

Bill Conkle's strategy combats diversion

Bill Conkle is a lawyer who has spent decades fighting to protect brands and intellectual property from diversion, infringement, counterfeiting and other attacks. As such, he has been the go-to guy for companies in the professional salon-only hair care industry for years. **Beauty Industry Report (BIR)** is delighted to have Bill share his knowledge and expertise on one of the most persistent problems affecting salon-only hair care brands and their owners, distributors and salon owners and professionals in this issue. Note: ***This article is not intended to constitute legal advice to any BIR reader.***

BIR: Can the diversion of professional beauty products really be controlled or eliminated?

Bill Conkle (BC): Manufacturers of professional beauty products want them to be sold exclusively in hair salons so that licensed stylists will recommend and promote them. Customers in a salon have access to a knowledgeable stylist who can show them how to use the product. The professional salon environment gives products an allure and elegance that you can't find in chain drugstores, grocery stores or big box stores.

Diversion is the removal of products from the salon-only marketing channel into an unintended channel. That means that you might find your beloved salon-only products carelessly thrown on a dimly lit drugstore shelf vying for space with toe fungus removers. Maybe they show up in a grocery store or on an online retailer like eBay.

Finding a salon-only product in such environments causes great harm to a brand's reputation and sales. When consumers see it on a retail shelf, they think twice about purchasing the "exclusive" product the next time they visit their salon. Stylists see it and feel their blood boil, because retail stores are taking customers away from them and raising doubts about the products their salons choose to market.

BIR: I'm fond of your saying that in this life you protect two things with equal vigor—your brand and your firstborn. Shouldn't there be a law that protects brands from diversion?

BC: In the United States, there isn't one single law that restricts a person from reselling non-pharmaceutical beauty products to anyone he wants. Suits by companies like **Sebastian** that were based on trademark and copyright laws

were defeated by the First Sale Doctrine, which says that a person who buys a product from the manufacturer or from the owner of the trademark or copyright can sell the product if it is not damaged or defaced, to whomever he pleases. This rule is intended to promote commerce. Otherwise, think of the outcry we'd hear if everyone with an eBay account was required to have a government permit to sell their used electronics or unwanted clothing.

BIR: Wouldn't that make it difficult or impossible to use the law to stop diversion?

BC: The fact that there's no single law restricting the resale of products doesn't prevent a company from using a combination of legal tools to stop diversion.

BIR: What are the secrets to your approach?

BC: While diverters might not be infringing trademarks, they usually break other laws. In the first case I filed against diverters, I focused on their frauds. A ring of diverters posed as authentic distributors and salons and deceived the manufacturer into selling product to them for what a manufacturer thought was genuine salon-only distribution. The manufacturer shipped its products overseas and the "distributors" shipped them back to the cheats in the United States, who delivered them to wholesalers in the diversion industry. The wholesalers then sold the products to chains of drug and retail stores. One of the federal crimes committed was the fabrication of customs documents to avoid paying customs duties. I used that against the ring in our suit. As you can imagine, that conduct didn't sit well with the judge.

As I learned more about diversion and what was causing it, I saw that the way to control it was to combine four elements to create a successful plan of attack, which I call the Conkle Strategy: 1. strong contracts prohibiting all but salon-only distribution, 2. item tracking, 3. anti-diversion education and policies and 4. robust legal enforcement.

BIR: The first element of the Conkle Strategy is a strong contract. Tell us about that.

BC: Any contract a manufacturer enters into with a distributor should specifically prohibit diversion and any type of conduct that is connected with diversion. Each distributor should be prohibited from selling salon-only products to

persons or businesses that are not licensed salons that have been inspected by the distributor. I believe that distributors must agree to review the orders from each salon to ensure orders are a mixture of product types and sizes consistent with purchases made by customers in a salon. A large order of only 8-oz. bottles of shampoo, for example, is a red flag.

Distributors must agree to supervise and investigate the activities of their salespersons. Salespersons hired by distributors are generally paid on commission, and thus have little economic incentive to abstain from filling orders from questionable buyers. Unless the distributor is required to compensate the manufacturer for the damages from misconduct by its salespeople, it won't have any reason to adequately investigate its employees' activities. I urge manufacturers to require that distributors' salespeople sign a contract that allows the manufacturer to sue the salespeople directly. That can help keep sales representatives honest.

The distributor should also be required to scan coded products as they arrive and depart from its warehouse. Finally, sloppy bookkeeping and recordkeeping allows a faithless distributor to conceal diversionary sales. A manufacturer should require contemporaneous record-keeping of inventories and sales and require access to the records with a few hours' notice.

BIR: You've talked about distributor contracts. Do you suggest having contracts with salons?

BC: Absolutely! I recently had a case in which a ring of distributor sales representatives and confederates set up more than 20 phony salons. The ringleader forged salon contracts with bogus names and addresses, which were at UPS Store mailboxes. The ring ensured that purchases from the salons were small enough that they didn't trigger any alarm bells. During a two-year period, the ring arranged for purchases of more than \$1 million worth of products, which were sold into diversion. Because the salon agreement that was signed for each of the "salons" allowed the manufacturer to sue them all in a single location, all the conspirators were sued in Los Angeles.

Just like distributor agreements, salon agreements must specifically prohibit diversion. Every salon that is caught diverting cries foul and claims it was a freak accident or that it only

diverted because the manufacturer forced it to buy a large amount of products. Thus, I have drafted specific language by which the salon promises that every purchase will be intended only for use in the salon or for sale in small quantities to salon customers for personal use.

It is difficult to prove the damage that salon diversion costs the manufacturer. To eliminate that problem, I include language saying that the salon agrees that the amount of damages the diversion caused will be calculated at three times the retail price of every product diverted. That eliminates the hassle and uncertainty of determining the actual damages.

BIR: How does item tracking help in the war against diversion?

BC: When you see your product on a drugstore shelf, how do you know how it got there? If you have a unique code on every product and you track the codes from the manufacturing plant to the distributor to the salon, you'll know where the products left your distribution network. If a product is tracked to a distributor and there is no record that the distributor sold the product, it was likely diverted by the distributor. While a small number of products could be miscoded, when you find dozens of products from the same distributor or salon, the evidence is irrefutable.

BIR: Wouldn't distributors be concerned that a tracking system would allow the manufacturer to replace them because of its ability to locate and identify customers?

BC: That is no easy task. There's no guarantee of success and the manufacturer would be taking a substantial risk of alienating other distributors.

BIR: What happens when the code is removed?

BC: There are federal and state laws that regulate the decoding of products. Under U.S. federal law, decoding is trademark infringement, and you can sue on that basis. In California, decoding and even the mere possession of decoded products is a crime. As I mentioned before, you can sue in a civil case for criminal activity. Decoding is criminal, which is helpful.

BIR: Tell us about anti-diversion policies.

BC: It's important to have an anti-diversion mindset within your company. Employee education is a fundamental aspect of creating an anti-diversion mindset. Explain diversion to your employees and make sure they are aware that your product belongs only in authorized salons. If

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you asked one of your employees today what she would do if she came across one of your products at her neighborhood grocery store, what would her answer be?

I emphasize drafting and distributing to everyone the company's anti-diversion policy. This policy should address whether photos of the product, the shelf and the storefront should be taken; whether the employee should scan any product codes; whether she should purchase a product and if so, how many; where she should mail a physical product; and to whom at the company she should send this information.

BIR: I'm interested to hear what you have to say about the fourth element of the Conkle Strategy: robust legal enforcement.

BC: Legal enforcement and the threat of legal enforcement make people obey laws, regulations and rules. If you aren't willing to take legal action

when you find diverted products, any time and money you put into your contracts, item tracking or employee education is wasted. I believe that diversion is a commercial crime or wrong committed to make money. If a diverter learns that you won't enforce your rights, the diverter will continue to cheat you.

I have filed lots of enforcement suits against distributors, distributor sales reps, salons, individual stylists, diversion wholesalers and retailers. Some of the suits are a slam dunk. It isn't too difficult to win a case when a “salon” has an address of a UPS Store mailbox or when its retail sales and inventory are insignificant, yet it is purchasing giant amounts on a monthly basis. Some suits are more difficult. There might be complex issues such as determining how the products got to a retailer. Of course, those defenses are undercut when the product codes reveal the guilty party.

BIR: What would you say in conclusion?

BC: Diversion CAN be stopped. Strong contracts give distributors and salons the incentive not to cheat you. The specific-item coding allows you to determine where the products were removed from the salon-only channel. Ensuring that your employees are aware of diversion and how to properly react when they see it is invaluable. Lastly, taking legal action to show that you will not tolerate diversion or other misconduct is a powerful deterrent.

Mike, years ago you recommended to one of your clients when he had only three employees that he retain me to design an anti-diversion strategy. He retained me, I designed the strategy and he followed it. It is a strong testament to the effectiveness of the Conkle Strategy that you never see any of that company's products in CVS, Rite Aid, Target or Costco.

There is a physical and legal means for any manufacturer that is committed to protect its brand. If you are willing to make the effort to stop diversion, you can protect your brand, your reputation and your profit margins. It's up to you.

Bill Conkle is an attorney at **Conkle & Olesten** in Los Angeles. To learn how you can fight diversion, reach him at 310-820-3700 or bill@conkle.us. Bill is no longer practicing with Conkle, Kremer & Engel, the firm he founded in 1982.



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