Buck and David work in our Energy, Infrastructure and Resources group in the United States. For more information about this practice, please visit our **website**.

Caitlin and Damon work in our Litigation and Dispute Resolution team in the United States. For more For more information about this practice, please visit our **website**.

CONSUMER LAW HOTS UP IN AUSTRALIA

MIKE TYSON SUES AUSTRALIAN STREETWEAR BRAND CULTURE KINGS

By Savannah Hardingham and Olivia Coburn

In June 2021 Mike Tyson, the famous former boxer, sued Australian streetwear brand Culture Kings and its founders. Mr Tyson alleged the respondents engaged in misleading and deceptive conduct under the Australian Consumer Law for using his name, nicknames and likeness to sell t-shirts, without his permission. Mr Tyson alleged that Culture Kings' t-shirts bear images of him, his name as well as his monikers "Iron Mike", and "Kid Dynamite". The proceeding was short-lived: it was dismissed by consent in July 2021.

What is interesting about this case is Mr Tyson's cause of action. Mr Tyson did not bring his claim under trade mark law. Mr Tyson does not own registered trade marks in Australia for "Mike Tyson", "Iron Mike" or "Kid Dynamite". It is common practice for celebrities and well-known people to register their names as trade marks for a wide range of goods (like jewelry, toys, fragrances and clothes) in order to have the exclusive right to apply their name to such goods.

Since Mr Tyson does not have trade mark registration for his name or monikers in Australia, he could not rely on trade mark law and instead relied on other avenues in an effort to stop Culture Kings' alleged conduct and to claim damages.

To establish his claim under the Australian Consumer Law, Mr Tyson would have needed to prove that the conduct of Culture Kings (and its founders) misled or deceived customers – or was likely to mislead or deceive customers – into falsely believing that he is somehow affiliated with, or has sanctioned or approved of, Culture Kings or its Mike Tyson t-shirts. This is arguably a higher hurdle to meet than would be required in a trade mark case.

If Mr Tyson had a registered Australian trade mark for clothing for "Mike Tyson" (or his monikers) and a brand like Culture Kings sold t-shirts emblazoned with "Mike Tyson", he would not have needed to prove that consumers would likely be misled to make out trade mark infringement – he would instead have needed to show that his name was applied to the t-shirts without his permission and was being used on the t-shirts "as a trade mark" (that is, as an indicator of the source of the goods).

Key Takeaways

We always recommend that our clients file trade marks for important brand names or branding elements. A registered trade mark is a valuable IP right because it affords the owner an exclusive right to use that mark in relation to the registered goods or services, and take enforcement action against other traders who adopt the same or similar marks.

AUTHORS

Savannah Hardingham
Partner
Melbourne
savannah.hardingham@klgates.com

Olivia Coburn
Lawyer
Melbourne
olivia.coburn@klgates.com

Savannah and Olivia work in our Intellectual Property team in Melbourne. For more information about this practice, please visit our **website**.

UNFAIR CONTRACT TERMS—SIGNIFICANT BROADENING OF SCOPE AND PENALTIES FOR BREACHES: IS YOUR BUSINESS PREPARED?

By Ayman Guirguis, Thomas Shaw, Jessica Mandla, and Mei Gong

The Australian Government has released the Exposure Draft legislation and Explanatory Materials for an anticipated suite of reforms to unfair contract terms (UCT) laws found in the Australian Consumer Law (ACL) and Australian Securities and Investments Commission Act 2001 (ASIC Act). Treasury is now considering feedback on the exposure draft with a view to the Government introducing a bill to effect wide-ranging changes to the UCT regime.

There are six key proposed changes:

- significant financial penalties for contraventions;
- significantly expanding the number of business-to-business contracts subject to UCT laws;
- greater flexibility of remedies for breaches;
- introduction of a rebuttable presumption that certain terms which are "the same or substantially similar in effect" to UCT will also be unfair;
- clarity on the definition of a "standard form contract"; and
- exclusion of clauses that refer to "minimum standards" provisions contained in legislation.

These changes materially increase the risk profile for larger businesses that engage B2B and B2C via standard form contracts.

While many businesses reviewed relevant contracts in 2016 in the lead-up to the extension of ICT to B2B contracts, the significant increase in scope of the UCT laws, the introduction of penalties, together with developments in the law means that it is vital for business to re-examine the terms of affected contracts to ensure compliance.

What is the Current UCT Regime?

Australia's UCT regime is designed to stop powerful businesses from using their stronger bargaining position to essentially "force" the inclusion of UCT into agreements with consumers or small businesses.

The UCT regime currently captures standard form contracts that are either 'consumer contracts' or 'small business contracts'.

A '**consumer contract**' exists where at least one party is an individual who acquires goods or services wholly or predominantly for personal, domestic or household use.

At present, a '**small business contract**' exists where:

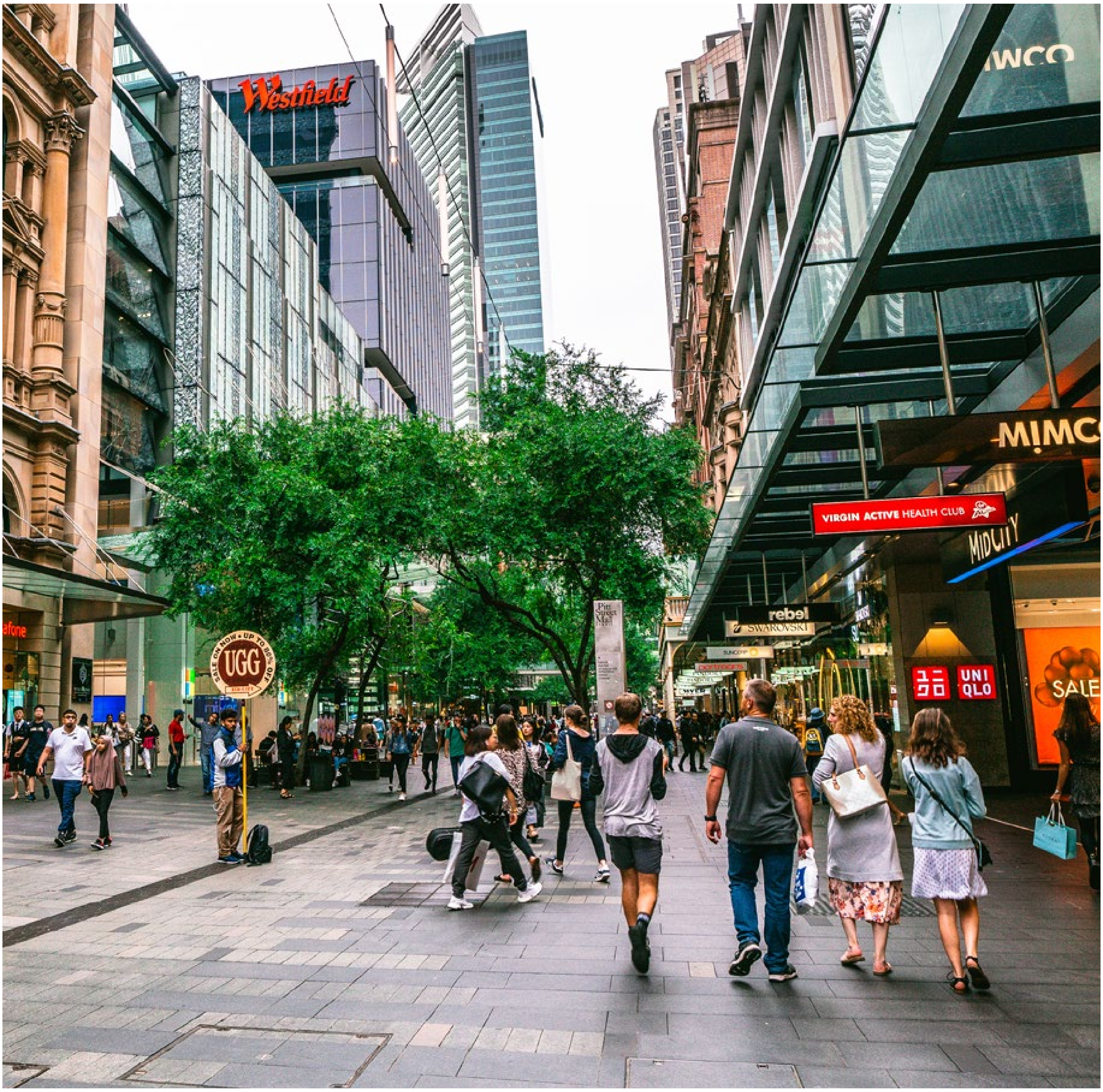
- at the time the contract is entered into, at least one party to the contract is a business that employs fewer than 20 persons; and
- the upfront price payable under the contract does not exceed AU$300,000, or AU$1 million if the contract runs for more than 12 months.

Under both the ACL and the ASIC Act, a term is **unfair** if it:

- would cause a **significant imbalance** in the parties' rights and obligations arising under the contract;
- is **not reasonably necessary** to protect the legitimate interests of the party who would be advantaged by the term (the term is presumed to not be reasonably necessary); and
- would **cause detriment** (whether financial or otherwise) to a party if it were to be applied or relied on.

The UCT regime only applies to 'standard form contracts'. Generally speaking, these are contracts where there are no opportunities to negotiate meaningful changes to the terms. However, exactly what 'standard form contract' means has never been clearly defined under the current regime, and is one of the proposed areas of reform.

The UCT regime does not currently provide any penalties for businesses that use UCT. Rather, if a term is found to be unfair, a court will declare the term void, and may also make a range of additional orders. Void terms are not binding on the parties, but the rest of the contract will continue to operate to the extent possible without those void terms.



The Proposed Changes

Topic of Change	Current Law
1. Pecuniary penalties for contraventions	No equivalent
2. Scope for business-to-business contracts	A 'small business' is defined as employing less than 20 people, with an upfront payable price under the contract of no more than AU$300,000, or AU$1 million if the contract is for more than 12 months.
3. Broader, more flexible remedies	A court may make orders: • where a person has suffered, or is *likely* to suffer, loss or damage because of an UCT; • to void, vary or refuse to enforce the term or the entire contract; and • preventing a party from applying or relying on (or trying to apply or rely on) a term of a contract that has been declared unfair.
4. Introduction of a rebuttable presumption for similar terms	No equivalent
5. More clarity on the meaning of a "standard form contract"	In determining whether a contract is a 'standard form contract', the Court must take into account a number of matters including whether one party was: • required to reject or accept the terms of the contract in the form it was presented; or • given an effective opportunity to negotiate the terms of the contract.
6. Exclusion of "minimum standards" provisions	No equivalent

New Law	implication
Prohibits the inclusion of, or reliance on, unfair terms in standard form consumer or small business contracts and enables a court to impose substantial pecuniary penalties for **each contravention**: • for businesses, the greater of AU$10 million, three times the value of any benefit from the contravention and (if the value of the benefit cannot be determined) 10 per cent of the contravening businesses' Australian turnover in the 12 month period prior to the contravention; and • for individuals, AU$500,000.	Introducing civil penalties for UCT contraventions will increase deterrence. However, there is often uncertainty as to whether a clause is 'unfair'. This uncertainty may deter businesses from entering into 'legitimate' contracts and could restrict some business activities.
The definition of 'small business' is expanded, with UCT provisions applying to any standard form contract where one party has up to 100 employees or an annual turnover of up to AU$10 million. The dollar value test for the size of contract has been removed altogether—all contracts with a 'small business' have to comply.	A much broader class of business contracts will be 'caught' by the UCT regime.
In addition to current powers, a court may make orders where a person has suffered, or may suffer, loss or damage because of an UCT. Those orders can also extend to loss or damage relating to a same or substantially similar term in: • any current contract the person is a party to; or • any future contract the person will be a party to.	The lower threshold of 'may', and the broader categories of contracts over which orders can be made, will have broad implications. These changes will allow the courts greater flexibility in compensating wronged parties. However, that flexibility will increase the uncertainty for larger businesses as to both the breadth and magnitude of the 'downside risk' associated with losing such proceedings.
Unless a party proves otherwise, a contract term will be presumed to be unfair if the same or a substantially similar term has been deemed unfair in another proceeding in similar circumstances (i.e., proposed by the same entity or in the same industry).	If a term is claimed to be an UCT, and a court has previously declared a similar term to be unfair, the defendant will have to prove why their contractual term is not unfair in these circumstances. This will incentivise the quick removal of unfair terms without the need for repeated litigation. However, it will increase the regulatory burden and uncertainty on larger businesses to stay abreast of UCT cases.
In addition to current factors, the Court must also consider whether a party has used the same or a similar contract before, and the number of times this has been done. The court must not consider: • whether a party had an opportunity to negotiate minor or insubstantial changes; • whether a party had an opportunity to select a term from a range of options; or • the extent to which a party to another contract or proposed contract was given an effective opportunity to negotiate terms of the other contract or proposed contract.	Currently, Courts analyse a series of factors in determining whether a contract is a 'standard form contract', which have been criticised as providing insufficient guidance to businesses. The proposed amendments would assist a court in determining whether a 'standard form contract' has been used by providing further guidance in determining whether an 'opportunity to negotiate' has taken place, and allowing a Court to look at a business' contextual usage of a particular contract.
UCT provisions will not apply to terms that include 'minimum standards' or other industry-specific legislative requirements.	Businesses will not need to worry about contravening the UCT regime in respect of terms relating to 'minimum standards' or industry-specific requirements contained in Commonwealth, state or territory legislation.

Why are the Changes Required? Are they All Required?

In recent years, there have been numerous calls from government, the ACCC, and various consumer rights groups to strengthen the UCT regime. It is argued that this is due to the relative inefficiencies in the current regime, such as the lack of financial penalties undermining deterrence. Despite, or perhaps because of, these inefficiencies, consumer protection bodies have received over 5,000 UCT complaints in the last few years, relating to both B2C and B2B transactions.

In December 2019, the Treasury announced a consultation into the UCT regime following concerns that the regime:

- did not provide sufficient deterrence to businesses using unfair terms in standard form contracts due to the absence of penalties;
- did not provide sufficient coverage to many small businesses which would benefit from being included;
- was undermined by ambiguity with certain compliance aspects of the law; and
- required more flexible remedies and means of addressing UCT than only being able to declare the term void.

The Government has accepted the Treasury's conclusion that the absence of penalties is a deterrence problem with the current UCT regime. Because UCT are not prima facie illegal and do not attract any penalties, businesses are incentivised to include them and see whether they can "get away with it", only changing the terms "on the court steps" when challenged by the ACCC. Having the term merely declared void does not serve a deterrent purpose and is arguably not an efficient use of the public funds allocated towards the ACCC's investigation and litigation of the matter.

However, as referred to in the "Implications" in the above table, the proposed changes, in circumstances where the "unfairness" of a term is situational (the "unfairness" of a term being "situational"/having regard to the totality of the rights/obligations in a contract) are likely to result in considerable uncertainty and risk for businesses that need to engage with counterparties via standard form contracts—particularly given proposed "rebuttable presumptions" and the size of potential penalties.

The Competition and Consumer Committee of the Law Council of Australia raised these issues/concerns in its submission to Treasury, to which K&L Gates contributed. The link to the submission is **here**.

What Does this Mean for Your Business?

Review and Update Your Standard Form Contracts

The proposed UCT regime foreshadows additional scope, remedies, and penalties. Businesses should act now to ensure their small business and consumer contracts are compliant with UCT provisions.

The ACCC's proceedings against Fuji Xerox provide guidance for businesses on the kinds of contract terms that the ACCC will consider to be unfair in the first instance, such as:

- unilateral variation terms;
- automatic renewal terms;
- excessive exit fees;
- unilateral price increases;
- unilateral liability limitation terms;
- disproportionate termination terms; and
- unfair payment terms.

Recent ACCC investigations also suggest that terms governing payment and supply chain finance for small businesses (discounting amounts due in exchange for earlier payments) can also attract under scrutiny.

Ignorance is Risk

The UCT regime interacts with a number of other protections under the ACL, meaning a breach of the UCT regime could also breach other parts of the ACL. Some of these other provisions are subject to pecuniary penalties, significantly increasing the risks of non-compliance:

- **Misleading and deceptive conduct**: Misrepresenting the rights of consumers and small businesses to negotiate contracts, or argue against the inclusion of and reliance on unfair terms, can be deemed misleading and deceptive conduct.
- **Unconscionable conduct**: The inclusion of implied terms, terms hidden in fine print, terms hidden in a schedule or in another document, or terms written in legalese can expose a business to contravention of both unconscionable conduct and UCT laws.

  A systemic policy of employing UCT in a business' contracts may also amount to unconscionable conduct. The ACCC investigated UGL in 2020 regarding extensions of payment terms in supply chain financing.
- **Consumer guarantees**: Terms that interfere with a consumer's rights under Australia's Consumer Guarantee laws may be deemed to be UCT, and thus void.

The ACCC expects businesses to be aware of their negotiation practices with consumers and small businesses, and understand the presence and effect of any unilateral terms to avoid falling foul of the new regime.

AUTHORS

Ayman Guirguis
Partner
Sydney
ayman.guirguis@klgates.com

Thomas Shaw
Senior Associate
Sydney
thomas.shaw@klgates.com

Jessica Mandla
Lawyer
Sydney
jessica.mandla@klgates.com

Mei Gong
Lawyer
Sydney
mei.gong@klgates.com

Ayman, Thomas, Jessica, and Mei work in our Antitrust, Competition, and Trade Regulation group in Australia. For more information about this practice, please visit our **website**.

LORNA JANE PAYS AU$5 MILLION IN PENALTIES OVER FALSE "ANTI-VIRUS ACTIVEWEAR" CLAIMS

By Ayman Guirguis, Mei Gong, and Nam Nguyen

The Australian Federal Court has ordered women's active wear manufacturer and retailer, Lorna Jane Pty Ltd (Lorna Jane), to pay AU$5 million in penalties for making false and misleading representations to consumers, and engaging in conduct liable to mislead the public, in connection with the promotion and supply of its "LJ Shield Activewear."

In July 2020, Lorna Jane falsely represented to consumers that its LJ Shield Activewear, which were treated with a "LJ Shield" spray "eliminated," "stopped the spread," and "protected wearers" against "viruses including COVID-19." Lorna Jane made such claims on its website, Instagram account, in-store, by way of media releases, and emails to consumers. Certain claims were also published on Chief Creative Officer Lorna Jane Clarkson's Instagram account. Lorna Jane admitted that it had falsely represented that it had a scientific or technological basis for making the "anti-virus" claims about its LJ Shield Activewear, when no such basis existed.

The COVID-19 context in which these representations were made was a significant consideration for the Court, with Justice Rangiah deeming Lorna Jane's conduct as "exploitative, predatory, and potentially dangerous." However, Justice Rangiah also considered as relevant mitigating factors that Lorna Jane has not been shown to have actually profited from its conduct, and there was no indications that the contraventions actually caused harm to consumers.

In addition to the penalty, Lorna Jane also received corrective advertising orders as well as entering into a court enforceable undertaking to implement an appropriate Australian Consumer Law compliance program for a period of three years.

This case clearly indicates that all fashion businesses should carefully review any COVID-19 related claims as even brief advertising campaigns involving COVID-19 misrepresentations. Such claims have heightened sensitivity and impact in this global pandemic context and can attract significant penalties and reputational damage notwithstanding the potentially good intentions of the businesses in making such representations.

For more, read the ACCC's press release **here** and the Court judgment **here**.

AUTHORS

Ayman Guirguis
Partner
Sydney
ayman.guirguis@klgates.com

Mei Gong
Lawyer
Sydney
mei.gong@klgates.com

Nam Nguyen
Graduate
Sydney
nam.nguyen@klgates.com

Ayman, Thomas, Jessica, and Mei work in our Antitrust, Competition, and Trade Regulation group in Australia. For more information about this practice, please visit our **website**.

ACCC TO EXAMINE COMPETITION AND CONSUMER CONCERNS IN GENERAL ONLINE MARKETPLACES

By Ayman Guirguis, Thomas Shaw, Jessica Mandla, and Mei Gong

The Australian Competition and Consumer Commission (ACCC) is examining competition and consumer concerns with general online retail marketplaces such as eBay Australia, Amazon Australia, Kogan, and Catch.com.au as part of its inquiry into digital platform services in Australia.

In particular, the ACCC is looking to understand the potential competition and consumer protection issues that matter most to sellers (ranging from small businesses to global brands), consumers, and other stakeholders that utilise general online retail marketplaces in Australia.

The ACCC has released an **issues paper**, which seeks stakeholders' views on the:

- Degree of competition between marketplaces in Australia
- Benefits derived by consumers and third-party sellers
- Nature and impact of marketplace terms and conditions
- Product placement on marketplaces
- Data collection, analysis, and use by marketplaces
- Supply of own products by marketplaces
- Pricing strategies by sellers
- Consumer protection roles played by marketplaces
- Dispute resolution mechanisms employed by marketplaces

The ACCC is keen to receive submissions from consumers, platforms, and third-party sellers, from small businesses to major brands, to inform its inquiry. Consumers and small business sellers are also invited to share their experiences with marketplaces by completing short online surveys.

Submissions were open until 19 August 2021, and a final report will be provided to the Australian Treasurer by 31 March 2022.

Read the ACCC's **media release here**.

AUTHORS

Ayman Guirguis
Partner
Sydney
ayman.guirguis@klgates.com

Thomas Shaw
Senior Associate
Sydney
thomas.shaw@klgates.com

Jessica Mandla
Lawyer
Sydney
jessica.mandla@klgates.com

Mei Gong
Lawyer
Sydney
mei.gong@klgates.com

Ayman, Thomas, Jessica, and Mei work in our Antitrust, Competition, and Trade Regulation group in Australia. For more information about this practice, please visit our **website**.

WHAT'S HAPPENING IN FASHION INTELLECTUAL PROPERTY?

UNICOLORS V. H&M: COPYRIGHT REGISTRATION VALIDITY

By Susan Kayser and Betsy Byra

On 8 November 2021, the Supreme Court will hear arguments in the case of *Unicolors v. H&M Hennes & Mauritz, L.P.*, No. 20-915. With a nearly US$1 million copyright verdict on the line, pattern manufacturer Unicolors, Inc.'s (Unicolors) fate is now at the Supreme Court to decide whether courts should refer copyright registration validity challenges to the Copyright Office where there is a known misrepresentation in the registration, but no evidence of intent to defraud.

A copyright registration certificate is not valid if

- "inaccurate information" is included in an application "with knowledge that it was inaccurate;" and
- that information, if known, would have resulted in refusal of the registration.

Under 17 U.S.C. §411(b)(2), where such facts are alleged, "the court shall request the Register of Copyrights to advise the court whether the inaccurate information, if known, would have caused the Register of Copyrights to refuse the registration."

This dispute began in 2016 when Unicolors, Inc. sued Hennes & Mauritz, L.P.'s (H&M) for selling garments that infringed on a design it created in 2011. It is a relatively common practice to file for a copyright registration of a collection of designs. Here, however, the group registration Unicolors relied on included designs that were *not public* as of the claimed publication date. In this case, some designs were kept from the public during an exclusivity period and therefore published at different times.

A jury found the works were substantially similar. H&M filed for judgment as a matter of law arguing in part that the copyright registration was not valid. H&M argued that the thirty-one separate designs included in the registration were not published at the same time as claimed by Unicolors in the application. H&M's motion was denied on the grounds that there was

- no evidence of intent to defraud the Copyright Office; and
- no evidence that the works were presented to different purchasers on different days.

H&M appealed this decision to the Ninth Circuit, which reversed and remanded to the district court. The Ninth Circuit noted that a collection of works can be registered as a single work if they are published in a "singular, bundled collection" to the general public. Rather than using an intent to defraud the standard, the Court found that Unicolors knew the registration was inaccurate as it was aware that some of the works were confined and offered to the public at different times.

The Ninth Circuit remanded to the district court to ask the Register of Copyrights whether this information would preclude registration. The Court emphasized that the validity of the registration is not an issue for the court in the first instance, but should be determined by asking the Register of Copyrights.

In its petition to the Supreme Court, Unicolors stated bad faith or fraudulent intent as the Eleventh Circuit has required is a prerequisite to referring validity challenges to the Copyright Office. H&M's position is, as the Ninth Circuit found here, that the plain language of the Copyright Act requires that when evidence of inaccurate information in the application becomes known, the court should ask the Copyright Office if it would have issued the copyright registration, regardless of intent to defraud by the applicant.

Amicus briefs have been filed in support of both sides. Arguing in favor of Unicolors' position, entities including the United States state that constructive knowledge is insufficient for "intent," contrary to the Copyright Act and Pro IP Act, and may provide a windfall to infringers. The groups who have filed in favor of this position include Copyright Alliance, The Intellectual Property Law Association of Chicago, American Society of Media Photographers, California Society of Entertainment Lawyers, American Intellectual Property Law Association, and Intellectual Property Law Professors. Building off of these positions, Unicolors subsequently filed a brief stating that a good faith mistake does not rise to the level of fraud required by 17 U.S.C. § 411(b) and in fact negates the state of mind required by the statute.

In September 2021, H&M filed a brief noting that "knowledge" does not equate to fraudulent intent and arguing that the question in this case is limited to this narrow issue. Also in favor of upholding the Ninth Circuit's position, several entities have filed amicus briefs, including: the National Retail Federation, New York Intellectual Property Law Association, Victoria Burke, Center for Democracy & Technology and Electronic Frontier Foundation, Andrew D. Lockton and McHale & Slavin, P.A., Professors of Copyright Law, and California Fashion Association.

The National Retail Federation (NRF), the world's largest retail trade association supports "knowledge" as the standard under §411(b)(2), and that courts must request the Register of Copyrights' advice regarding inaccurate information where properly alleged. NRF notes that many "prolific" fabric design litigants do not involve wrongdoing by retailers or their vendors, but instead are part of a cottage industry of litigation-for-profit. The NRF urges that adopting Unicolors' interpretation would open the door for "copyright trolls" and notes the registration at issue did not meet the requirement of "publication" of "single unit."

In light of this pending case, copyright owners should check publication dates on any applications filed for collective works to ensure that they are accurate. If not all works will have the same publication dates, copyright owners should file separate applications. In instances where a registration inaccuracy is detected, copyright owners should determine if they can amend their registration or need to re-file.

The Supreme Court is expected to issue a decision by June 2022.

AUTHORS

Susan Kayser
Partner
Washington, D.C. and New York
susan.kayser@klgates.com

Betsy Byra
Associate
Boston
betsy.byra@klgates.com

Susan works in our Intellectual Property practice group in the United States. For more information about this practice, please visit our **website**.

Betsy works in our Complex Commercial Litigation and Disputes practice group in Boston. For more information about this practice, please visit our **website**.

"ALL ABOARD" AS GUERLAIN DEPARTS FROM THE NORM: THE GENERAL COURT OF THE EU FINDS DISTINCTIVE CHARACTER IN BOAT HULL SHAPED LIPSTICK PACKAGING

By Simon Casinader and Kate McDermott

In what will be welcomed by innovative design brands, on 14 July 2021, the General Court of the EU handed down a **decision** annulling the European Union Intellectual Property Office (EUIPO) and Board of Appeal's decisions that a mark filed by Guerlain lacked distinctive character. This decision emphasises that a distinctiveness assessment of a three-dimensional mark must be undertaken by reference to the specifics of common practice in the market for the relevant products.

The Application

Guerlain, the French luxury perfume, cosmetics, and skincare house, originally applied to the EUIPO for registration of a three-dimensional trademark in respect of lipsticks.

The EUIPO, and consequently the Board of Appeal, dismissed Guerlain's application on the basis that the mark lacked "distinctive character," meaning it was not sufficiently distinctive to enable the product to be identified as originating from Guerlain.

The General Court of the EU's Decision

On appeal, the General Court of the EU annulled the EUIPO and Board of Appeal's decisions, finding that merely because a certain sector is characterised by a wide variety of shapes (such as in the case of lipsticks) does not necessarily mean that a particular new shape would merely be perceived as a decorative shape.

The General Court's decision emphasised that assessment of distinctiveness by reference to the aestheticism of any aspect of the mark is concerned with "determining whether that product is capable of generating an objective and uncommon visual effect in the perception of the relevant public."

Looking closely at the shape of the Guerlain mark in comparison to other lipstick shapes on the market, the General Court noted that the mark was distinctive on account of:

- its shape—noting that the Guerlain mark is comparable to a "boat hull" or "baby carriage," as opposed to the cylindrical shapes usually encountered in the product market;
- its surface markings—as the small oval embossed shape on its surface is unusual; and
- its functionality (or lack thereof)—given that the Guerlain shape would not be able to be placed upright.

On this basis, the General Court concluded the shape of the Guerlain mark would be 'memorable' by consumers in the lipstick sector, and as such should be registered.

Takeaways

This judgment demonstrates that the issue of distinctiveness of three-dimensional shape marks should be assessed closely on a case-by-case basis, with precise reference to the relevant product market and sector. It also confirms that assessment of aesthetic elements of any mark applied for should be carried out with a view to establishing whether the product is capable of generating an objective, uncommon visual effect on the wider public.

Guerlain's ultimate success in registering this mark also demonstrates that cosmetic and fragrance producers can hold out hope for the future and their ability to register distinctive 3D packaging.

AUTHORS

Simon Casinader
Senior Associate
London
simon.casinader@klgates.com

Kate McDermott
Trainee Solicitor
London
kate.mcdermott@klgates.com

Simon works in our Intellectual Property team in London. For more information about this practice, please visit our **website**.

Kate McDermott is a trainee solicitor in the firm's London office.

TRADEMARK MODERNISATION ACT

By Susan Kayser, Betsy Byra, and Kristin Wells

The Trademark Modernisation Act (TMA), enacted on 27 December 2020, is the first major legislative update to the Trademark Act of 1946—the Lanham Act—in nearly 75 years. Key updates provide the United States Patent and Trademark Office (USPTO) and trademark owners with tools to improve the integrity of the federal trademark register with more efficient prosecution processes and streamlined ways to clear unused marks from the register. It also codified the rebuttable presumption of irreparable harm in trademark infringement claims, erasing uncertainty and burdens on trademark owners to "prove" irreparable harm.

In early 2021, the USPTO issued a notice of proposed rulemaking to implement the TMA. The formal comment period for this proposed rule ended on 19 July 2021. New rules are to be implemented by 27 December 2021.

Expanded Letter of Protest Practice

The USPTO's Letter of Protest (LOP) practice provides third-parties with the opportunity to submit evidence challenging a trademark application prior to a formal opposition. The TMA expands the number of grounds interested parties can include in an LOP. More information can be provided to examining attorneys at an earlier stage.

The TMA permits third-parties to submit "evidence relevant to the examination of the application for a ground for refusal of registration." LOPs can now be submitted for *any* ground on which an examiner can refuse registration, including evidence that a proposed mark is not in use for the goods or services identified in the application, suggests a false connection with the protestor, or is so widely used that the mark does not function as a trademark.

Brand owners must submit an LOP no later than 30 days after an application is published for opposition, submit a US$50 filing fee, and include evidence to support each grounds for refusal. The USPTO has two months to determine whether to include LOP evidence in a protested application. LOP decisions are final and non-reviewable.

Shorter Response Periods for Office Actions

In another effort to create a more efficient trademark prosecution process, the TMA authorizes the USPTO to shorten response periods for Office Actions. The statute amends the blanket six-month response period to provide the USPTO with discretion to implement response periods between two and six months.

The USPTO proposes a three-month response deadline for all applications and registrations not filed under Madrid Section 66(a). Beyond the three-month period, applicants and registrants would be allowed a one-time three-month extension to respond for US$125 (per request—not per class). An alternate option proposes issuing all procedural refusals with a three-month deadline before issuing all substantive refusals with a second three-month deadline for applicants to respond. Finally, a third suggestion emulates the patent prosecution model of increasing extension fees for each additional extension.

Formal comments in response to the proposed changes generally advocate for retaining the six-month response period for substantive Office Action refusals. While some commenters agree that the response time could be shortened for procedural refusals—or refusals based on abusive behaviors—the consensus is that the director should designate which refusals fall under the three-month response period, rather than affording examining attorneys discretion in determining when a shorter response deadline applies.

Recognizing the administrative and docketing challenges posed by shortened Office Action response periods, the USPTO plans to implement changes to these deadlines on 27 June 2022.

Ex-Parte Proceedings to Cancel Goods and Services in Existing Registrations

To create a more efficient way to challenge trademark registrations, the TMA provides for two new ex parte challenges: expungement and re-examination. Both procedures can be initiated by a petitioner or by the director's own initiative, and may cancel a registration in whole or in part.

Under Section 16A of the Act, expungement proceedings may be initiated for marks that have never been used in commerce, so long as the petitioner demonstrates that they have conducted a "reasonable investigation." Proceedings must be brought between three and ten years of the registration date. However, until 17 December 2023, petitioners may file against any registrations that are at least three years old regardless of the 10 year limit.

Re-examination proceedings may be brought under Section 16B of the Act within five years of registration to determine whether a registered mark was in use in commerce at the time of the "relevant date"—the application date for use-based applications or, for intent-to-use applications, the later of the date of statement of use or deadline to file statement of use.

These proceedings cannot be brought simultaneously (though expungement proceedings do not bar future re-examination proceedings), and must only concern one registration per petition. Proceedings may be consolidated. The director's determination as to whether a petition makes a prima facie case is final and non-reviewable, but once use of goods and services has been established, identical goods and services cannot be challenged again. If the director accepts a petition, an Office Action will be issued and the registrant will have two months to respond.

In practice, brand owners should identify problematic registrations, consider narrower identifications for new applications, and periodically audit registrations.

Affirming Rebuttable Presumption of Irreparable Harm in Trademark Litigation

Prior to 2006, federal courts granted plaintiffs a rebuttable presumption of irreparable harm if a likelihood of success on the merits was established. However, the landmark Supreme Court case *eBay, Inc. v MercExchange, LLC* required plaintiffs to establish all four elements for injunctive relief without a rebuttable presumption of irreparable harm. This case ultimately resulted in a circuit split, with various district courts and circuit courts affirmatively holding that trademark owners should prove irreparable harm.

The TMA has since amended Section 34(a) of Lanham Act (15 U.S.C. § 1116(a)) to include a rebuttable presumption of irreparable harm. In codifying this presumption, Congress intended to rectify the circuit split and minimize inconsistency and unpredictability. Other rationales for this amendment include that damage from trademark confusion is often not quantifiable or rewarded by monetary relief, and if there is a likelihood of success, it is also likely that an injury would occur.

AUTHORS

Susan Kayser
Partner
Washington, D.C. and New York
susan.kayser@klgates.com

Kristin Wells
Associate
Washington, D.C.
kristin.wells@klgates.com

Betsy Byra
Associate
Boston
betsy.byra@klgates.com

Susan and Kristin work in our Intellectual Property practice group in the United States. For more information about this practice, please visit our **website**.

Betsy works in our Complex Commercial Litigation and Disputes practice group in Boston. For more information about this practice, please visit our **website**.

THE COMING BLOCKCHAIN REVOLUTION IN CONSUMPTION OF DIGITAL ART AND MUSIC: THE THINKING LAWYER'S GUIDE TO NON-FUNGIBLE TOKENS (NFTS)

By Daniel Nuñez Cohen, Clifford Histed, Stephen Humenik, Jeremy McLaughlin, Anthony Nolan, Judith Rinearson, and Mark Wittow

First there were CryptoKitties. Then came digital art, CryptoPunks, and NBA Top Shot. But when Beeple's digital art piece "Everydays: The First 5000 Days" sold at Christie's for US$69 million, the NFT mania truly began. As with any wave of media mania, there also came the groundswell of negative media and hand-wringing about NFTs.

We believe it is time to address the pros and cons of NFTs from a thoughtful, legal perspective. NFTs are not all evil nor are they a panacea for artists and musicians. Here are our thoughts on the most common questions we have received from our clients about NFTs.

What Are NFTs?

NFTs are non-fungible tokens issued on a distributed ledger such as a blockchain. They are similar to cryptocurrencies like bitcoin in that they can be identified individually and are authenticated through a decentralized system of nodes via a consensus protocol. However, they differ from cryptocurrencies in that they are each unique, indivisible, and "non-fungible."[1]

Watch our webinar, **NFTs—A "Flash in the Pan"? or a True "Game Changer"?** available on **YouTube.**

NFTs are stored in "smart contracts," which are automatically executable code that run on top of the distributed ledger on which the NFT is recorded. They provide a method of "provable uniqueness" and ownership for pieces of digital art, images, music, and other content. NFTs are provably unique because each image and piece of content is linked to a single token stored in a smart contract on the distributed ledger and its ownership can be irrefutably established.

While others may have copies of the same content, only one person can own the specific token authenticating ownership of the content. Currently, most, but not all, NFTs operate on the Ethereum blockchain. NFTs may help realize the long-touted but practically elusive goal of making blockchain technology a powerful tool to protect artists' rights to benefit from their creations without the need of intermediaries, and to protect investors by helping establish provenance of art works.

Why Are People Spending Massive Sums on NFTs?

NFT purchasers often are collectors who view NFTs as a way to support their favorite artists, actors, musicians, and athletes. While there have been some recent high-profile large dollar sales,

[1] NFTs created using the ERC-721 standard are indivisible.

most NFT sales are at a reasonable price that provides a much-needed way for artists, collectors, and musicians to monetize their work. As with collectors of many items (antiques, baseball cards, art) many collectors purchase NFTs because they hope they will increase in value and will be a good investment.

The legal and regulatory analysis of an NFT will be heavily influenced by how it is intended to be used and how it is marketed. Given the recent high-profile stories of people getting rich from new technology, some bad actors will try to take advantage of the situation.[2]

What Advice Would You Provide to Artists or Musicians Who Want to Issue Their Own NFT?

If you are an artist or musician who is interested in issuing NFTs as a way to monetize your creative content, you need to be careful on how you proceed.

For instance:

- Ensure that the piece of art/image, digital music, or other creative work associated with the NFT is unique and authenticated. Ensure that you have all of the rights necessary to reproduce and distribute the work.
- Work only with a reputable technology company that will issue the token on your behalf in a manner that is transparent and secure.
- Inquire about the technology company's position on payment of royalties. While certain token standards prohibit royalties (because they are viewed as stifling the ability to freely transfer tokens) there have been discussions in the Ethereum community about the creation of a royalty standard.[3] At present, artists generally receive a payment when their NFTs are initially sold, but often not if they are resold in the future.
- Work only with a reputable marketplace that does not over-promise or hype the NFTs, and that does not require you to make significant up-front payments in order to issue and sell your NFTs. Find out which blockchain platform the technology company is using.

  Jodee Rich, founder of NFT issuer Kred and the NFT conference "NFT/NYC," told us:

  "NFTs are minted on different blockchain platforms. Ethereum is the standard (called ERC721). Minting and transacting on the Ethereum blockchain is really expensive. We recommend minting on Ethereum compatible blockchains (such as Matic) which are just as effective and much less expensive."
- Make sure disclosures are clear regarding the purpose of the NFTs as a royalty vehicle, whether there is expected to be an established trading market for them, risk factors, or other special considerations, and whether they are or are not investment contracts or other types of securities.

What Advice Would You Provide to Collectors Who Want to Purchase NFTs?

Prospective purchasers of NFTs should keep in mind that, while the NFTs may have some similarities to other collectibles, such as artwork, comic books, music, or trading cards, they also differ from those traditional physical assets in important ways:

- You are purchasing a unique piece of code on a blockchain that is linked to the product. You will not have a piece of art that can be hung on a wall; rather, you will need to store your NFT in a digital asset wallet, whether a wallet you control or one provided by a third-party.

[2] *See* David Gerard, NFTs: crypto grifters try to scam artists, again (Mar.11, 2021).

[3] *See* James Beck, Can NFTs Crack Royalties and Give More Value to Artists?, CONSENSYS BLOG (Mar. 2, 2021).

- Purchase an NFT that you personally like from an artist you admire as a collectible.
- While the value of an NFT may be influenced by the reputation of the artist and the provenance of the NFT and the art work that it represents, do not expect that your purchase will necessarily increase in value or maintain a stable value.
- Recognize that while you own the token with code linked to the provably unique image or other work, others may have copies of the underlying work. But only you can own that token.
- Ensure you understand where the underlying work referenced by your NFT is stored. In most cases, the work is not actually stored on the blockchain and the NFT will "point" to a traditional internet site where the work is housed.
- Understand whether the NFT sponsor is carefully addressing compliance with regulatory requirements, and understand the potential effect on liquidity if the NFT is marketed as a security or a commodity. You should also understand potential rescission rights if an NFT that is not marketed as a security is subsequently determined to be a security that was issued in violation of the registration requirements of the securities laws.

Listen to our **Payments Across the Globe Miniseries from our Fintech Forward podcast.** Episodes, including one focused on "Cryptocurrencies and Digital Assets in the U.S." can be **found on our website.**

What Advice Would You Provide to Lawyers Who Have Clients Interested in NFTs?

As with any new product or service, there is some uncertainty about the regulatory landscape for NFTs. Nevertheless, there are some clear rules to follow. If you are a lawyer with clients in this space, here are some top areas of the law that you need to be familiar with. It is important to realize that plaintiffs, prosecutors, or enforcement agencies have sought to hold lawyers responsible for advice in other areas of the fast-developing legal framework for digital tokens and cryptocurrencies where that advice was, in hindsight, considered to have been overly aggressive.

Are NFTs Securities?

As with other blockchain-based tokens, the question of whether a given NFT might be a security will be highly dependent on the facts and circumstances. Being categorized as a "security" could subject an NFT to detailed registration and disclosure requirements, or alternatively, to suitability requirements and offering restrictions for transactions exempt from registration.

Complying with the registration requirements of the Securities Act would be impracticably expensive, while offering restrictions could make NFTs unsuitable for certain anticipated use cases such as facilitating artists' rights and royalties. The sale of a one-off NFT that only confers ownership over a piece of art likely would not be considered an offering of securities. However, more complicated transactions related to NFTs could easily cross the line and become securities offerings. For example, projects where large numbers of NFTs are minted and sold and where the issuer creates a platform to support secondary trading of the NFTs could potentially be viewed as a securities offering.

Similarly, NFTs that are "fractionalized" and sold to individual investors are also likely to be considered securities.[4] To do so, the NFT itself is held by the owner or a custodian and fungible digital tokens that collectively represent 100 percent of the ownership of the NFT are created and sold to third-parties. For NFTs minted on Ethereum, the NFT would be created using the ERC-721 standard and "ownership" tokens would be created using the ERC-20 standard.

Finally, if the NFTs or ownership tokens being sold will entitle the holders to a royalty payment or dividend stream related to the underlying music or art, such digital tokens could be deemed securities if the tokens are considered to represent an investment in a common enterprise with an expectation of profits to be derived from the entrepreneurial or managerial efforts of others under the Howey test.[5]

The Security and Exchange Commission's (SEC) regulatory guidance and enforcement activities over blockchain-based tokens of all types have evolved rapidly in recent years and continue to evolve to keep pace with technological innovation. Issuers of NFTs and platforms supporting the sales and trading of NFTs should be mindful of the rapid evolution within the recent past of the SEC's view of digital tokens and the circumstances that could cause it to regard a token as a security even if the token has elements of utility tokens.

Lawyers advising clients on NFTs should be familiar with no action letters, and regulatory guidance related to initial coin offerings (ICO), decentralized autonomous organizations, and "utility tokens" and "security tokens," including the "Framework for 'Investment Contract' Analysis of Digital Assets."

Lawyers should pay particular attention to the numerous SEC enforcement actions.[6] Lawyers should also be mindful of the SEC statements in the context of ICOs that articulate an expectation that securities lawyers, accountants, and consultants as gatekeepers have a special responsibility to help prevent violations of securities law in the design and offering of digital tokens. Moreover, if an NFT (or ownership token) is a security, a transaction that does not prompt regulatory scrutiny could nonetheless result in private litigation, because state and federal anti-fraud statutes typically apply even to securities that are exempt from registration requirements.

Are NFTs Commodities?

Even if an NFT is not a security, if the NFT may reasonably be expected to have secondary market trading and liquidity, a lawyer should also consider whether the NFT is a "commodity" under the U.S. commodity laws. A commodity is typically defined as a reasonably interchangeable good or material, bought and sold freely as an article of commerce, which includes all services, rights, and interests in which contracts for future delivery are traded presently or in the future.

In several enforcement actions, the Commodity Futures Trading Commission (CFTC) has taken the view that bitcoin and virtually all other primary digital currencies that are not securities are commodities subject to the anti-fraud and anti-manipulation jurisdiction of the CFTC. As CFTC-registered trading venues now offer futures contracts and other derivatives with Bitcoin and Ether as the underlying assets, it is now established that those digital assets are in fact commodities under U.S. law.

What are the Intellectual Property Considerations for NFTs?

With respect to intellectual property laws, we recommend that lawyers ensure that the NFT issuer controls all of the rights in the content that are necessary for the reproduction and distribution of the NFT. For example, the owner of rights in a sound recording also would need to control or have license rights to the underlying musical composition performed on the sound recording.

[4] *See* https://cointelegraph.com/news/going-to-pieces-fractionalized-nft-projects-gather-steam.

[5] SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

[6] *See* SEC v. Ripple Labs, Inc., et al., Case No. 20-cv-10832, Southern District of New York, complaint filed December 22, 2020.

The rights in the music composition that were granted to make and distribute the sound recording may not extend to the creation and distribution of one or more NFTs. Although fair use and first sale rights also would apply to the creation, reproduction, and distribution of NFTs, no court decisions have yet addressed the application of those doctrines to NFTs. NFT creators and distributors should be quite careful in relying on those doctrines given the current lack of precedent with respect to their application.

Similarly, the distribution of images that utilize trademarks such as product logos generally will require a license from the trademark owner and typically would be outside the scope of any existing trademark license. Brand owners already have entered the NFT markets and are likely to vigorously object to unauthorized uses of their trademarks as part of an NFT.

The owner of an NFT, like the owner of a unique work of art, generally will own only the digital item itself, and not any underlying intellectual property rights, which typically remain with the creator of the work or their designee. The owner of the NFT therefore will have limited rights to exploit ownership of the NFT, apart from resale of the NFT itself, unless additional license rights are included with the NFT.

What Other State and Federal Laws Should Be Considered?

As with most commercial transactions, transactions involving NFTs will need to consider state and federal consumer protection laws, especially restrictions on unfair, deceptive (and abusive) acts and practices. These broadly construed laws generally prohibit actions that cause unfair harm or mislead parties to transactions. Federal and state regulators have issued various warnings to consumers about the uncertainty of the cryptocurrency industry, and we expect those regulators would have equal concern about the NFT marketplace, especially given its novelty and lack of general consumer understanding. As a result, those involved in NFT transactions should pay particular attention to representations in marketing and other disclosures to ensure their accuracy and thoroughness.

NFTs may implicate other laws depending on their particular characteristics. For example, to the extent an NFT is linked to a cryptocurrency (such as ownership tokens) or other monetary value, state money transmitter laws might be implicated. Forty-nine states have money transmitter laws on their books, and some (but not all) of those laws apply to activities involving cryptocurrency, such as holding cryptocurrency on behalf of others, receiving it for transmission to a third-party, or issuing it. If such laws are triggered, a license would be required (unless an exemption or partnership with a licensee applied) and various obligations would apply, such as minimum capital, recordkeeping, examinations, and disclosures.

At the federal level, the same activity that could trigger state money transmitter laws may also trigger an obligation to register with the Financial Crimes Enforcement Network (FinCEN) and implement an anti-money laundering program. FinCEN has issued guidance explaining that it regulates “administrators” and “exchangers” of cryptocurrency and has continued to expand its regulatory oversight of cryptocurrency transactions, including recent proposals to impose new reporting and recordkeeping requirements.

Although FinCEN has issued little guidance on NFTs specifically, in March 2021, the Financial Action Task Force, a global anti-money laundering body, proposed revisions to its virtual asset guidance that could subject certain NFTs—such as those that enable the transfer or exchange of value on secondary markets—to regulation. It is unlikely these attempts at regulation will fade, so NFT issuers and exchanges should proceed accordingly.

Conclusion

NFTs can be a true win-win for both the sellers and purchasers, as well as for the artists and musicians who use them. The close relationship of many NFTs to works of art, and their popularity with artists and musicians may provide a basis to hope that NFTs will not suffer the challenges faced by the ICO market. However, care should be taken to ensure that the NFT transactions are implemented with clear and transparent terms, and a full understanding from all as to the laws that apply, the underlying nature of the product, and how it provides true provable uniqueness.

Watch our webinar on "**Crypto and Digital Asset Businesses Take Note—Capitol Hill Legislators and Regulators Are Turning Up the Heat Even More on Cryptocurrencies**" available on the K&L Gates HUB.

AUTHORS

Stephen Humenik
Partner
Washington, D.C. and Chicago
stephen.humenik@klgates.com

Clifford Histed
Partner
Chicago
clifford.histed@klgates.com

Jeremy McLaughlin
Partner
San Francisco
jjeremy.mclaughlin@klgates.com

Daniel Nuñez Cohen
Associate
Washington, D.C.
dan.nunezcohen@klgates.com

Judith Rinearson
Partner
New York and London
judith.rinearson@klgates.com

Anthony Nolan
Partner
New York
anthony.nolan@klgates.com

Mark Wittow
Partner
Seattle
mark.wittow@klgates.com

Our global Fintech and Payments, Banking Regulation, and Consumer Financial Services team includes partners and lawyers from various areas of law from around the world.

For more information about our Fintech Lending team, visit our **website**.

To view details about our Payments, Banking Regulation, and Consumer Financial Services team, visit our **website**.

FASHION EVENTS AND EXCITING UPDATES

The Fashion Marketplace: Law and Policy, Fashion Law London

On 22 October 2021, Fashion Law London hosted a high-profile online event bringing together members of the industry, regulators, and legal experts to discuss the most pressing legal, regulatory, and policy issues affecting and shaping the fashion marketplace today. Special Counsel Gabi da Costa was a panelist on a 360° discussion exploring “Competition Issues and Consumer Protection.” Other panel discussions include the “Regulatory and Legislative Ecosystem,” “The IP Dimension,” and “The Changing Policy and Legal Landscape.”

To sign up for updates or learn more, visit **www.fashionlawlondon.com**

LUXURY LAW AWARDS

Congratulations to our Intellectual Property partner **Arthur Artinian** for being named the **Luxury Law Partner of the Year** at the 2021 Luxury Law Summit and Awards held at the British Museum on 22 September 2021.

Hearty congratulations to Joanne Loughrey of L’Oréal for being awarded the K&L Gates prize for **Business Leader of the Year**.

LUXURY PRODUCTS AND FASHION

The world of fashion raises legal issues that can be as intriguing as the designs that glide down runways. Our lawyers are ready with integrated, detailed, and creative solutions to address the many challenges faced by luxury and fashion brands around the world.

Luxury Goods, Fashion and Retail at K&L Gates

K&L Gates has been ranked in the recent *Legal 500 United Kingdom—Solicitors 2022* directory for the new industry group **Retail and Consumer**. In the directory, Legal 500 commented:

"K&L Gates LLP has an enviable track record not only in the fashion and luxury goods space but also in the electronics and general consumer goods sectors. Part of the wider firm's IP and technology department, the retail offering advises across a myriad of issues affecting retail businesses, most notably intellectual property work, commercial contracts, social media-related issues, and brand and technology transactions. Jennifer Marsh focuses on distribution strategies, Arthur Artinian's personal practice emphasises IP, while Catherine Adam's retail experience includes supply chain issues."

Clients also provided feedback about K&L Gates team: 'they have a global reach for local expertise and presence when sending letters' and 'our contacts are always willing to have calls when needed on new topics that need escalation.'

Our London competition team has once again been recognised by *Legal 500* for its unique expertise in vertical distribution matters. *Legal 500* commented:

"K&L Gates LLP regularly advises on merger control issues, and uses its international network to provide clients with global coverage on multinational deals. In addition, the team has a niche in selective distribution agreements as well as other vertical issues such as resale price maintenance, online marketplace policies, cross-border resale restrictions, dual pricing and reseller selection…"

WE ARE PROUD SPONSORS OF THE MELBOURNE FASHION FESTIVAL AND THE LUXURY LAW AWARDS.

MELBOURNE FASHION FESTIVAL

LUXURY LAW AWARDS

WE ASSIST

national and international designers, luxury fashion brands, clothing and footwear retailers, specialty retailers, boutiques, startups, and fashion outlets.

WE ARE PROUD TO SUPPORT

various fashion associations including the Luxury Law Alliance (UK).

From establishing the business and e-commerce structures, to protecting the brand and designs, to assisting with employment and real estate needs, **OUR PRACTICE CAN WORK WITH CLIENTS IN MOST ANY ASPECT OF THEIR BUSINESS**.

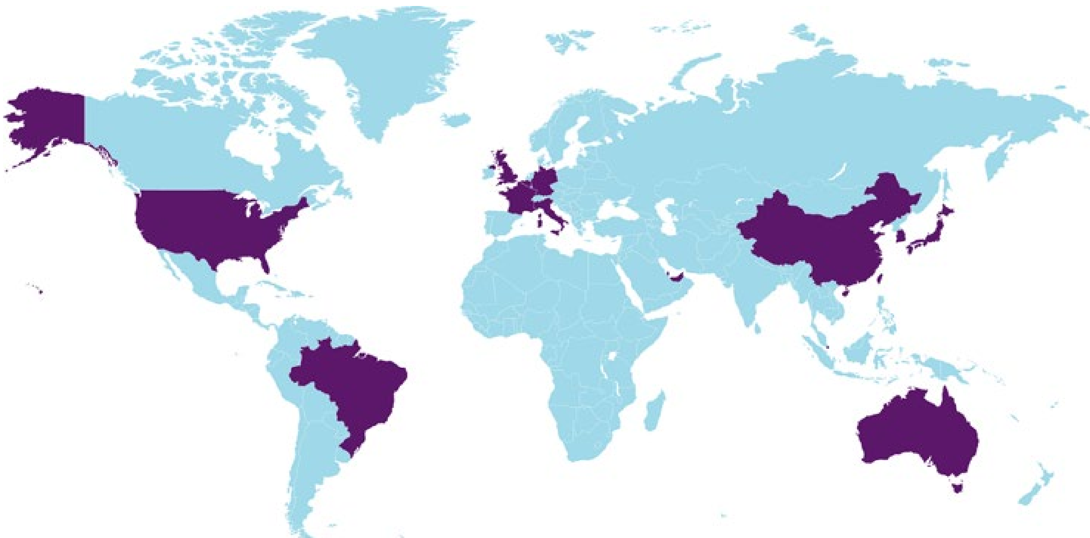
LUXURY LAW FIRM OF THE YEAR

We were awarded Luxury Law Firm of the Year at the 2020 Luxury Law Awards.

K&L Gates is an Official Partner of the Australian Fashion Laureate and will provide a prize for the new award category, the Indigenous Designer Award. The winner will be announced on 30 November in Sydney, Australia.

We wish Indigenous Designer Finalists good luck:

- Denni Francisco, Ngali
- Grace Lillian Lee
- Julie Shaw, MAARA Collective
- Lillardia Briggs-Houston, Ngarru Miimi



We have a **GLOBAL TEAM OF LAWYERS ACTIVE IN FASHION AND RETAIL**—meaning we can assist wherever you need it.

CONTACTS

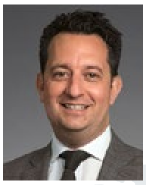
For any questions relating to your company's needs, please contact:

UNITED STATES

SUSAN KAYSER
Washington, D.C. and New York
+1 202 778 9421, +1 212 536 4053
susan.kayser@klgates.com

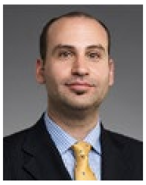
ASIA PACIFIC

SAVANNAH HARDINGHAM
Melbourne
+61 3 9205 2043
savannah.hardingham@klgates.com



JONATHAN FEDER
Melbourne
+61 3 9640 4375
jonathan.feder@klgates.com

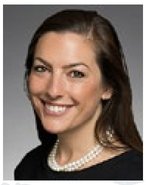
EUROPE



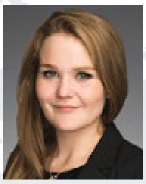
ARTHUR ARTINIAN
London
+44 20 7360 8207
arthur.artinian@klgates.com

CATHERINE ADAM
London
+44 20 7360 8214
catherine.adam@klgates.com

FRANCESCO CARLONI
Brussels and Milan
+32 2 336 1908, +39 02 3030 291
francesco.carloni@klgates.com



GABRIELA DA COSTA
London
+44 20 7360 8115
gabriela.dacosta@klgates.com



GEORGINA RIGG
London
+44 20 7360 6442
georgina.rigg@klgates.com

Subscribe to our Fashion Law Watch blog at
www.fashionlawwatch.com

K&L GATES

K&L Gates is a fully integrated global law firm with lawyers located across five continents. The firm represents leading multinational corporations, growth and middle-market companies, capital markets participants, and entrepreneurs in every major industry group, as well as public sector entities, educational institutions, philanthropic organizations and individuals. For more information about K&L Gates or its locations, practices and registrations, visit klgates.com.

22696