

**Intellectual Property in Foreign Markets - The Case of Gallagher Guitars**  
by Dr. Lara Short, Assistant Professor of Accounting, MTSU

J.W. Gallagher and Son, one of America's premier manufacturers of folk guitars, is located in Wartrace, Tennessee. For over thirty years the Gallagher's have been making steel-string acoustic flat-top guitars for musicians in several foreign countries as well as throughout the U.S. Today their catalog offers fourteen different models of six and twelve string guitars priced from \$1486.00 to \$2750.00. Each guitar is still made to order by hand. Most of the company's sales are through its catalog, but Gallagher and Son will also custom make guitars.

High quality has always been the focus of the company. This was never more evident than in the late 1980s, when changes mandated in the lacquer industry by the Environmental Protection Agency affected the formulation of lacquer applied to Gallagher guitars. When a customer contacted Don Gallagher and informed him that the lacquer finish on a newly purchased guitar was cracking, Gallagher decided to stop taking orders, though he had eighty guitars in his finishing room. He halted production of new guitars and laid off his staff. The production of new guitars did not recommence until he had resolved the problem with the lacquer company, and had stripped and refinished all forty of the guitars in the shop.

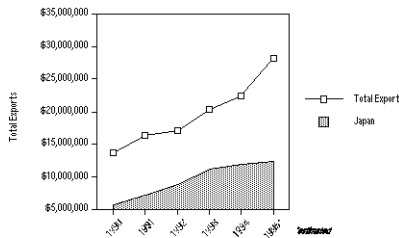
Gallagher guitars can be readily identified by two unique characteristics. One is the curved or "French-scroll" headstock, and the other is the Old English G inlaid on the headstock. The company has relied solely upon common law trademark protection to guard against use of these unique characteristics by other companies in the U.S. and abroad.

**The Problem**

In April of 1993 Don Gallagher discovered that he had a serious problem marketing in Japan. He was contacted by a Japanese national named Kotaro Fujii, who wanted to order a guitar as a result of an ad he had seen in *Vintage Guitar Magazine*. Fujii was happy to discover that Gallagher and Son was still in business: he had read ads in Japan stating that Gallagher was no longer producing guitars and that the Gallagher guitar was being produced by a Japanese company. Don Gallagher then obtained copies of some of these ads, which did indeed state that his company had ceased business, and that the Gallagher guitar was being made by the Kanda Shokai company in Japan. The ads also mentioned Gallagher's most prominent customer, Doc Watson. This was not the first such experience. In the 1970s guitars closely resembling the Gallagher guitars were produced and sold in Japan. However these guitars were marketed as Aria guitars and there was no mention of the Gallagher name in any promotion of the guitars.

Though no action had been taken against the company producing Aria, Don Gallagher decided that the Kanda Shokai ads required action because they actually used the Gallagher name. Gallagher wrote to the Japanese company and demanded that it cease production of the copies and also cease the misleading advertisements. The company replied by letter, indicating that its president had long been an admirer of Gallagher guitar and so decided to produce the Gallagher after he had heard that J.W. Gallagher was no longer living and that the company had gone out of business! The Kanda Shokai company further stated in its letter that it would cease production of the Gallagher copies. However, Gallagher still faces the prospect that the Japanese company may ignore this agreement in the future. He has been advised that Japanese companies respond only to formal legal action in cases like this. Further, he is concerned about the continued distribution of extant copies.

Winter 96- Short article graphic  
American Guitar Exports 1990-1995



Since first hearing from Fujii, Gallagher has also received communications from individuals in the United States who believed that they also had purchased J.W. Gallagher and Son guitars, but who had in fact purchased lower quality copies. He suspects that the actions of the Kanda Shokai company have resulted in lost sales for Gallagher and Son, both in the U.S. and abroad. Mr. Fujii's order was the first he had received from Japan in several years.

**Current Trademark Law**

Mr. Gallagher's options are not clear. This is certainly a case of international trademark infringement. While in the U.S. Gallagher and Son has relied solely upon common law protection for its name and distinctive design, protection under Japanese law depends upon explicit registration. Use of the trademark is not a prerequisite for registration, but failure to use the mark within three years of registration leaves the mark vulnerable. Since Gallagher and Son did not register the trademarks in Japan, it is unlikely that the company would prevail in any Japanese court.

Both the U.S. and Japan are members of the Paris Convention for the Protection of Industrial Property, but this compact does not create an international law of trademark. Instead, it is based on the principle that each state's trademark law should apply only in its own country, and that foreign nationals should operate under the same rules as the state's own citizens.

The U.S. Supreme Court has, nonetheless, applied U.S. Trademark law to activity outside the U.S., notably in the 1952 case *Steele v. Bulova Watch Co.* This decision was based on three factors. First, the defendant was a United States citizen. Second, the Court found the activities of the defendant had an effect on U.S. Commerce. Third, many of the watches involved in this case had been brought into the U.S. by purchasers who believed they had purchased "the real thing." Following this logic, it is unlikely a U.S. court would engage in an application of U.S. trademark law should Gallagher and Son take the case to an American court. There is no clear evidence that Kanda Shokai has affected commerce in the U.S., and the defendant is not a U.S. citizen. Kanda Shokai's lack of presence in the U.S. would also prevent a U.S. court from exercising personal jurisdiction over the defendant.

Gallagher and Son can certainly take effective action with U.S. customs to prevent an unlikely attempt by Kanda Shokai to import into the U.S., but the problems with counterfeit guitar makers in the Japanese market is a far more difficult matter. The problem has been alleviated somewhat by corrections published in several of the Japanese magazines which printed the original advertisements. Also, Gallagher and Son has recently received positive publicity in Japan. In May, 1995, the company was visited by a group of people working on an anthology of acoustic guitars for publication in Japan. Don Gallagher believes that the inclusion of Gallagher and Son in this publication is the result of the Kanda Shokai incident.

**Protection in Foreign Markets**

The question remains, what can, and should, companies like Gallagher and Son do to protect their intellectual property in foreign markets? Gallagher could have registered its trademark in Japan, but use within three years would have been required in order to protect against a cancellation proceeding. Use of the mark could easily be established through advertising the product, but Mr. Gallagher has been successful in fostering the image associated with the size, location, history, and mystique of his company, which would be defeated by mass media advertising. There is also the issue of cost. Gallagher sells its products in several foreign countries; the cost of registering his trademark in each of those would be prohibitive. Unfortunately, the small business owner is at the mercy of foreign entrepreneurs who file at their local trademark office.

*Editor's note: Registering trademarks internationally has just gotten much easier. The European Union has decided to consolidate its registration process. Beginning January 1, 1996, an American company will need to file only one application to register its trademark in all fifteen EU countries.*

*Currently a company must register independently in each EU state. This change will save U.S. firms thousands of dollars in filing fees, and years of processing their trademark registrations.*

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**Editor's Note on Project International Case Studies**

An important part of Project International, the internationalization of the MTSU College of Business programs and activities, is the production and compilation of a series of case-studies on the experiences of Tennessee businesses as they "go international." These studies, authored by professors in the College of Business, cover many of the topics and concerns which have confronted local firms doing business overseas. The cases will be extensively used in MTSU's international business and economics courses, providing students the opportunity to learn from real-life Tennessee examples and to gain a more practical understanding of global business. In this issue of Global Commerce we are delighted to present an abridged version of one of these case-studies, Professor Lara Short's examination of J.W. Gallagher and Son's discovery that a Japanese firm was selling unauthorized copies of its guitars. Overseas trademark violations are an Achilles heel for many U.S. exporters. Over \$80 billion in counterfeit U.S. goods are being sold world wide every year. This is a major concern for big companies, such as Reebok and Levi Strauss, but the problem is just as serious for the smaller exporter, as Professor Short demonstrates in this interesting case.

Project International is supported by a grant from the U.S. Department of Education.

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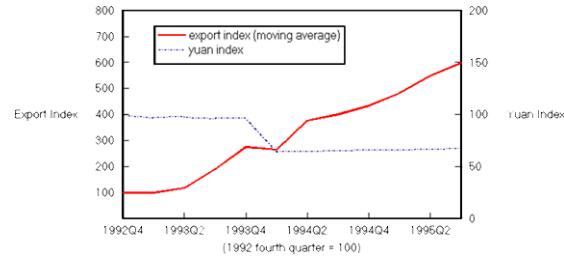
## The Dollar and Tennessee's Trade

by Steven G. Livingston

Price competitiveness is essential to sales. This, surely, is the first lesson of business. And this holds true whether the market is in Tennessee in or in a foreign country. But in selling internationally, one doesn't always have full control over the price. There is an extra determinant of the price of one's goods: the value of the dollar. As the dollar rises against another currency, American products will cost more in that country (unless the exporter or the local retailer are willing to compensate by lowering their prices). Foreign exchange rates are thus an important part of global business.

The price of the dollar is an important part of the overall competitiveness of American firms internationally. Economists and government officials, as well as people in business, worry about the links between the dollar and America's ability to export. Some countries try, in effect, to "cheat" by maintaining artificially low exchange rates with the dollar (i.e. an expensive dollar), insuring that U.S. firms are always at a price disadvantage. Indeed, anything which raises the value of the dollar may hurt U.S. trade. One continuing problem with the U.S. budget deficit, for example, is concern that heavy U.S. government borrowing might produce higher U.S. interest rates than would otherwise be the case. This would lead to a stronger dollar, and contribute to the trade deficit.

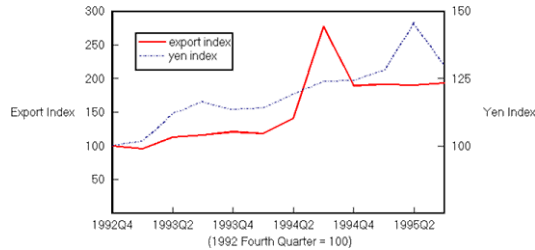
In the first issue of *Global Commerce* we saw that the sudden devaluation of the Mexican peso quickly braked the expansion to Tennessee exports to that market. A second devaluation confirms the linkage of trade to the dollar. In late 1993, China devalued its yuan. Unlike Mexico, this was a carefully controlled one time action. We see in Chart 1 that this devaluation produced a slump in the growth rate of Tennessee



exports to China (the state's exports to China fluctuate greatly, so we have displayed a line showing the moving average of exports to better observe what happened). Again unlike Mexico, exports seem to have adjusted to the new exchange rate and continued on their merry way after this brief setback. However, a close look at either export line should convince you that the slope of the lines shifted downward. In other words, the rate of expansion of Tennessee exports may have been permanently slowed as a result of the Chinese action.

A third, happier story shows the effects of a weakening dollar. Much has been made of the soaring Japanese yen, which recently broke through the yen/dollar ratio of 100. This should be good news for exporters to Japan. And Tennessee products have in fact done very well there recently, as Chart 2 shows.

**Chart 2**  
Japan: An appreciating Yen helps Tennessee exports



### A Tennessee Trade-Weighted Dollar Index

These three country profiles are suggestive. But is there a way to get one single snap-shot of the entire global currency situation facing Tennessee exporters? Many U.S. and international agencies publish a monthly overall foreign exchange value of the dollar. For business, this can be somewhat misleading, because traders are concerned with exchange rates *where they trade* and not with an abstract world average. An effort to create a more useful exchange rate figure is the trade-weighted dollar index. Here currencies are weighted according to the percentage of U.S. exports their countries take. Thus the index measures how the dollar is doing relative to our biggest trading partners.

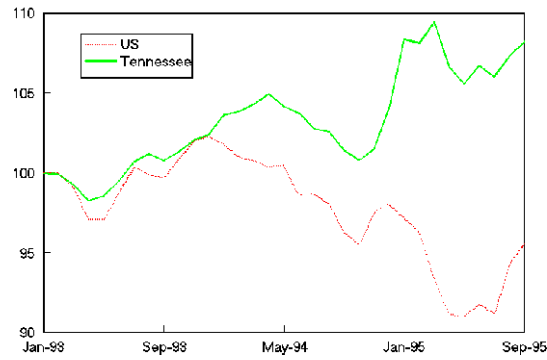
Tennesseans may find a limitation with the several trade-weighted dollar averages which exist: they measure overall U.S. trade, not specifically Tennessee trade. Our export profile does not match that of the entire country. Chart 3 shows the

**Chart 3**  
Export Destinations: Tennessee vs. the U.S.  
(average percentage, 1991-1994)

	Tenn. Exports (%)	U.S. Exports (%)
Canada	81.62	21.96
Mexico	7.14	8.48
Japan	7.12	10.89
Germany	5.74	4.11
UK	5.36	5.29
Netherlands	4.24	2.81
France	3.42	2.96
Hong Kong	2.5	2.16
Korea	2.39	3.21
Australia	2.26	1.89
China	2.26	1.81
Taiwan	2.19	3.28
Belgium	2.16	2.17

relative size of export markets for the state vs. the nation, based on 1991-1994 exports. As you can see, Canada is a much more important market for Tennessee than for the rest of the country. Japan and Mexico absorb a smaller percentage of Tennessee goods than is the national average. We have created a Tennessee trade-weighted dollar index based on our state's export profile. If factors in the currency rates of our 22 largest trading partners, who together account for about 90% of the state's exports. This index (with January 1993 set at 100) should be the most reliable guide to the currency situation affecting Tennessee exports. Chart 4 graphs the Tennessee index against the U.S. index. They do not move together. In particular, over the last several months the Tennessee index has been rising, indicating a tougher currency

Chart 4  
Trade-Weighted Dollar Indices, 1993-1995 (Jan. 1993=100)

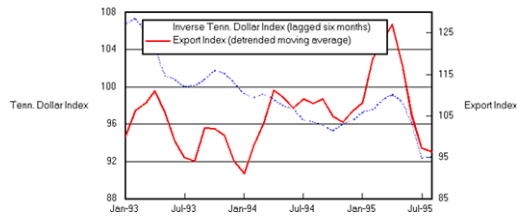


environment for Tennessee traders, while the U.S. index has been falling, indicating a more favorable dollar rate for U.S. exporters generally. It should be noted that there is another reason for this discrepancy: the U.S. index does not include developing countries except for those in East Asia. Mexico, for example, is not included. Thus, while the falling dollar has been much commented upon recently, that dollar is only falling in the industrial world, it is doing very well indeed in most emerging markets.

**The Impact of the Dollar on Tennessee Exports**

The state's exports have grown robustly over the last several years, whether the dollar has risen or fallen. But, overall, have exchange rates operated to help or hinder this trend? Many firms attempt to shield themselves from foreign exchange risks. Some find ways of maintaining flexible pricing, some engage in sophisticated financial hedging operations, and many try to do business entirely in American dollars. So we cannot conclude that the value of dollar must always affect sales. But a final graph gives some indication that the dollar has its say in the success of Tennessee exports. Chart 5 measures the impact of the dollar on the last three years of Tennessee exports. It graphs the inverse of the Tennessee trade-weighted dollar index against the Tennessee export index, after some statistical adjustment. Because we presume that currency changes will usually take some time to affect trade, the dollar index is used as a leading indicator, it is lagged six months. January's dollar index is matched against June's export index, and so on. The Chart shows a remarkable ability of the dollar index to predict future changes in Tennessee exports. Six of the seven turning points in the export index are predicted five to seven months in advance by the dollar index. The exception is a big increase in exports, mostly to Germany and the U.K., in the first part of 1994 - this the index missed entirely.

Chart 5  
Does the value of the dollar effect Tennessee exports?



In future issues, *Global Commerce* will be keeping a close watch on this graph to see if it continues to operate as an accurate leading indicator of the Tennessee trade picture. And we will follow the Tennessee trade-weighted dollar index, our single best measure of one of the most important influences on Tennessee's trade.

## Tennessee International Trade Report 3rd Quarter 1995

The state's exports continued to grow through the third quarter, but there are some silver threads among the gold. At \$2.09 billion, third quarter exports gained 3.7% from last year, but fell some \$250 million from the second quarter. Transportation equipment, resuming its place as the state's largest export sector, continued its healthy growth, but just below it, the Chemical, Industrial Machinery, and Electrical Equipment industries all posted export declines from a year ago. The forestry and livestock sectors were this quarter's biggest gainers. Canada, the European Union, and Japan continued to account for the vast majority of the state's exports. Exports to Canada soared, making up for a lackluster performance in East Asia. There were healthy gains in a number of emerging markets. Pakistan must be singled out; for the third consecutive quarter it was one of the most dynamic Tennessee export markets. Latin America was schizophrenic: Bolivia grew faster than other significant market, and Chile, El Salvador, Guatemala, Peru, and Venezuela also showed robust growth. But Colombia, Honduras, and Argentina were three of the worst performing markets for Tennessee's this past quarter.

The fourth quarter has started out strong, with October exports up 13% from a year ago.

Trade Report Figure 1

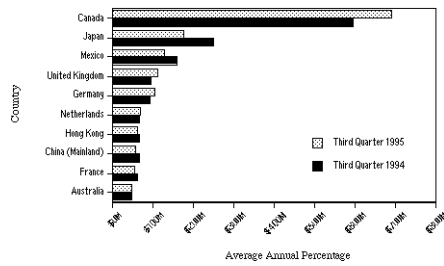
Tennessee's Largest Exports Sectors  
3rd Quarter 1995

Sector	Exports	Change from Last Year
Transportation Equipment	\$408,324,017	17.32%
Chemicals	\$372,274,271	(7.80)%
Industrial Machinery	\$250,609,365	(11.25)%
Electronics and Electrical Equipment	\$175,596,627	(17.96)%
Food and Food Products	\$123,067,607	33.01%
Instruments and Related Products	\$95,567,378	7.55%
Rubber and Misc. Plastics	\$89,529,901	11.99%

Note: Figures in parentheses are negative numbers.

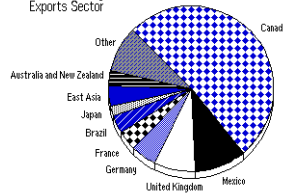
Trade Report #2

Comparing Tennessee's Trade Profile



Winter 96 trade report #3

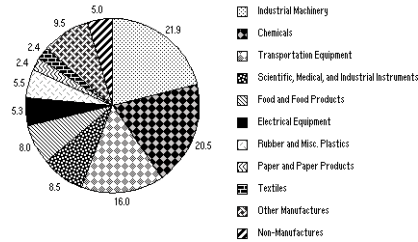
Tennessee's Transportation Manufacturing Exports Sector



Note: Transportation equipment was Tennessee's largest export sector in the 3rd quarter of 1995.

winter 96 trade report #4

Tennessee's Exports to Australia



Australia is this quarter's new entrant as one of the state's top ten export destinations. What is Australia buying from Tennessee?

Greatest Growth and Decline  
in Exports by Industry  
3rd Quarter 1995

Industry	Value of Exports	Decline%	Growth%
<i>Sectors with the Greatest Growth</i>			
Forestry	\$1,131,771		994
Livestock	\$328,566		669
Petroleum and Coal Products	\$1,589,999		129
Stone, Clay, and Glass Products	\$25,281,897		46
Food and Feed Products	\$123,087,607		33
<i>Sectors with the Greatest Decline</i>			
Oil and Gas Extraction	\$0	-100	
Coal Mining	\$229,349	-49	
Agriculture (crops)	\$87,326,941	-22	
Electronics and Electrical Equipment	\$175,596,627	-18	
Leather and Leather Goods	\$11,465,568	-13	

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Fastest Growing Export Destinations\*  
3rd Quarter 1995

Destination	Value of Exports	Greatest Decline %	Largest Growth %
<i>Countries with the Greatest Growth</i>			
Bolivia	\$2,946,655		708
Jordan	\$2,429,787		616
Pakistan	\$4,655,369		526
Nigeria	\$2,655,869		427
Kuwait	\$5,252,103		306
<i>Countries with the Greatest Decline</i>			
Ethiopia	\$91,502	-99	
Colombia	\$9,994,195	-72	
Honduras	\$1,493,150	-68	
South Africa	\$9,324,904	-41	
Argentina	\$7,702,543	-36	

\*Among countries with more than \$2M in sales, 3rd Quarter 1994

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Tennessee Monthly Exports

