

# **DIVERSION**

By Donald E. deKieffer  
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## INDEX

I. Diversion: the Law and the Remedies	5
A. Criminal Law	5
1. National Stolen Property Act	6
a. Diversion Is a Violation of the National Stolen Property Act	7
b. Title Is Not a Defense to a Violation of the National Stolen Property Act	11
2. Mail and Wire Fraud	12
3. False and Fraudulent Statements to the U.S.	12
a. False Statements Regarding Exportation of U.S. Products	13
b. False Statements Regarding Reimportation of U.S. Products	13
4. Trademark Counterfeiting	14
5. Criminal RICO	15
6. False Bills of Lading	16
B. Customs Violation and Seizure	18
1. Customs Violations on the Entry Documents	18
a. False Statements of Ownership	19
b. Incorrect Statements of Valuation	20
c. Entry as U.S. Goods Returned	21
d. Misdescription of Goods	23
2. Seizure by the U.S. Customs Service	24
a. Permissive Seizure under 19 § 1592	24
b. Required Seizure under 19 § 1595a	24
3. Type of Entry	25
C. Civil Remedies	26
1. Copyright Act Violations	26
2. Temporary Restraining Orders/ Injunctive Relief	31
a. Establishing Possible Irreparable Harm	32
b. Diverter's Engagement in Wrongful Conduct in Contravention of U.S. Producer's Rights	33
c. The Balance of Hardship Weighs in Favor of U.S. Producer	34
3. Replevin/ Recovery	34
4. Statutory and Common Law Fraud	35
5. Admiralty	37
6. Civil RICO	40
7. Breach of Contract	42

D. Who Has Title?	43
1. Title to Diverted Merchandise Never Vests in the Putative Buyer or U.S. Importer	43
2. Any Title Claimed by the Foreign Exporter or U.S. Importer Is Voidable Title	44
3. U.S. Producer Retains Title Pursuant to the Language of the Commercial Invoice	45
II. Diversion: Stop it Before it Stops You	46
A. Prevention	46
1. Title Retention Clauses	46
2. Reclaiming Title	47
3. "Poison Labels"	50
4. Offshore Pricing	51
5. Salting	51
6. Altering UPCs	51
7. Intellectual Property Registration	52
8. Shipping	52
9. Buyer Scrutiny	53
B. Control	54
III. Conclusion	55

## DIVERSION

By Donald E. deKieffer\*

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Diversion. Has a nice ring to it, doesn't it? Video arcades are a "diversion". So are People magazine and the Chicago Cubs. In international trade, however, diversion is more ominous. The international diversion of American-made products costs U.S. firms billions of dollars per year. This is not gray market. This is theft. Here is how it works.

Imagine the following scenario:

APEX Adapters ("APEX"), a major American corporation, manufactures electrical appliances which are used around the world. In the United States, and in selected European markets, it sells these products at \$10 each.<sup>1</sup> This price (\$10) includes overhead costs for APEX's distribution networks in the various countries where it maintains warehouses, warranty services, etc., as well as advertising and promotional costs. In other countries, however, (particularly Third-World countries where it does not ordinarily sell its products) APEX will sell the same item for a lower price which is "stripped" of these distribution, advertising, and promotional costs. Sometimes, these ancillary costs amount to as much as 50% of the sales price in the U.S. and selected European markets.

On March 1, APEX receives an order from GONZO Trading Company (PTY) Ltd. ("GONZO"), a Lesotho corporation for \$500,000 worth of APEX's Superfratostat Model No. 6. GONZO states in its letter, and subsequent telephonic contacts with APEX, that the order is for product to be distributed in Mozambique.

APEX responds that it is willing to sell 75,000 superfratostats to GONZO at the price offered (i.e., \$6.66 each -- \$3.34 less than the U.S. wholesale price) with the specific understanding that the goods are to be sold in Mozambique and nowhere else. Further, APEX tells GONZO that it always includes a "title retention clause" on all of its shipping documents specifying that it (APEX) does not lose title until the goods physically arrive at the ultimate destination (i.e., Mozambique). GONZO responds affirmatively. APEX then specifies that terms are either cash or irrevocable letter of credit. Again, GONZO agrees. A confirming letter of credit is opened through a Swiss bank to the credit of APEX's account in an American bank. APEX produces the goods, packages them and delivers

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<sup>1</sup> All of APEX's products have valid, registered trademarks and all labels and instructions have registered copyrights.

them to the port of exportation.<sup>2</sup> It presents the appropriate shipping documents to the correspondent bank in the United States and the letter of credit is paid down. In other words, APEX has received payment for the goods nominally destined for Mozambique.

Because there are not many direct shipping routes to Mozambique, GONZO, the putative buyer, has requested that the goods be sent first to an entrepôt trade port, Rotterdam.<sup>3</sup> The goods are duly sent via ocean freight to Rotterdam and APEX forgets about the sale. Once the ship has sailed, however, APEX's problems have just begun. Upon arriving in Rotterdam, the containers carrying the goods are off-loaded from the ship, and transported to a warehouse where they are stripped, and the products restuffed in new containers; the original containers being returned to the ocean carrier. The new containers, rather than being shipped to Mozambique, are put on the next available ship to the United States. Upon arrival in the U.S. port, the goods are declared as "U.S. Goods Returned"<sup>4</sup> through U.S. Customs, thereby avoiding any U.S. duty.<sup>5</sup>

Upon Customs' clearance, the goods are stripped from their containers and immediately shipped to U.S. stores for resale. The U.S. importer (which we will call DIVCO) is often directly linked to the seller (GONZO). This relationship, however, is camouflaged. APEX has no idea of the identity of the ultimate consignee (i.e., the U.S. importer, DIVCO). To perpetuate this scheme, the diverters go to elaborate lengths to disguise the nature of the transaction. Often, the nominal "foreign" purchaser (GONZO) is nothing more than an answering service. The company may not even be registered and exists only on a letterhead. The money for the initial transaction sometimes originates in the United States, but in many instances it originates in countries such as Panama, Hong Kong, Colombia, etc., and is then routed through banks in Panama, Cayman Islands and Switzerland.

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<sup>2</sup> In this instance, because APEX has retained control of the goods until they are delivered to the port of exportation, APEX is acting as the "shipper." That is, APEX is responsible for making all arrangements for transportation of the products from its warehouses to the port.

<sup>3</sup> Other entrepôt trade ports commonly used in diversion include Antwerp, Hong Kong, Alexandria, Egypt and Naples, Italy.

<sup>4</sup> Products which are exported from, but then returned to, the United States, are classified as "U.S. Goods Returned" if the products have not been advanced in value or improved in condition by any processing. See Harmonized Tariff Schedule of the United States (1995) -- § 9801.00.10, 19 U.S.C. §1202 (hereinafter HTSUS). See also 19 C.F.R. §10.103.

<sup>5</sup> Every article which is imported into the United States is subject to a rate of duty found in the Harmonized Tariff Schedule of the United States. However, articles which are classified as "U.S. Goods Returned" are entitled to a "Free" rate which means that no duty is paid on these products. HTSUS § 9801.00.10. See also, HTSUS General Notes 1, 3; 19 C.F.R. § 10.103.

If the U.S. importer (DIVCO) is asked about the source of its funds by government investigators, it can respond that it earned the cash by selling imported merchandise and has the documents to prove it. In some cases, there is a profit to be made in the diversion scheme. In others, the diversion of legitimate goods is a mere smokescreen for money laundering.

This scheme wreaks havoc on the U.S. distribution plans of APEX.

- M Domestic distributors lose commissions due to loss of sales to diverted goods;
- M Direct advertising does not benefit legitimate sales but rather benefits the sellers of diverted goods;
- M Retail stores which enter into cooperative advertising programs with APEX are undercut by re-sellers of diverted goods, thus making all of the advertising worthless, inuring to the benefit of diverters rather than those participating in the joint advertising;
- M APEX's Intellectual Property rights are seriously compromised;<sup>6</sup> and
- M There is, shall we say, a certain amount of tension generated between APEX's domestic sales division and its international operations. International sales have (nominally) increased by 20% while domestic sales of the same products have declined correspondingly. The domestic sales division is not amused.

In addition, diversion of legitimate goods causes significant public policy problems:

- M U.S. export statistics are grossly skewed, inflating the apparent exports, particularly since imports of U.S. goods returned are not reflected in U.S. Customs statistics.<sup>7</sup> Thus, the entire U.S. balance of

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<sup>6</sup> See infra section I.C.1.

<sup>7</sup> The U.S. Customs Service, through the Bureau of Census, maintains official U.S. import and export statistics which reflect both government and nongovernment shipments of merchandise between the U.S. and foreign countries. These statistics are maintained on the basis of product HTSUS categories. If a product is exported from the United States, the export statistics show the quantity and value of such shipment. However, if the same product reenters the United States as a "U.S. Good Returned" the export statistics are not adjusted to reflect reentry. This completely distorts the balance of trade.

For example, assume that during the month of February the U.S. exported 75,000 fratostats with a value of \$3,000,000. In May, 25,000 diverted fratostats with a value of \$1,000,000 were imported into the U.S. However, these fratostats are entered as U.S. Goods

trade is deformed by this scheme;

- ! False export documents are used by the manufacturer to obtain money and commodities through U.S. government programs designed to encourage exports through monetary incentives<sup>8</sup>; and
- M The perpetrators of these frauds generally get away scot-free. Although there have been a number of cases where diverters have been apprehended and faced criminal charges<sup>9</sup> and civil penalties<sup>10</sup>,

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Returned. Therefore, while the actual figure for exports of fratostats should be \$2,000,000, the statistics continue to show that exports totaled \$3,000,000.

During the first six months of 1995, U.S. goods returned in HTS category 9801.00.1098 totaled over \$3,300,000,000. This is an average of over \$550,000,000 in U.S. Goods Returned per month. The export statistics are not adjusted to reflect the reimportation of these products. Accordingly, our export statistics do not reflect the true value of U.S. exports, and our export statistics are grossly skewed. U.S. Bureau of Census, General Imports, Report IM145.

<sup>8</sup> U.S. manufacturers can obtain cash rebates, called "drawback", from the U.S. Customs Service for import duties paid on raw materials that are used to make finished goods for export. *See* 19 C.F.R. Part 191. Where the finished goods are never actually exported or are returned to the U.S. the manufacturer is not entitled to the drawback.

This situation has occurred in at least one case, United States v. LaSala, Crim. No. 94-185 (D. N.J. April 12, 1994). In that case, the manufacturer imported petroleum-based resins to make household plastic bags, on which it paid import duties at the time of entry into the U.S. The company used false bills of lading, obtained from the purchaser who was supposed to export the products, to obtain a refund of duties previously paid to import the resins. Two of the 39 diversion schemes LaSala pled guilty to cost taxpayers close to \$1,000,000 in unjustified export incentives (over \$200,000 in drawback and over \$660,000 in USDA credits).

<sup>9</sup> *See e.g., U.S. v. Costanzo*, 4 F.3d 658 (8th Cir. 1993) (conviction of defendants who defrauded drug manufacturers in diversion scheme affirmed under mail fraud, wire fraud, and interstate transportation of stolen goods); U.S. v. Schardar, 850 F.2d 1457 (11th Cir. 1988) (conviction of defendant in diversion scheme upheld under wire fraud, making false bills of lading and interstate transportation of stolen goods); U.S. v. Weinstein, 762 F.2d 1522 (11th Cir. 1985) (conviction of defendants in pharmaceutical diversion scheme upheld under RICO and mail fraud); U.S. v. Lasala, No. 94-185 (D. N.J. filed April 12, 1994) (defendant pleaded guilty to charges of wire fraud, entry of goods by means of false statements and causing false record keeping by pharmaceutical company in connection with a product diversion scheme); U.S. v.

it remains a relatively "risk-free" method of money laundering.

## I. DIVERSION: THE LAW AND THE REMEDIES

Although the sophisticated diversion scheme discussed supra is a relatively new phenomenon, the concept of diversion is not. It has been addressed in Common Law and U.S. statutes for many years, generally under the rubric of fraud. However, this new sophisticated trend in diversion schemes presents an array of potential remedies beyond just fraud. This section of the article outlines the several remedies a particular prosecutor or practitioner could pursue in a certain situation. Nevertheless, which remedy is best suited for a certain situation is fact driven and will vary with different scenarios. The best remedy against diversion in one situation may not be the best in another. Attorneys utilizing any of the remedies discussed infra should constantly be aware of the possibility of using a combination of remedies particularly in criminal prosecutions.

Returning to our scenario, after APEX has discovered the diversion, it has a number of options under current U.S. law.

### A. CRIMINAL LAW

Under the scenario described, by far the clearest violations of law stem from the criminal nature of the acts committed. Criminal violations have occurred under the National

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Kotbey, No. 95-374 (D. N.J. filed July, 1995) (defendants pleaded guilty to charges of wire fraud, mail fraud, interstate transportation of goods obtained by fraud, and false statements in connection with a scheme to divert pharmaceutical products).

<sup>10</sup> See e.g., Ameritrade Corp. v. Carnes, 831 F.2d 260 (Fed. Cir. 1987) (revoking bonded warehouse license where warehouse was aware of diversion and acted "with reckless disregard" of the Customs regulations); Schreiber Distrib. Co. v. Serv-Well Furniture Co., 806 F.2d 1393 (9th Cir. 1986) (holding that district court erred in dismissing plaintiff's claims under RICO in diversion action; case remanded); Dial Corp. v. Manghnani Inv. Corp., 659 F. Supp. 1230 (D. Conn. 1987) (granting summary judgment in favor of Dial where products were diverted to the U.S. from an authorized foreign licensee); Ortho Pharmaceutical Corp. v. Sona Distrib., Inc., 663 F. Supp. 64 (S.D. Fla. 1987) (holding that defendant companies committed fraudulent misrepresentation in diversion of pharmaceuticals destined for China; defendants ordered to pay compensatory and punitive damages of \$975,257.31); Shulton Inc. v. Optel Corp., 1986 WL 15617 (D.N.J. 1986) (civil RICO action).

Stolen Property Act<sup>11</sup> (interstate transportation of stolen goods), mail and wire fraud,<sup>12</sup> false and fraudulent statements to officers of the U.S. government<sup>13</sup>, and if the acts represent a pattern of conduct, violations of the criminal portions of the Racketeer Influence and Corrupt Organizations Act ("RICO").<sup>14</sup> In addition, where several entities are involved together, such as GONZO and DIVCO, there may be a punishable criminal conspiracy to commit one of these offenses against the United States.<sup>15</sup> All of the elements of these crimes have been described in the scenario and have been prosecuted by various law enforcement agencies including the Federal Bureau of Investigation, U.S. Customs Service and U.S. Attorney Offices. The paucity of criminal prosecutions in diversion matters is more a reflection of the unwillingness of U.S. attorneys to criminally prosecute diversion cases since such cases often lack the "jury appeal" of other types of proceedings such as drug dealing, murder, extortion, etc. Nevertheless, the fact that so few cases are prosecuted does not in any way reflect upon the criminal character of the acts themselves or their cognizability under the criminal statutes noted infra.<sup>16</sup>

## **1. National Stolen Property Act**

The receipt of diverted products may constitute violations under the National Stolen Property Act ("NSPA").<sup>17</sup> Section 2314 of the NSPA provides that it is illegal for anyone to "transport in interstate or foreign commerce any goods ... knowing the same to have been stolen, converted or taken by fraud."<sup>18</sup>

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<sup>11</sup> See 18 U.S.C. §§ 2314, 2315. See also U.S. v. Costanzo, 4 F.3d 658 (8th Cir. 1993); U.S. v. Schardar, 850 F.2d 1457 (11th Cir. 1988); U.S. v. Lasala, No. 94-185 (D. N.J. filed April 12, 1994); U.S. v. Kotbey, No. 95-374 (D. N.J. filed July, 1995).

<sup>12</sup> See 18 U.S.C. §§ 1341, 1343. See also Costanzo, 4 F.3d 658; Schardar, 850 F.2d 1457; U.S. v. Weinstein, 762 F.2d 1522 (11th Cir. 1985); U.S. v. Lasala, No. 94-185 (D. N.J. filed April 12, 1994); U.S. v. Kotbey, No. 95-374 (D. N.J. filed July, 1995).

<sup>13</sup> See 18 U.S.C. § 1001.

<sup>14</sup> See 18 U.S.C. §§ 1961-1968. See also Weinstein, 762 F.2d 1522.

<sup>15</sup> See 18 U.S.C. § 371.

<sup>16</sup> See infra notes 18, 36, 40, 51 and 52 and accompanying text.

<sup>17</sup> See 18 U.S.C. §§ 2314, 2315. See also Costanzo, 4 F.3d 658; Schardar, 850 F.2d 1457; Lasala, No. 94-185 (D. N.J.); Kotbey, 95-374 (D. N.J.).

<sup>18</sup> 18 U.S.C. § 2314.

Section 2315 provides that it is illegal for anyone to receive, sell, or dispose of any goods with a value of over \$5,000 if such goods have moved in interstate or foreign commerce if such person knows the goods have been stolen, unlawfully converted, or taken.<sup>19</sup> Although not specifically enumerated, the prohibitions contained in §2315 apply to goods acquired by fraud.<sup>20</sup>

*a. Diversion is a Violation of the National Stolen Property Act*

Although the term "stolen" is not defined in the National Stolen Property Act, the courts have adopted a broad definition encompassing "all felonious takings ... with intent to deprive the owner of the rights and benefits of ownership, regardless of whether or not the theft constitutes common-law larceny."<sup>21</sup> In the context of interpreting the NSPA, the United States Court of Appeals for the Fifth Circuit has stated that the term "stolen" is "... 'a word of general and broad connotation, intended to cover and covering any criminal appropriation of another's property to the use of the taker, particularly including theft by swindling, false pretenses, and any other form of guile.'"<sup>22</sup> The Fifth Circuit found the use of the terms "stolen," "converted" and "taken by fraud" in the Stolen Property Act to be instructive *ve.* The Court stated:

The aim of the statute is, of course, to prohibit the use of interstate transportation facilities for goods having certain unlawful qualities. This reflects a congressional purpose to reach all ways by which an owner is wrongfully deprived of the use or benefits of the use of his property. It was one way to meet the difficulties in legislative draftsmanship. The experience with this Act, the Dyer Act and others bears witness that "what concerned codifiers of the larceny-type offenses is that gaps or crevices have separated particular crimes of this general class and guilty men have escaped through the breaches." Morissette v. United States, 1952, 342 U.S. 246 at page 271, 72 S.Ct. 240, at page 254, 96 L.Ed. 288, at pages 304-05. Congress by the use of broad terms was trying to make clear that if a person was deprived of his property by unlawful means amounting to a forcible taking or a taking without his permission, by false pretense, by fraud, swindling, or by a conversion by one rightfully in possession, the

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<sup>19</sup> 18 U.S.C. § 2315.

<sup>20</sup> U.S. v. McClintic, 570 F.2d 685 (8th Cir. 1978).

<sup>21</sup> U.S. v. Turley, 352 U.S. 407, 417 (1957).

<sup>22</sup> Lyda v. United States, 279 F.2d 461, 464 (5th Cir. 1960) (quoting Edwards v. Bromberg, 232 F.2d 107, 110 (5th Cir. 1956)).

subsequent transportation of such goods in interstate commerce was prohibited as a crime. Since the aim of Congress was to reach all such deprivations, it would distort that purpose if by a sort of reverse process the transaction under review had to consider whether the property was stolen or converted or taken by fraud.<sup>23</sup>

The Fifth Circuit held that the appropriation of goods by one having initial lawful custody constituted embezzlement and that the term "stolen" was broad enough to encompass embezzlement.

The District Court for the Eastern District of New York summarized the state of the law respecting stolen merchandise by asserting:

In sum, the courts seem uniformly to have adopted the view that "the issue as to whether the goods were obtained by one of the unlawful methods of acquisition referred to in the statute is not to be decided upon the basis of technical common law definitions," Bergman v. United States, 253 F.2d 933, 935 (6th Cir. 1958), but rather on a broad common sense basis encompassing all forms of wrongfully depriving an owner of the possession or use of his property.<sup>24</sup>

Applying this broad definition of what constitutes stolen property, the courts have held that fraudulently inducing a company to agree to sell its merchandise at prices that are substantially lower than the price that would otherwise be available to the putative purchaser constitutes theft. In a recent decision, the Court of Appeals for the Eighth Circuit sustained the convictions of institutional pharmacy owners who defrauded drug manufacturers using a scheme similar to the one being perpetrated against APEX.<sup>25</sup>

The defendants in Costanzo owned and controlled a number of institutional pharmacies. In order to purchase drugs at discounted institutional prices, the pharmacies were required to sign "own-use" clauses, which were similar to the "anti-diversion" language of the APEX invoices. The own-use clauses provided that drugs purchased at institutional prices could be dispensed only to patients in institutional settings. The evidence showed that the defendants were aware of these clauses.

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<sup>23</sup> Id. at 464.

<sup>24</sup> United States v. Sam Goody, Inc., 506 F. Supp 380, 390 (E.D.N.Y. 1981). See also Leslie Shaw v. Rolex Watch, U.S.A., 726 F. Supp. 969 (S.D.N.Y. 1989) (quoting Hammerschmidt v. U.S., 265 U.S. 182, 188 (1924) (stating to defraud commonly refers to "wronging one of his property rights by dishonest methods or schemes."))

<sup>25</sup> See U.S. v. Costanzo, 4 F.3d 658 (8th Cir. 1993).

Nevertheless, the defendants resold many of the "institutional" pharmaceuticals to non-institutional pharmaceutical wholesalers. They also made extensive efforts to conceal the diversion operation from the manufacturers. Knowledge of the clauses, coupled with additional evidence of intent to defraud, was sufficient to convict the defendants of mail fraud, wire fraud, and interstate transportation of stolen goods.

Just as the institutional pharmacies were privy to deeply discounted drug prices, buyers of APEX products for export are privy to a deeply discounted export pricing structure. The drug manufacturers in Costanzo were defrauded when the defendants induced the sales at institutional prices under the pretense that the pharmacies would comply with the "own-use" clause. The diverters have defrauded APEX by misrepresenting the ultimate destination of the goods they purchased, thereby fraudulently inducing APEX to sell the goods at low, export prices. By diverting the goods back to the United States, the diverters have in fact engaged in theft by deception. This amounts to fraud and is a violation of 18 U.S.C.A. §2314.

In U.S. v. Schardar, the defendant engaged in a number of fraudulent diversion activities which resulted in his conviction based upon violations of the NSPA, mail and wire fraud, and making and uttering false bills of lading.<sup>26</sup> The defendant, a commodities broker and exporter, would arrange to export a commodity (tires, apples, eggs, and carpets) to an overseas purchaser. After the arrangements were finalized, the defendant would present false invoices and bills of lading to the bank so that he could receive payment under a letter of credit for goods. However, such goods were never shipped overseas, but diverted to the U.S. market. Bank and export documents were fraudulent, mentioning non-existent ships, shipping companies, freight forwarders, suppliers, and individual addresses.

In the Constanzo and Schardar cases, the courts did not address whether title to the goods had passed to defendants. Passage of title under the terms of the Uniform Commercial Code is not an element of wire fraud, mail fraud, or interstate transportation of stolen goods. The critical issue is whether or not the seller has been defrauded in the formation of the contract. The terms and conditions of sale included on the face of the APEX invoices indicate a form, method, and time of payment. The diverters defrauded APEX by consciously evading these terms and by making false statements to both the Customs Service and APEX. This fraud renders the goods subject to the "stolen property" provisions of 18 U.S.C.A. §2314.

In the New Jersey Federal District Court, the court declined to dismiss allegations in a civil RICO action that the defendants violated the National Stolen Property Act by dealing in fraudulently obtained merchandise.<sup>27</sup> In Shulton, the plaintiff alleged, among other things, that it had been

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<sup>26</sup> Schardar, 850 F.2d 1457.

<sup>27</sup> Shulton Inc. v. Optel Corp., 1986 WL 15617, RICO Bus. Disp. Guide 6518 (D. N.J. 1986).

fraudulently induced to export its products at low prices for sale in overseas markets when, in fact, the defendants sold the merchandise in the United States. The court stated that given the alleged knowing involvement of the domestic distributor defendants and their principals in the fraudulent scheme, these allegations, if proved, would establish their liability for the criminal violations allegedly committed, i.e., trafficking in stolen goods.

In diversion cases, the manufacturer is wrongfully deprived of the possession and use of its property by the fraudulent misrepresentation of the destination of merchandise. With respect to the issue of whether fraudulently obtained merchandise is "stolen," the facts in an international diversion matter are not materially different from Costanzo, Schardar and Shulton.

If an owner has been wrongfully deprived of the use or benefit of its merchandise, that merchandise has been stolen. Certainly, the victims of diversion have been fraudulently deprived of the possession and use of the merchandise which has been diverted from its intended destination. They have also been fraudulently deprived of the opportunity and benefit of selling the diverted merchandise in the true destination country. A violation of either §2314 or §2315 brings with it substantial fines, up to ten years in jail, or both.<sup>28</sup>

It is worth noting that any effort to conceal a diversion scheme is evidence of the perpetrators' intent to defraud.<sup>29</sup> Fraudulent intent is evidenced by the fact that from the initial point of contact with APEX, GONZO, or its agents, made false statements (through the mails and wires) the goods would be shipped for onward distribution in a foreign country.

Further, the buyers induced APEX to make false statements on the international commercial invoice and Shipper's Export Declaration ("SED") which explicitly stated that such products were ultimately destined for a foreign country. The fraudulent inducement to APEX to prepare these documents was merely part of a comprehensive scheme to conceal the purchasers' plan to resell the products in the United States. Products sold under such a scheme are considered "stolen."<sup>30</sup>

Finally, intent to defraud may also be evidenced in an examination of entry documents filed with the Customs Service. Any false statements or omissions on Customs entry documents

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<sup>28</sup> See 18 U.S.C. §2314; 18 U.S.C. §2315.

<sup>29</sup> See Costanzo, 4 F.3d at 665; Lasala, No. 94-185 (D. N.J.); Kotbey, No. 95-374 (D. N.J.).

<sup>30</sup> See supra text accompanying notes 23, 24. See also Gay v. U.S., 408 F.2d 923, 926-27 (8th Cir. 1969) (ruling that where invoice and bill of lading were prepared as subterfuge to evade Interstate Commerce Commission regulations to conceal true ownership of cargo, and cargo was never delivered to beneficial owner, cargo was "stolen" within statute prohibiting interstate transportation of stolen property).

associated with diverted shipments would be material. Such false statements could conceal the possible entry of stolen property and the importer's knowledge of the diversion scheme. In addition, such false statements would tend to conceal from Customs facts relevant to the importer's right to enter the merchandise and inhibit Customs' ability to enforce other laws including copyright and trademark statutes. As a result, such false statements and omissions may give rise to liability for civil penalties under 19 U.S.C. § 1592.<sup>31</sup>

***b. Title is Not a Defense to a Violation of the National Stolen Property Act***

Neither GONZO nor DIVCO can claim title to the APEX products as a defense to a violation of either §2314 or §2315 if title and possession were secured as a result of fraud.<sup>32</sup> A violation of the National Stolen Property Act has occurred because APEX products have been transported and received in interstate and foreign commerce by means of theft and fraud.<sup>33</sup>

Further, the possibility that the defrauding party may still comply with its original obligations is no defense when the contract was fraudulent from the beginning.<sup>34</sup> Therefore, the fact that the putative buyer (GONZO), or its agents, could ultimately deliver the products to the foreign country specified on the invoice (Mozambique), is of no avail as the contract was fraudulent from the beginning.

Accordingly, assuming that the foreign exporter or American importer may establish evidence of title, such as possession and receipt of payment, this would not preclude the Customs Service from seizing the products<sup>35</sup> because putative title is not a defense to goods obtained in violation of the NSPA.

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<sup>31</sup> See *infra* notes 68-96 and accompanying text.

<sup>32</sup> *U.S. v. Mucci*, 630 F.2d 737, 741 (10th Cir. 1980); *Gay v. U.S.*, 408 F.2d 923, 927 (8th Cir. 1969);

<sup>33</sup> See 18 U.S.C. §§ 2314, 2315.

<sup>34</sup> *Mucci*, 630 F.2d at 741.

<sup>35</sup> See discussion *infra* part I.B.2.b.

## 2. Mail and Wire Fraud

The diversion scheme described herein is a criminal violation of the mail and wire fraud statutes.<sup>36</sup> Under these statutes, the use of the mails or wires in interstate or foreign commerce, to carry out any scheme to defraud is a criminal violation of U.S. law.<sup>37</sup>

These statutes are extremely broad. All that must be shown to establish a violation of either the mail or wire fraud statutes is that the diverters knowingly engaged in a scheme to defraud and that they used the mails or wires to further the scheme.<sup>38</sup> As discussed, supra, GONZO was engaged in a scheme to defraud APEX. This scheme was effected through GONZO's representations to APEX that the products purchased would be sold or distributed in Mozambique.

This diversion scheme was carried out through the use of the mails and wires. The participants in the scheme, fraudulently confirmed through written correspondence and telephonic conversations that products purchased from APEX would be distributed in Mozambique. GONZO, however, never intended for the products to be sold or distributed in Mozambique. Rather, after fraudulently obtaining control over the products, GONZO round-tripped the products back to the United States. A charge of mail or wire fraud is punishable by up to 5 years imprisonment, fines, or both.<sup>39</sup> Because the mail and wire fraud statutes are so broad they are often useful as a type of “catch-all” remedy when other sources of proof may be scarce. Mail and wire fraud occur frequently in diversion schemes and therefore are ideal for attaching to other charges to increase the likelihood of conviction.

## 3. False and Fraudulent Statements to the United States

Section 1001 of Title 18 of the U.S. Code proscribes making false and fraudulent statements to any U.S. department or agency.<sup>40</sup> Anyone violating this section shall be fined not more than

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<sup>36</sup> See 18 U.S.C. §§ 1341, 1343. See also U.S. v. Costanzo, 4 F.3d 658 (8th Cir.); U.S. v. Schardar, 850 F.2d 1457 (11th Cir. 1988); U.S. v. Weinstein, 762 F.2d 1522 (11th Cir. 1985); U.S. v. Lasala, No. 94-185 (D. N.J. filed April 12, 1994); U.S. v. Kotbey, No. 95-374 (D. N.J. filed July, 1995).

<sup>37</sup> See 18 U.S.C. §§ 1341, 1343.

<sup>38</sup> See, e.g., Schardar, 850 F.2d at 1461; U.S. v. William Savran & Assoc., Inc., 755 F. Supp. 1165 (E.D.N.Y. 1991).

<sup>39</sup> See 18 U.S.C. §§ 1341, 1343.

<sup>40</sup> See 18 U.S.C. § 1001.

\$10,000 or imprisoned not more than five years, or both.<sup>41</sup>

***a. False Statements Regarding Exportation of U. S. Products***

To establish a violation of §1001, the defendant must knowingly and willfully make a statement in relation to a matter within the jurisdiction of a department or agency of the United States with the knowledge that it was false, fictitious or fraudulent.<sup>42</sup> The false statement need not be made directly to the government; it is enough that the statement is made with the knowledge that it will be utilized in a matter within the jurisdiction of a U.S. agency.<sup>43</sup>

A deliberate misrepresentation to an exporter as to the destination of exported merchandise is a false statement that was intended to be utilized in a matter within the jurisdiction of the Customs Service, i.e., the exportation of merchandise. Accordingly, because the foreign consignor (GONZO) fraudulently induced APEX to make false statements on its Shipper's Export Declaration, GONZO has violated 18 U.S.C. §1001.<sup>44</sup>

***b. False Statements Regarding Reimportation of U. S. Products***

To perpetuate this fraudulent scheme, the U.S. importer, as a matter of necessity, will make false and fraudulent statements directly to the U.S. Customs Service. The U.S. importer, in filing of the entry documents, will claim title to the products as purchasers. However, the importer cannot claim title for several reasons: (1) the goods constitute stolen property under the National Stolen Property Act;<sup>45</sup> (2) title is voidable because the products were obtained by fraud;<sup>46</sup> and (3) title never

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<sup>41</sup> Id.

<sup>42</sup> U.S. v. Sprecher, 783 F. Supp. 133, 157 (S.D.N.Y. 1992).

<sup>43</sup> Id.

<sup>44</sup> Before APEX may ship any products from the United States, it is required to file an SED. 15 C.F.R. § 786.1. The SED contains information on the exported shipment, including the "Country of Ultimate Destination." APEX has indicated Mozambique as the country of ultimate destination. However, as GONZO never intended to ship the products to Mozambique, it not only fraudulently induced APEX to make the sale, but also fraudulently induced APEX to make a false statement on the SED regarding the country of ultimate destination.

<sup>45</sup> See supra notes 21-35 and accompanying text.

<sup>46</sup> A U.S. importer may have valid title only if it is a "good faith" purchaser of the diverted products. See infra notes 170-173 and accompanying text.

passed to the foreign consignor pursuant to the language on the invoice.<sup>47</sup> Further, the U.S. importers may be misstating the value of the imported merchandise.<sup>48</sup> Accordingly, any statements or representations made by the U.S. importers violate 18 U.S.C. §1001 because such statements are false and fraudulent.

As a prosecution tool, violation of §1001 is frequently used successfully because of its long reach and its ability to intimidate potential offenders into telling the truth in federal investigations.<sup>49</sup> To prove a violation of §1001 is very straightforward and factually simple and is common in diversion schemes as discussed supra. As such, it should be an attractive offense for prosecutors to add to any charges they have against a diverter or as a tool to encourage a heftier plea bargain.

#### **4. Trademark Counterfeiting**

If the perpetrators of the diversion scheme altered the packaging of the goods in question, it could give rise to criminal prosecution under the Trademark Counterfeiting Act of 1984 as amended. (18 U.S.C. 2320) Repackaging is a rather common practice. Often, U.S. manufacturers will put exported goods into Distinctive packaging for export sale. Sometimes, this is done to assure that the labels comply with local laws (e.g. weight, ingredients, language requirements etc;) and sometime it is merely for marketing purposes.

In these cases, diverters often remove, replace or "oversticker" export labeling with U.S.-style labels (e.g. inclusion of Universal Product Codes ("UPCs")). If a good is so relabeled or repackaged, it can fall afoul of the Trademark Counterfeiting act. This law provides for criminal penalties of up to \$2,000,000 for individuals and \$5,000,000 for companies. Prison sentences are up to 10 years. Individual second offenders may be fined up to \$5,000,000 and imprisoned up to 20 years; second offender entities may be fined up to \$15,000,000.

In order to show a violation of the Trademark Counterfeiting Act of 1984 one must prove that the diverter "intentionally trafficked or attempted to traffic in goods or services and knowingly used a counterfeit mark on or in connection with such goods or services."<sup>50</sup> Clearly, a diverter participating in a diversion scheme has dealt with the traffic of goods because he is attempting to import them into the United States. Furthermore, by altering the packaging or by repackaging the

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<sup>47</sup> See infra notes 174-177 and accompanying text.

<sup>48</sup> See discussion infra part I.B.1.b.

<sup>49</sup> See Jeffrey L. God, Demise of the Little White Life Defense: The Supreme Court Rejects the "Exculpatory No" Doctrine Under 18 U.S.C. §1001. 67 U. CIN. L. REV. 859 (1999).

<sup>50</sup> Id.

goods, the diverter has in some way changed the mark originally affixed by the manufacturer for export, thus making the new mark counterfeit because it is unauthorized. Therefore, even though the goods are still genuine, the packaging is not and the diverter will likely be found in violation of the Trademark Counterfeiting Act of 1984.

## 5. Criminal RICO

In certain cases, the government may choose to prosecute diverters under the criminal provisions of the Racketeer Influenced and Corrupt Organizations Act.<sup>51</sup> This law was initially intended to attack organized crime syndicates. Generally, a "pattern" of "predicate acts" must be pleaded and proven for RICO to apply.<sup>52</sup> Such predicate acts include violations of mail fraud, wire fraud and the National Stolen Property Act.<sup>53</sup> The prosecutor can demonstrate that the diversion scheme is part of a pattern, particularly if it was not a one-time event, and RICO may apply.

U.S. v. Weinstein involved the diversion of pharmaceuticals which were putatively destined for developing countries.<sup>54</sup> The defendants in Weinstein misrepresented themselves to pharmaceutical manufacturers as nonprofit or export companies in order to obtain discounted export pricing. After becoming aware that products supplied to the defendants were being diverted to the U.S., the manufacturers became reluctant to continue dealing with the defendants. In response to this reluctance, the defendants arranged to do business through other organizations, established new organizations and operated under "aliases" to continue the diversion operation. The court found that such fraudulent activity was a sufficient basis for establishing violations under RICO<sup>55</sup> and upheld the criminal convictions.<sup>56</sup>

Another possible RICO charge could lie if the perpetrators of the diversion scheme altered the packaging of the goods in question as discussed under "Trademark Counterfeiting" above. A relatively new law, the Anticounterfeiting Consumer Protection Act of 1996, makes trademark and copyright counterfeiting a predicate offense under RICO.

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<sup>51</sup> See 18 U.S.C. §§ 1961-1968. See also U.S. v. Weinstein, 762 F.2d 1522 (11th Cir. 1985).

<sup>52</sup> 18 U.S.C. § 1962.

<sup>53</sup> 18 U.S.C. § 1961(1)(B).

<sup>54</sup> Weinstein, 762 F.2d 1522.

<sup>55</sup> Id. at 1536-38.

<sup>56</sup> Id. at 1542.

The new law expanded the definition of "racketeering activity" under RICO (18 U.S.C. 1961 et. seq.) to include violations of laws which relate to trafficking in goods and services bearing counterfeit marks 18 U.S.C. 1961(1)(B). Criminal penalties under RICO are substantial, including fines of \$25,000, twenty years' incarceration and forfeiture of property.

It should be noted that RICO also has a civil component which allows plaintiffs injured by racketeering activity to recover damages. Historically, an injured plaintiff could bring a civil action seeking remedies under RICO by establishing "(1) that the defendant (2) through the commission of two or more acts (3) constituting a "Pattern" (4) of 'racketeering activity' (5) directly or indirectly invests in or maintains an interest in, or participates in (6) an 'enterprise' (7) the activities of which affect the interstate or foreign commerce." *Moss v. Morgan Stanley, Inc.* 719 F. 2d 5, 17 (2d Cir. 1983), *cert. denied sub nom, Moss v. Newman* 465 U.S. 1025 (1984). The law specifically defines the activities which may be considered "racketeering activity". 18 U.S.C. 1961. Thus, only owners of intellectual property who could prove that a defendant had engaged in some form of "racketeering activity" (e.g. mail or wire fraud) could file suit. Under the new law, since counterfeiting packaging is regarded as "racketeering activity" per se, it gives much greater flexibility to plaintiffs as well as prosecutors.

## **6. False Bills of Lading**

Often, a diversion scheme will take on a different twist than our original scenario involving APEX, GONZO, and DIVCO. In this kind of a diversion scheme, the foreign purchaser (GONZO) works in conjunction with the freight forwarder or common carrier in the U. S. to produce false bills of lading and other documents showing that the goods were shipped to the port of destination while actually diverting the goods at the docks for immediate sale in the United States. These false bills of lading are in turn used by the seller (APEX) to draw down the letter of credit from GONZO's bank for payment.

This type of a scenario may involve criminal liability for a violation of the Bills of Lading Act.<sup>57</sup> The Act would apply to any bill of lading issued by a carrier for the transportation of goods "from a place in a State to a place in any foreign country."<sup>58</sup> To establish a violation of §80116 of the Act you must show that a person knowingly or with intent to defraud:

1. falsely made, copied, or altered a bill of lading; or
2. uttered, published, or issued a falsely made, altered, or copied bill of lading;  
or

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<sup>57</sup>See 49 U.S.C. § 80116.

<sup>58</sup>49 U.S.C. § 80102.

3. negotiated, or transferred for value a bill of lading containing a false statement.<sup>59</sup>

GONZO's intent to defraud APEX is clear simply because they purposefully issued false bills of lading on goods that were never shipped. Furthermore, because the false bills of lading were issued by GONZO and their cohorts, a violation of §80116 has probably occurred. Such a violation is punishable by up to 5 years imprisonment and potential fines.<sup>60</sup>

As a practical matter, it is difficult to prove or detect a false bill of lading because counterfeit bills are very similar if not identical to valid bills. Probably the most efficient way to prove that a bill of lading is false is to look for a corresponding SED in the files of the U.S. Customs Service. Usually, diverters such as GONZO will give the purchaser not only a false bill of lading but also a false SED that was never filed with the Customs Service. If no corresponding SED exists with the Customs Service then it is proof that the bills of lading issued by GONZO's cohorts are false and a violation of §80116 has occurred.

It is also important to note that a bill of lading is often a negotiable instrument particularly when the bill itself states that the goods are to be delivered to the order of a consignee and where the bill does not state on its fact that it is not negotiable.<sup>61</sup> It is logical in a diversion scheme scenario for a bill of lading to be considered a negotiable financial instrument because it is the seller's key to receiving payment through a letter of credit from the purchaser's bank. Without the bill of lading, it is practically impossible for the seller to receive payment.<sup>62</sup> As financial instruments, false bills of lading may raise issues of securities fraud and thus a further remedy against a diverter.

Because diversion usually involves several different entities to successfully carry out the scheme, there is usually a criminally punishable conspiracy to commit one of the crimes discussed supra.<sup>63</sup> However, conspirators behind schemes like that promulgated by GONZO and DIVCO often attempt to cover the conspiracy by revealing to the different entities in the conspiracy only information that is relevant to that particular entity's role in carrying out the conspiracy. This is a

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<sup>59</sup>See 49 U.S.C. §80116.

<sup>60</sup>See id.

<sup>61</sup>See 49 U.S.C. §80103.

<sup>62</sup>If a seller's bank confirms to the purchaser's bank that all the necessary shipping documents needed for the letter of credit have been received and they have not, then the seller's bank is liable for demanding payment through the letter of credit.

<sup>63</sup>See 18 U.S.C. 371 §371.

typical form of a “wheel and spoke” conspiracy that makes the conspiracy more difficult to detect and prosecute. Nevertheless, it is still a conspiracy and any act in furtherance of the conspiracy by any one of the parties involved is a violation of 18 U.S.C. §371 and is punishable by fines , up to 5 years imprisonment, or both.<sup>64</sup>

## **B. CUSTOMS VIOLATIONS AND SEIZURE**

Violations of Customs laws and regulations may be criminal and civil. The law prohibits the submission of false or fraudulent documents in connection with the entry of merchandise into the United States.<sup>65</sup> If products are entered contrary to U.S. law, the Customs Service may have the authority to seize such products. Such authority is discretionary<sup>66</sup> or mandatory,<sup>67</sup> depending on the nature of the violation.

### **1. Customs Violations on the Entry Documents**

Section 542 of Title 18 proscribes the entering, or the attempt to enter, into U.S. commerce any imported merchandise by means of any fraudulent or false invoice, or declaration.<sup>68</sup> The fraudulent diversion of APEX products is a criminal violation of 18 U.S.C. §542.

Civil penalties levied by the Customs Service are addressed in 19 U.S.C. §1592. This section provides that an importer who by fraud, gross negligence, or negligence enters or attempts to enter any merchandise into the United States by means of any document or statement which is material and false, or by any material omission, or aids or abets any person to do the same, is subject to penalties, including seizure of the merchandise.<sup>69</sup>

GONZO and DIVCO have engaged in a number of activities which violate Customs laws and regulations. Such activities include false statements of ownership, fraudulent inducement in the completion of the SED, incorrect statements of valuation, entry as U.S. goods returned, and possible

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<sup>64</sup>Id.

<sup>65</sup> See 18 U.S.C. § 542 (criminal provisions); 19 U.S.C. § 1592 (civil provisions).

<sup>66</sup> See infra notes 97-101 and accompanying text.

<sup>67</sup> See infra notes 102-105 and accompanying text.

<sup>68</sup> 18 U.S.C. § 542.

<sup>69</sup> 19 U.S.C. § 1592.

misdescription of imported goods. These activities constitute violations under 18 U.S.C. §542 and 19 U.S.C. §1592.

*a. False Statements of Ownership*

Customs regulations state that entry shall be made for every importation, whether free or dutiable, and regardless of value.<sup>70</sup> Documentation required for the release of imported merchandise includes Customs Form 3461, evidence of the right to make entry, a commercial invoice, a packing list, and any other documentation as may be required by Customs.<sup>71</sup> The U.S. importer must also execute a declaration stating the information contained in the entry documents is true and correct.<sup>72</sup>

A commercial invoice must be filed with each entry, unless an exemption provides otherwise.<sup>73</sup> The commercial invoice must contain an adequate description, the quantities, the values or approximate values, and the HTSUS classifications for the merchandise, and the name and address of the individual or firm responsible for invoicing the merchandise.<sup>74</sup> The invoice must also include the purchase price or the value of the merchandise, costs of shipping and freight, country of origin, and in adequate detail, what is contained in each package.<sup>75</sup>

A commercial invoice is not required, however, for merchandise which is exported, not

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<sup>70</sup> 19 U.S.C. § 1484(a); 19 C.F.R. § 141.4.

<sup>71</sup> 19 C.F.R. § 142.3. If the imported merchandise is sold, or consigned to a person in the United States, the name, address, and appropriate identification number of that person must also be included. Id.

<sup>72</sup> 19 U.S.C. § 1485(a); 19 C.F.R. § 141.19 (1993). Specifically, the declaration must state whether the merchandise is imported in pursuance of a purchase agreement or an agreement to purchase, or whether it is otherwise imported; that the prices on the invoice are true; that all other statements in the invoice or other documents filed with entry are true, or in the entry itself, are true and correct; and that declarant will produce at once to the appropriate Customs officer any invoice, paper, letter, document or information received showing that any such prices are not true or correct. 19 U.S.C. § 1485(a).

<sup>73</sup> 19 C.F.R. §141.83(a).

<sup>74</sup> 19 C.F.R. §142.6(a).

<sup>75</sup> 19 C.F.R. §141.81(a), (e).

delivered to the consignee, and returned to the United States.<sup>76</sup> Diverters may use this tactic to import goods into the U.S. Although the diverter would not be required to file the commercial invoice, it would be required to submit other documents.<sup>77</sup>

The importer of diverted products has almost certainly acted contrary to U.S. law in the filing of the above required entry. As discussed *infra*, because DIVCO does not qualify as a *bona fide* purchaser, it is not able to acquire valid, legal title to the products.<sup>78</sup> Thus, any statements contained on its declaration to the contrary may be fraudulent and this is a violation of 18 U.S.C. §542 and 19 U.S.C. §1592.

Fraudulent or attempted fraudulent entry of merchandise into the United States by any material and false statements or omissions, or aid in any such practices, may subject the violator to civil or criminal penalties, including seizure of the goods.<sup>79</sup>

***b. Incorrect Statements of Valuation***

The Customs regulations provide that required documents for entry contain statements of the value or price of the imported merchandise.<sup>80</sup> Further, the importer must make a declaration that the prices included on the invoice are true.<sup>81</sup> Any APEX invoices submitted to prove valuation are fraudulent as the importers do not have any legal claim to the imported goods.<sup>82</sup>

DIVCO could be misstating the value of the imported goods on the invoices. This could occur the following way. If DIVCO attempts to enter the merchandise as U.S. goods returned, it may attempt to use the invoices APEX prepared in the original transaction. It is doubtful that the diverters who are selling the goods to the U.S. importer are selling them for the same price at which they purchased the products. If so, the diverters would not make any money, and this obviously is

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<sup>76</sup> 19 C.F.R. § 141.83(d)(6). *See infra* notes 83-94 and accompanying text.

<sup>77</sup> *See infra* note 83 and accompanying text.

<sup>78</sup> *See infra* notes 170-172 and accompanying text.

<sup>79</sup> 19 U.S.C. §§1592, 1595a. *See infra* notes 97-105 and accompanying text.

<sup>80</sup> *See* 19 C.F.R. §142.6(a).

<sup>81</sup> *See* 19 C.F.R. §141.19.

<sup>82</sup> *See supra* notes 21-34 and accompanying text. *See infra* notes 166-173 and accompanying text.

one of the objectives of diversion.

*c. Entry as U.S. Goods Returned*

DIVCO may enter the goods as "U.S. Goods Returned" under HTSUS 9801.00.10, thereby circumventing the applicable duty rates had the goods been entered under the appropriate HTSUS classification.

Pursuant to 19 C.F.R. §10.1(a), the following documents must be filed in connection with the entry of articles claimed as "U.S. Goods Returned:"

1. A declaration by the foreign shipper that to the best of his knowledge and belief the articles are products of the United States, that they were exported from the United States (naming the port and date), and that they are returned without having been advanced in value or improved in condition by any process of manufacture or other means.
2. A declaration for free entry by the owner, importer, consignee, or agent on the top portion of Customs Form 3311.
3. A Certificate of Exportation, on the bottom portion of Customs Form 3311, executed by the District Director at the port from which the merchandise was exported. This certificate must show whether drawback was paid on the merchandise and, if any was paid, the amount.<sup>83</sup>

Any of the aforementioned documents submitted by DIVCO in conjunction with an entry for U.S. goods returned contain fraudulent and material misstatements of fact because DIVCO does not have title to the goods.<sup>84</sup>

Compliance with the above Customs regulations relating to claims for free entry of U.S. goods returned is mandatory, unless the District Director waives such requirements or the U.S. importer establishes impossibility of compliance.<sup>85</sup>

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<sup>83</sup> 19 C.F.R. § 10.1.

<sup>84</sup> See infra notes 166-173 and accompanying text. See supra notes 21-34 and accompanying text.

<sup>85</sup> See General Note 8, HTSUS, Mi-Scott International Ltd. v. U.S., 13 C.I.T. 1046 (1989), Maple Leaf Petroleum, Ltd. v. U.S., 25 CCPA 5, T.D. 48976 (1937).

If DIVCO is not able to secure the aforementioned documents, it may request that the District Director waive the mandatory documentary requirements of 19 C.F.R. §10.1(a). The District Director may do so if he is "reasonably satisfied," either because of the nature of the products, or production of other evidence, that the articles are imported in circumstances meeting the requirements of 9801.00.10 of the HTSUS.<sup>86</sup> The decision to grant such a waiver rests solely with the District Director.<sup>87</sup>

Notwithstanding the fact that any documentary evidence submitted by the diverters, whether mandatory or not, probably contains fraudulent information and material misstatements of fact, the District Director can exercise his discretion by refusing to accept anything but the mandatory documentation. This, at the minimum, would guarantee that the reimported APEX products would be entered under the appropriate HTSUS classification, and where applicable, duties would be paid.

Courts have consistently upheld the decisions of District Directors who refuse to waive the mandatory documentary requirements 10.1(a).<sup>88</sup> Accordingly, these cases provide some guidelines for the "reasonably satisfied" test of 19 C.F.R. §10.1(d). In a decision by the Court of International Trade, the Court found that alternative documentation submitted in lieu of the Certificate of Exportation on Customs Form 3311 was not sufficient to establish U.S. origin, therefore, the merchandise was not entitled to entry as U.S. goods returned.<sup>89</sup>

The plaintiff, an importer of toiletry products from Singapore, attempted to prove U.S. origin by submitting several documents in lieu of the Certificate of Exportation. The plaintiff argued that where other evidence establishes the merchandise as American goods, duty-free entry should be granted notwithstanding the absence of a Certificate of Exportation. Documents submitted by the plaintiff included: (1) a "Certificate of Origin/Process" attesting that the goods were made in the United States; (2) a letter from the foreign shipper stating that the shipper had access to the original factory certificate of origin from Mennen and the original factory invoice; and (3) a letter from an independent testing laboratory in Singapore which stated, "one would conclude that the goods were of U.S. origin."<sup>90</sup>

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<sup>86</sup> 19 C.F.R. §10.1(d).

<sup>87</sup> See Treasury HQ Ruling 555754 (Feb. 4, 1991).

<sup>88</sup> Mi-Scott International, 13 C.I.T. 1046 (1989).

<sup>89</sup> Id.

<sup>90</sup> Id. at 1052. Although the letter from the testing laboratory referred to a "certificate of origin" issued by the Singapore Chamber of Commerce," Customs questioned the certificate's authenticity because it was not signed by any government official, nor did it bear any official

The Customs Service countered the plaintiff's assertion by, "noting, first, that statutes granting duty-free entry are to be strictly construed. ... 19 C.F.R. §10.1 is such a statute, and its provisions regarding which documents an importer must present to qualify for duty-free entry should be strictly read."<sup>91</sup> Customs also argued that "where the returned merchandise is not imported through the original port of exportation, the filing of a Certificate of Exportation is mandatory, as noted in 19 C.F.R. §10.1(a)(3)."<sup>92</sup>

The Court rejected the plaintiff's documents as proof of U.S. origin, finding that "assumptions and inferences cannot provide the basis for submission of alternative information, instead of the required export certificate."<sup>93</sup> The Court, citing an earlier decision, stated that:

"Proof offered, in lieu of a certificate of exportation, [which] consists merely of some facts from which an inference of support of plaintiff's position may be drawn \*\*\* may not be accepted in lieu of a certificate of exportation." Id., citing J.F. Goldkamp & Co. v. U.S., 38 Cust. Ct. 376, 384, C.D. 1890 (1957). However, an original factory certificate of origin and an original factory invoice could resolve the question of country of origin. Id. Additionally, oral testimony, letters from the importing company to Customs with proposed Customs Form 3311 attached are not sufficient, but other documents proving export, such as a duplicate parcel-post receipt may be accepted. Am. Express Co. v. U.S., Protest 62/17245-12875, 55 Cust. Ct. 413 (U.S. Cust. Ct., 8/30/65) (citations omitted).<sup>94</sup>

***d. Misdescription of Goods***

Finally, it is possible that DIVCO is attempting to cover up the reimportation of APEX products by erroneous descriptions of the imported merchandise. Such misdescription may be an effort not only to evade detection by APEX, but also an effort to evade Customs duties.<sup>95</sup> Also, in

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number. Id.

<sup>91</sup> Id. at 1049 (citations omitted) (emphasis added).

<sup>92</sup> Id. (emphasis added).

<sup>93</sup> Id. at 1051.

<sup>94</sup> Id. at 1052.

<sup>95</sup> See 19 C.F.R. §§152.3, 152.11 and 152.12. Rates of duty are imposed according to the classification category of an import under the Harmonized Tariff Schedule of the United States.

the area of prescription drugs, diverters may be tempted to mislabel the goods to avoid statutes prohibiting the reimportation of prescription drugs by anyone other than the original manufacturer.<sup>96</sup> If a violation of this statute occurs, prosecutors have one more remedy to add as they build their case against a certain diverter.

## **2. Seizure by the U.S. Customs Service**

Based upon the forgoing observations and current state of law, the importation of the APEX products is a violation of several U.S. laws and regulations, and seizure of the goods may be authorized.

Section 1595a of Title 19 provides that merchandise entered contrary to U.S. law shall be seized.<sup>97</sup> Furthermore, anyone who assists in such activity is subject to penalties.<sup>98</sup>

### ***a. Permissive Seizure Under 19 U.S.C. §1592***

The Customs regulations provide that property may be seized by any Customs officer who has "reasonable cause" to believe that the merchandise is imported in contravention of U.S. law.<sup>99</sup> However, if merchandise is seized for a violation of 19 U.S.C. §1592, the District Director must also believe that seizure otherwise is essential to protect the revenue or to prevent the introduction of prohibited or restricted merchandise into the U.S.<sup>100</sup> Prohibited goods include "stolen" goods. As discussed supra, the APEX products constitute stolen goods<sup>101</sup>. Additionally, if the items are misdescribed in order to obtain a lower tariff rate, there is a loss of revenue.

### ***b. Required Seizure Under 19 U.S.C. §1595a***

The containers in which the APEX products have been imported must be seized pursuant to 19 U.S.C. §1595a. Subsection (c)(1)(A) of Section 1595a(c) of Title 19, as amended by Section 624 of the North American Free Trade Agreement Implementation Act, provides that the United States

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<sup>96</sup>See 21 U.S.C. §381(d).

<sup>97</sup> 19 U.S.C. § 1595a(c)(1).

<sup>98</sup> 19 U.S.C. § 1595a(b).

<sup>99</sup> 19 C.F.R. §§ 162.21 and 162.23.

<sup>100</sup> 19 C.F.R. § 162.75.

<sup>101</sup> See supra notes 21-30 and accompanying text.

Customs Service "shall" seize and forfeit imported merchandise if it "is stolen, smuggled or clandestinely imported or introduced;... ." <sup>102</sup> This language is distinguishable from both the earlier §1595a(c) and the new §1595a(c)(2) which provides that merchandise may be seized in a number of other situations. <sup>103</sup>

In connection with the unlawful diversion of imported products, a question has arisen as to whether goods which a manufacturer is fraudulently induced to deliver into the possession and control of certain customers are "stolen" goods within the meaning of Section 1595a(c)(1)(A). By misrepresenting the true destination of the merchandise, some customers induce manufacturers to sell products at export prices which are substantially lower than the prices that would be available if the true destination of the products were disclosed. The customers do transfer at the time of delivery cash amounts equivalent to the export prices for the merchandise, as if it had been delivered to the nominal destination.

The term "stolen" as used in the newly-revised Section 1595a is not explicitly defined. The National Stolen Property Act makes it unlawful for any person to transport in interstate or foreign commerce any goods with knowledge that the goods have been "stolen, converted or taken by fraud." <sup>104</sup> However, as discussed supra, the courts have had ample opportunity to interpret statutory references to stolen merchandise. Goods such as the APEX products which are obtained at lower than normal prices through misrepresentation are "stolen" within the meaning of this statute. <sup>105</sup>

Certainly, nothing in the language or history of Section 1595a indicates that the term "stolen" as used in that civil forfeiture statute should be given a more narrow meaning than the meaning courts have given the term in the interpretation of criminal statutes.

### **3. Type of Entry**

Merchandise entered into the United States may be entered under bond or as a consumption entry. Seizure is mandated when the merchandise is imported, regardless of the type of entry made. The language of § 1595a(c)(1) does not distinguish between entries into the commerce of the United States and entries under bond. <sup>106</sup> Accordingly, mandatory seizure is applicable to either a

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<sup>102</sup> See 19 U.S.C. § 1595a(c)(1)(A).

<sup>103</sup> See § 1595a(c)(2) (emphasis added).

<sup>104</sup> 18 U.S.C. § 2314.

<sup>105</sup> See supra notes 21-30 and accompanying text.

<sup>106</sup> See 19 U.S.C. § 1595a(c)(1).

consumption or bonded entry.

When the law applies only to certain types of entries, it is so stated. For example, Section 592 of the Tariff Act of 1930 prohibits the entering, introduction, or attempted introduction of merchandise, "into the commerce of the United States, by fraud, gross negligence, or negligence".<sup>107</sup> The language, "into the commerce of the United States" is not included in § 1595a(c)(1) because Congress did not intend to limit the seizure authority of the U.S. Customs Service to consumption entries.

The seizure authority of § 1595a(c)(1) also applies to the importation of controlled substances and contraband.<sup>108</sup> The law does not limit the Customs Service's authority to seize drugs and contraband to those instances where a consumption entry has been made. The Customs Service must seize such articles at the time of importation.

## C. CIVIL REMEDIES

In addition to criminal charges which may be brought by the government, U.S. companies that are victims of diversion may bring a civil case against the diverter. There are a number of theories which may be pursued. This section of the article discusses these alternatives.

### 1. Copyright Act Violations

Each of the products manufactured and sold by APEX contains a label which is copyrighted according to the provisions set forth in the Copyright Act of 1976.<sup>109</sup> The importation of APEX products is probably a violation of this act.

Section 501 provides that anyone who violates the exclusive rights of the copyright owner as provided in §106 or who imports copies into the United States in violation of §602 is an infringer of the copyright. Furthermore, the Notes of the Committee on the Judiciary state that under §602 an unauthorized importation of copies acquired abroad is an infringement of the exclusive right of distribution under certain circumstances.<sup>110</sup> APEX may be entitled to relief as discussed infra because its exclusive right to distribution has been violated by the unauthorized importation of its

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<sup>107</sup> 19 U.S.C. § 1592(a)(1).

<sup>108</sup> See 19 U.S.C. § 1595a(c)(1)(B), (C).

<sup>109</sup> See 17 U.S.C. § 1 et seq.

<sup>110</sup> See, H.R. Rep. No. 94-1476, Cong., 2d Sess. \_\_ (1976).

products.

The language of Section 602(a) plainly states that certain importations of copyrighted material is an infringement:

Importation into the United States, without the authority of the owner of copyright under this title, of copies or phonorecords of a work that have been acquired outside the United States is an infringement of the exclusive right to distribute copies or phonorecords under section 106, actionable under section 501.<sup>111</sup>

The Notes of the Committee on the Judiciary make it clear that Congress intended to protect copyright owners against unauthorized importation of not only "piratical" copies, but also lawfully made copies.

Section 602, which has nothing to do with the manufacturing requirements of section 601, deals with two separate situations: importation of "piratical" articles (that is, copies or phonorecords made without any authorization of the copyright owner), and unauthorized importation of copies or phonorecords that were lawfully made.<sup>112</sup>

Under §602(a), for the importation of APEX products to constitute an infringement, the following conditions must be met:

1. APEX must be the owner of the copyright;
2. the copies must be imported into the United States "without the authority of" APEX;
3. the imported copies must have been "acquired outside the United States;" and
4. the exclusive right to distribution must have been violated.<sup>113</sup>

In the scenario outlined here, the first three requirements above have been met. APEX owns the copyright, it did not authorize the importation of the diverted products, and the diverters acquired the goods outside the United States.

Whether APEX's exclusive right to distribution has been violated is more doubtful in light of recent case law. Section 106 provides that subject to 17 U.S.C. §§ 107-120, the owner of

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<sup>111</sup> 17 U.S.C. § 602(a).

<sup>112</sup> H.R. Rep. No. 94-1476, 94th Cong., 2d Sess. 169 (1976).

<sup>113</sup> 17 U.S.C. § 602(a).

copyright under this title has the exclusive right to distribute copies of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending.<sup>114</sup> This exclusive right is limited, however, by the "first sale" doctrine at §109(a). The first sale doctrine provides that after the copyright owner has transferred the ownership of a "lawfully ... made" copy to another, the new owner may sell or otherwise dispose of the copy.<sup>115</sup>

DIVCO may attempt to shield itself from liability for copyright infringement by invoking the "first sale" doctrine. It would allege that because the labels were made and sold in the United States, the first sale doctrine applies, and therefore, no infringement of the exclusive right to distribution has occurred.

In 1993, a 9<sup>th</sup> circuit district court issued a decision involving the applicability of the first sale doctrine to a §602(a) violation.<sup>116</sup> Interpreting §602(a), the court held that the first sale doctrine is no defense to a §602(a) infringement.<sup>117</sup> The court reasoned that construing "lawfully made under this title" to mean "legally manufactured and sold within the United States" would contravene Congressional intent.<sup>118</sup> "[T]he legislative history of §109(a) reveals that the phrase "lawfully made under this title" clarifies what constitutes a "first sale" for purposes of the first sale doctrine; it makes no reference to the location of the manufacture or sale of goods."<sup>119</sup> Givenchy further held that the importation right of the copyright holder survives until there is a first sale within the U. S.

The U. S. Supreme Court has recently ruled and provided some guidance regarding this issue in L'anza Research Int'l, Inc. v. Quality King Distribs., Inc.<sup>120</sup>, a case involving a scenario very similar to the one presented in this article. L'anza manufactured various hair care products and marketed them through a chain of authorized distributors inside the U. S. However, L'anza also sold copies of its product at a much lower price for export to foreign countries and distributed outside of any authorized distribution chain. Quality King purchased some of the exported product in a foreign

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<sup>114</sup> 17 U.S.C. § 106(3).

<sup>115</sup> 17 U.S.C. § 109(a).

<sup>116</sup> See Parfums Givenchy, Inc. v. C&C Beauty Sales, Inc., 832 F. Supp. 1378 (C.D. Cal. 1993).

<sup>117</sup> See id.

<sup>118</sup> Id. at 1386.

<sup>119</sup> Id. at 1387.

<sup>120</sup> 523 U.S. 135 (1998).

country and imported it back into the U.S., selling it to unauthorized distributors at a lower price than L'anza's authorized distributors. L'anza then sued Quality King claiming that its exclusive right under Section 602(a) of the Copyright Act had been violated. Quality King countered that the importation of the products was protected under the first sale doctrine.<sup>121</sup>

The 9<sup>th</sup> Circuit Court of Appeals affirmed a lower court's ruling in favor of L'anza and held that the first sale doctrine did not apply because if the copyright holder could not bar unauthorized importations, its rights under the Copyright Act would be meaningless.<sup>122</sup> On the other hand, cases like Sebastian Int'l, Inc. v. Consumer Contacts Ltd.<sup>123</sup>, have held that a lawful sale abroad terminates the copyright holder's exclusive right to import and distribute those goods in the U. S.<sup>124</sup> Largely because of this split in the circuits, the Supreme Court decided to hear the 9<sup>th</sup> Circuit L'anza decision.

When the case reached the Supreme Court, the Court agreed with the 3<sup>rd</sup> Circuit and unanimously reversed the 9<sup>th</sup> Circuit and held that the first sale doctrine does apply to a lawful sale abroad and L'anza's exclusive right to distribute the goods in question had been terminated. The ruling in L'anza also effectively overturned the reasoning in Givenchy that the importation right of a manufacturer survives until there is a first sale in the U. S. Because diversion schemes commonly involve at least one sale of the goods abroad before being imported into the U.S., the L'anza decision significantly decreases the ability to successfully use copyright law as a remedy against diverters because of their protection under the first sale doctrine and makes previous copyright victories like Givenchy a thing of the past.

The "first sale" doctrine assumes that the copyright owner will be able to realize the full value of the work upon his initial sale through the selling price.<sup>125</sup> The price at which the copyright owner is willing to sell copies depends on market conditions and may vary from country to country.<sup>126</sup> In Givenchy, the court distinguished the situation whereby the goods are originally manufactured and "first sold" in the United States, exported, and then brought back into the U.S. In such a situation, the copyright owner has voluntarily released the copies into the U.S. market and received full value

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<sup>121</sup> See id.

<sup>122</sup> See L'anza Research Int'l, Inc. v. Quality King Distribs., Inc., 98 F.3d 1109 (9<sup>th</sup> Cir. 1996).

<sup>123</sup> 847 F.2d 1093 (3d Cir. 1988).

<sup>124</sup> See L'anza, 523 U. S. at 135.

<sup>125</sup> Id. at 1390.

<sup>126</sup> Id.

for which he is entitled.<sup>127</sup> This is inapplicable regarding the importation of APEX products. Although the products were manufactured in the U.S., they were not "first sold" in the United States and the goods never entered the U.S. market.

Despite the L'anza ruling, our scenario would probably still provide a remedy under the Copyright Act. APEX has included on its invoices a "Title Retention Clause" which states that title in the products does not pass until the goods physically arrive at the intended destination. Accordingly, products destined for overseas markets are not sold until the goods reach their intended ultimate destination. Because the imported APEX products have not reached their intended destination, title to the goods belongs to APEX.

The legislative history of § 109(a) states that its basic purpose is, "to make clear that full ownership of a lawfully-made copy authorizes its owner to dispose of it freely, and that this privilege does not extend to copies obtained otherwise than by sale or by other lawful disposition."<sup>128</sup> DIVCO does not have ownership because title has not passed, and therefore, it is not protected under § 109(a). Thus, even though DIVCO could successfully argue that § 109(a) does limit the applicability of § 602, a "first sale" has not yet occurred, thus barring the invocation of the "first sale" doctrine in a defense.

The wake of L'anza dampens the effectiveness of asserting a violation of the Copyright Act as a potential remedy against a diverter, particularly without a title retention clause in the original sales contract. Using copyright infringement as a remedy also has other limitations. Primarily, it does not apply to domestic diversion scenarios where the merchandise is diverted at the dock and never exported. However, some practitioners do still see copyright infringement as a viable alternative against diverters especially when the goods have been manufactured in a foreign country and imported into the U. S. without the authorization of the U. S. copyright holder.<sup>129</sup>

Despite L'anza trademark infringement is still an effective remedy against a diverter in at least one particular type of diversion scheme. Often, a U. S. manufacturer will produce two different versions of a particular product. One will be for distribution in the U. S. and the other for distribution somewhere outside of the U. S. For instance, Lever Bros. Co. put its trademark, "Shield", on soap sold both here and in the UK. The two products differed in several respects

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<sup>127</sup> See id. at fn. 12.

<sup>128</sup> Id. at 1387 (citations omitted).

<sup>129</sup>It is important to note that the L'anza decision applied only to goods manufactured inside the U.S. and that foreign manufactured goods were outside of the "lawfully made under this title" provision of the Copyright Act. See L'anza 523 U. S. at 145 (Ginsburg, J., concurring).

because the manufacturers had altered them to fit the different markets in the two countries.<sup>130</sup>

In this type of scenario, several recent circuit court decisions have affirmed that if the goods designed for market in a foreign country are imported and marketed here then it is often a violation of the Lanham Act.<sup>131</sup> These decisions have held that if there exists a single material difference between the authorized product and the diverted product then a violation of §42 of the Lanham Act has occurred.<sup>132</sup> A violation of the Lanham Act in this form is just one more potential remedy for practitioners to look for in any diversion scheme they may be facing.

## **2. Temporary Restraining Orders/ Injunctive Relief**

One of the primary means of halting diversion is to acquire a Preliminary Injunction, pursuant to Rule 65 of the Federal Rules of Civil Procedure, restraining DIVCO from marketing, selling or otherwise distributing certain shipments of APEX products which were improperly diverted. The invoices for the APEX products make it clear that title to the products is still held by APEX. Moreover, GONZO & DIVCO have conspired to violate APEX's rights. Such conduct clearly violates the rights of APEX and will cause APEX irreparable harm. Accordingly, APEX is entitled under established legal principles to the entry of an order enjoining and restraining defendants' continued misconduct pending the outcome of a trial on the merits.<sup>133</sup>

APEX sold goods specifically designated for export to foreign countries. GONZO & DIVCO, acting in concert, instead caused the goods to be diverted from its foreign destinations and returned for improper sale in the United States. The documentation that governed each sales

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<sup>130</sup>Rory J. Radding and Darren W. Saunders, Trademark Law Still Bars Gray Goods; Recent Circuit Court Decisions have Reaffirmed Unified Test, N.Y. LAW J. S8 (April 2000).

<sup>131</sup>See Lever Bros. Co. V. U. S., 877 F.2d 101 (D. C. Cir. 1989); Societe Des Produits Nestle, S. A. v. Casa Helvetia, Inc., 982 F.2d 633 (1<sup>st</sup> Cir. 1992); Gamut Trading Co. V. U. S. ITC, 200 F.3d 775 (Fed. Cir. 1999).

<sup>132</sup>See 15 U.S.C. §1124. Courts bring this type of diversion scenario under the Lanham Act by labeling the good as no longer genuine if there is one material difference between the products.

<sup>133</sup> Permanent injunctive relief is an equitable remedy and will issue only after a showing of both irreparable injury and inadequacy of legal remedies; and a balancing of competing claims of injury and the public interest. Public Interest Research Group, Inc. v. Powell Duffryn Terminals, Inc., 913 F.2d 64, 82 (3d Cir. 1990), cert. denied, \_\_ U.S. \_\_, 111 S.Ct. 1018 (1991), quoting natural Resources Defense Council v. Texaco Refining and Marketing, Inc., 906 F.2d 934, 941 (3d Cir. 1990). See also Glenside West Corporation v. Exxon Company, U.S.A., 761 F.Supp. 1118, 1131 (D. New Jersey 1991).

transaction expressly provided that title to the goods shall remain with the seller until the goods arrived in the importing country. All of the shipments were instead purportedly "sold" to DIVCO. As discussed below, unless the interim relief requested is granted, APEX will be irrevocably injured by the sale of the improperly diverted goods.

The Second Circuit's standards governing the issuance of a preliminary injunction are well-settled.

In order to obtain a preliminary injunction an applicant must show "(a) irreparable harm and (b) either (1) likelihood of success on the merits or (2) sufficiently serious questions going to the merits to make them a fair ground for litigation and a balance of hardships tipping decidedly toward the party requesting the preliminary relief." Jackson Dairy, Inc. v. H.P. Hood & Sons, Inc., 596 F.2d 70, 72 (2d Cir. 1979) (per curiam).<sup>134</sup>

The 3rd Circuit standard is virtually the same, requiring the movant to demonstrate:

(i) that he will probably succeed in the eventual litigation and (ii) that he would suffer imminent and irreparable injury if the relief were not granted.<sup>135</sup>

In this circuit, courts may also consider the potential for injury to other parties that might result from the grant or denial of an injunction, and the public interest.<sup>136</sup>

As demonstrated below, based on the applicable law and the facts at bar, APEX satisfies the standards for issuance of a preliminary injunction.

***a. Establishing Possible Irreparable Harm.***

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<sup>134</sup> Deeper Life Christian Fellowship, Inc. v. Board of Education, 52 F.2d 676, 679 (2d Cir. 1988). See also Eng v. Smith, 849 F.2d 80, 81-82 (2d Cir. 1988); American Cyanamid Co. v. Campagna Per Le Farmacie In Italia S.P.A., 847 F.2d 53, 54-55 (2d Cir. 1988); and RTC v. Elman, 761 F. Supp. 245, 248-249 (S.D. N.Y. 1991), aff'd 949 F.2d 624 (1991).

<sup>135</sup> Kershner v. Mazurkiewicz, 670 F.2d 440, 443 (3d Cir. 1982); Breyer v. First National Monetary Corp., 548 F.Supp. 955, 958 (D. N.J. 1978); Cubic Western Data, Inc. v. New Jersey Turnpike Authority, 468 F.Supp. 59, 62 (D. N.J. 1978).

<sup>136</sup> Constructors Ass'n of Western Pennsylvania v. Kreps, 573 F.2d 811, 815 (3d Cir. 1978).

The release of the merchandise which is the subject of this action into the possession and control of the defendants has caused substantial and irreparable damage to APEX and threatens to cause additional substantial and irreparable damages in at least the following respects:

i. APEX has suffered and will suffer irreparable damage to its relationships with its legitimate domestic customers who are being and will be deprived of sales due to the introduction of substantial quantities of stolen APEX merchandise into United States commerce;

ii. The prices obtained by APEX and its legitimate U.S. customers are being and will be artificially depressed due to the introduction of substantial quantities of stolen merchandise into the United States market;

iii. APEX and its legitimate U.S. customers are being and will be deprived of the benefit of their advertising and other promotional programs in the United States which APEX and its U.S. customers have jointly and individually undertaken to encourage the purchase and use of APEX products; and

iv. APEX has been or will be deprived of domestic sales in the United States with a value not capable of precise ascertainment at this time, but believed to be in excess of \$1,000,000.

***b. Diverter's Engagement In Wrongful Conduct in Contravention of U. S. Producer's Rights.***

APEX has retained title to the subject goods as a result of GONZO & DIVCO's wrongful conduct on three separate grounds. First, APEX retained title to the subject goods pursuant to the "Title Retention Clause" of the commercial invoices.<sup>137</sup> This clause specifically provides:

It is expressly agreed between the seller and the buyer that on all sales, beneficial and legal title to, ownership of, and right of possession to the merchandise shall remain with the seller until the shipment physically arrives ex-ship, at the port of entry in the country of ultimate destination. The time of payment, whether before or after shipment; the place or medium of payment; the method of shipment; the manner of consignment, whether to seller, or its agent, to buyer or its agent, or an agent for both; or any document in relation to any sale under this agreement shall in no way limit or modify the right of the

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<sup>137</sup> See also *infra* notes 174-177 and accompanying text.

seller as the legal and beneficial owner of the goods, its right to possession of such goods until they physically arrive ex-ship, at said port of entry in the country of ultimate destination. It is expressly agreed that transshipment through intermediate ports or consignees wherever located, shall in no way affect the retention of title by seller to the merchandise. The country of ultimate destination, as used in this Title Retention Agreement, is the country indicated on the Shipper's Export Declaration in box 33, "Country of Ultimate Destination." Further, it is expressly agreed between the seller and the buyer that the terms of this Title Retention Agreement are superior to and take precedence over any provisions of the Uniform Commercial Code or the Convention on the International Sale of Goods which may be otherwise inconsistent with the terms contained herein.

Second, DIVCO has voidable title because the goods constitute stolen property under the National Stolen Property Act.<sup>138</sup> Third, if the NSPA is not invoked, DIVCO has at best voidable title because it obtained the goods through fraud and false pretenses.<sup>139</sup> DIVCO acquires valid title only if it is a *bona fide* purchaser. However, the application of the facts at bar to the relevant law in respect of *bona fide* purchasers, discussed below, mandates the conclusion that the defendants are not bona fide purchasers.<sup>140</sup> Therefore, any purported title which DIVCO may have acquired is void or voidable and title remains vested in APEX.

*c. The Balance of Hardship Weighs In Favor of APEX.*

Even if APEX does not establish the likelihood of its success on the merits, a preliminary injunction should be granted, because APEX has clearly raised substantial questions going to the merits so as to make them fair ground for litigation; the evidence demonstrates that the balance of hardships weighs decidedly in APEX's favor since APEX still holds title to the subject goods and defendants have unlawfully converted APEX's goods.<sup>141</sup>

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<sup>138</sup> See *supra* notes 21-30 and accompanying text. See *infra* notes 166-173 and accompanying text.

<sup>139</sup> See *infra* notes 170-173 and accompanying text.

<sup>140</sup> See *infra* note 173 and accompanying text.

<sup>141</sup> See *Selchow & Richter Co. v. McGraw-Hill Book Co.*, 580 F.2d 25, 28 (2d Cir. 1978) (granting preliminary injunction on this ground), *Constructors Association of Western Pennsylvania v. Kreps*, 573 F.2d 811, 815 (3d Cir. 1978).

### **3. Replevin/Recovery**

APEX may bring an action under a replevin/recovery theory.<sup>142</sup> In a replevin action, the true owner may recover his goods from one who is wrongfully detaining the goods. The superfratostats are in DIVCO's possession at its warehouse. Because DIVCO does not have title to these goods, it is unlawfully detaining such merchandise from APEX. No other party, including DIVCO, has any right, title, or interest in the property superior to that of APEX. APEX is lawfully entitled to the goods pursuant to the specific terms and conditions on the commercial invoice.<sup>143</sup>

### **4. Statutory and Common Law Fraud**

GONZO fraudulently misrepresented that the sole purpose for purchasing the goods was for ultimate resale in Mozambique, that the goods would be distributed in Mozambique, and that GONZO had a buyer in place in Mozambique. These representations were false and fraudulent and made with intent to deceive.<sup>144</sup>

There are certain elements that a plaintiff must demonstrate in order to show fraud in a diversion case. You must show that the diverter:

1. falsely misrepresented a fact;
2. knew or should have known the fact was false;
3. intended to induce the seller to act on the false representation; and
4. the seller relied to his detriment on the false representation.<sup>145</sup>

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<sup>142</sup>A replevin action may only be available in certain jurisdictions but the same ends can be accomplished through an ex parte seizure order; see infra notes 145-147 and accompanying text.

<sup>143</sup> See National Retailers Mutual Ins. Co. v. Gambino, 1 N.J. Super. 627 (N.J. Super. Ct 1948).

<sup>144</sup> See Ortho Pharmaceutical Corp. v. Sona Distributors, Inc., 663 F. Supp. 64 (S.D. Fla. 1987) (held that defendant committed fraudulent misrepresentation by obtaining U.S. manufactured pharmaceuticals in Hong Kong at less than U.S. wholesale prices by falsely representing that they were purchased for resale in the People's Republic of China). See also Royal Typewriter Co. v. Xerographic Supplies Corp., 719 F.2d 1092, 1103 (11th Cir. 1983).

<sup>145</sup>See Ortho, 663 F. Supp. at 64.

GONZO misrepresented the destination of the goods because they did not go to Mozambique. In fact, GONZO had no intent to ship the goods to Mozambique. Rather, GONZO intended that APEX rely on the misrepresentations and take actions based on these misrepresentations to its detriment. A key to showing this fraudulent intent is that GONZO sought a lower price for the superfratostats. APEX did justifiably rely upon the misrepresentations and changed its position to its detriment. The actions by GONZO were willful, wanton and malicious, without right or justifiable cause, and with reckless disregard for the rights of APEX.

Because the availability of a remedy under copyright law is dubious following the L'anza decision, fraud is a particularly important remedy in an action against a diverter. Counsel should be wary of just attempting to seek damages from a diversion scheme because diverters are notorious for avoiding judgments and hiding assets. Often, a diverter will not enter an appearance in a cause of action against him leaving the plaintiff with the difficult task of tracking him down to execute the judgment. With this in mind, fraud becomes an important remedy as a basis for seeking an ex parte seizure order to recover the goods diverted.

A judge is more likely to grant a seizure order in the case of fraudulent misrepresentation than for a lesser remedy such as breach of contract. Under rule 64 of the Federal Rules of Civil Procedure, federal courts should follow state law regarding provisional remedies such as the pre-judgment seizure of goods to the extent such law comports with due process.<sup>146</sup> In many instances, the party seeking the seizure order is required to post a sizeable bond. Moreover, recently courts have leaned towards requiring the same showing for pre-judgment seizure as that required when seeking a Preliminary Injunction or Temporary Restraining Order.<sup>147</sup> Because GONZO has already paid APEX for the goods, it would be difficult to show a judge that APEX will be irreparably harmed without the seizure order, unless APEX strongly asserts that GONZO has been fraudulent from the beginning and is dishonest. Fraud's ability to increase the likelihood of successfully obtaining an ex parte seizure order and actually recovering what has been taken, make it one of the most attractive civil remedies to bring against a diverter.<sup>148</sup>

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<sup>146</sup>See Connecticut v. Doehr, 501 U. S. 1, 13 (1991)(outlining a three pronged balancing test used by many courts to determine if a civil seizure order will violate a defendant's rights to due process).

<sup>147</sup>See Paramount Pictures Corp. v. Doe, 821 F. Supp 82 (1993). See also, supra notes 133-141 and accompanying text.

<sup>148</sup>See NutraSweet Co. v. Vit-Mar Enterprises, Inc., 176 F.3d 151 (3<sup>rd</sup> Cir. 1999)(holding that if the goods have already been seized in benefit of the manufacturer either by writ of replevin or ex parte seizure then a preliminary injunction is not proper because the manufacturer can no longer be harmed).

*Conspiracy to commit fraud by GONZO and DIVCO.* GONZO and DIVCO acted together to conspire to defraud APEX and deprive APEX of the proper and full purchase price for the goods.

*Conversion.* APEX has the right of possession of the superfratostats on the basis that, pursuant to the written agreement between the parties, *ie.*, the commercial invoice, title and the right of possession were never transferred to DIVCO.

*Conspiracy to Commit Conversion.* GONZO and DIVCO and their agents acted together to conspire to convert the goods owned by APEX and deprive APEX of the right to possess such goods.

*Civil Theft.* GONZO, DIVCO and their agents knowingly obtained and used property that belonged to APEX with the specific intent of depriving APEX of the right to the property and the right to benefit therefrom. Actions were made with criminal and felonious intent, and rendered GONZO and DIVCO liable for civil theft pursuant to Chapters 812 and 772, Florida statutes.

*Unjust enrichment.* DIVCO has improperly taken the subject goods that belong to APEX. DIVCO had enjoyed and appreciated the benefit of the subject goods and has accepted the benefit of the goods. As a result, DIVCO has been unjustly enriched by virtue of the possession of the subject goods. It is inequitable to allow DIVCO to retain the benefit of the possession of the goods.

## **5. Admiralty**

Fraud, conversion, civil theft, conspiracy and related claims arise out of a maritime contract for the carriage of goods at sea. APEX may take action pursuant to the general maritime and admiralty law (FRCP 9(h)). APEX may also take action involving interference of a maritime contract for the carriage of goods subject to the Carriage of Goods at Sea Act. ("COGSA").<sup>149</sup> The facts here subject the goods to a maritime lien in favor of APEX.

The evidentiary threshold which must be met by APEX at a post-seizure hearing is that of "probable cause." The claims arise from the use and instrumentalities of traditional maritime commerce to perpetuate fraud, civil theft, and breach of contract. The specific instrumentality at issue is the Ocean Bill of Lading for the Contract of Carriage of Goods by Sea.

It is well established that a court's admiralty jurisdiction is invoked when the underlying claim arises from an Ocean Bill of Lading.<sup>150</sup> The United States Supreme Court has, on numerous

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<sup>149</sup> 46 U.S.C. Appx. § 1300, et seq.

<sup>150</sup> See Gilmore & Black, The Law of Admiralty, (2d Ed. 1975) §1-10, p.22, n. 63 ("Suits of this kind are now regarded as unquestionably within the jurisdiction, and constitute a large part

occasions, stated that the core function of admiralty jurisdiction is to redress the type of claim raised by APEX.<sup>151</sup> The Court has stated that the protection of maritime commerce was the core function of the grant of admiralty jurisdiction:

Although we recognize that protecting commercial shipping is at the heart of admiralty jurisdiction, we also noted that interest "cannot be adequately served if admiralty jurisdiction is restricted to those individuals actually *engaged* in commercial maritime activity ... The failure to recognize the breadth of this federal interest ignores the potential effect of noncommercial maritime activity on maritime commerce ....

[A] Court must assess the general features of the type of incident involved to determine whether such an incident is likely to disrupt commercial activity.

Our cases have made clear that the relevant "activity" is defined, not by the particular circumstances of the incident, but by the general conduct from which the incident arose .... Were the Courts required to focus more particularly on the causes of the harm, they would have to decide to some extent the merits of the causation issue to answer the legally and analytically antecedent jurisdictional question.<sup>152</sup>

In Exxon Corporation v. Central Gulf Lines, Inc., the Supreme Court considered the issue of whether a contract for agency was the proper subject of admiralty jurisdiction. Historically, such contracts had not been held to invoke admiralty jurisdiction. The Supreme Court held:

The District Court noted that "[a] prerequisite to the existence of a maritime lien based on a breach of contract is that the subject matter of the contract must fall within admiralty jurisdiction." ...

In determining the boundaries of admiralty jurisdiction, we look to the purpose of the grant. See Insurance Co. v. Dunham, 11 Wall. 1, 24, 20 L.Ed. 90 (1871). As we recently reiterated, the "fundamental

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of the business of the admiralty court.").

<sup>151</sup> Sisson v. Ruby, 497 U.S. 358 (1990) ("the fundamental interest giving rise to maritime jurisdiction is the protection of maritime commerce.")

<sup>152</sup> Id. at 362-365.

interest in giving rise to maritime jurisdiction is 'the protection of maritime commerce.'" (citations omitted).

As noted, the admiralty jurisdiction is designated to protect maritime commerce.... It is inappropriate, therefore, to focus on the status of a claimant to determine whether admiralty jurisdiction exists.<sup>153</sup>

APEX's maritime lien arises out of the restrictive endorsement on the fact of the primary document relevant to the transaction at issue: the Ocean Bill of Lading. An Ocean Bill of Lading is a unique document, and arises due to the unique requirements of maritime commerce. It is simultaneously a contract as well as a document of title.

A bill of lading is, in the first instance and most simply, an acknowledgment by a carrier that it has received goods for shipment. Secondly, the bill is a contract of carriage. Thirdly, if the bill is negotiable (as, for practical purposes, all ocean bills are) it controls possession of the goods and is one of the indispensable documents in financing the movement of commodities and merchandise throughout the world.<sup>154</sup>

The concurrent functions of an Ocean Bill of Lading are made necessary by the greatest peril to transactions involving goods in transit. There must be certainty that a purchaser is giving consideration to the actual party who is entitled to possession of the goods. The established maritime law, arising from commercial experience and practice, does not protect a party from the risk of double payment, where the party has not investigated title to the goods. This is so even where the purchaser is wholly "innocent" (See discussion *infra* part I.D.1).

The established maritime law does protect true owners, such as APEX, where the lien rights to the goods are properly recorded on the Ocean Bill of Lading relevant to the movement of the goods in transit. Allocation of the risks of fraudulent diversion between APEX and the purchaser is one of the hallmarks of the Ocean Bill of Lading. Professor Gillmore comments on the typical scenario of improper diversion of goods in transit:

A bill may be issued to a shipper who has no title to the goods. The thief, who has procured the bill to be issued, will seek to obtain advances against it, so there are good chances that the bill will end up in the hands of a good faith purchaser. On this state of facts the law

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<sup>153</sup> Exxon Corp. v. Central Gulf Lines, Inc., 111 S. Ct. 2071, 2073-75 (1991).

<sup>154</sup> Gilmore & Black, The Law of Admiralty, (2d Ed. 1975) §3-1, p.93.

protects the true owner of the goods, and incidentally, the carrier which has innocently issued its bill to the thief. The true owner may replevy the goods from the carrier or from anyone into whose hands they have passed after delivery. The carrier is doubly protected: if, without knowledge of the true owner's claim, it delivers the goods to the holder of the bill, the carrier is discharged.<sup>155</sup>

That there exists a maritime lien upon the goods, in favor of APEX, is made manifest by APEX's "ultimate destination" endorsement upon the Ocean Bill of Lading in its functional role as title to the goods. That endorsement put all purchasers of the goods on notice of APEX's lien rights.

That an in rem arrest is the appropriate remedy to foreclose a maritime lien on cargo is common and uncontroverted.<sup>156</sup> That the goods at issue are subject to a maritime lien is made manifest by the recordation of the "ultimate destination" endorsement on the Ocean Bill of Lading.

## **6. Civil RICO**

Based on the facts described herein, it is possible that the purchasers in these putative export transactions fraudulently misrepresented the ultimate destinations of these products in order to obtain the lower export price and that the persons involved in these schemes have violated the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-1968 ("RICO").

The RICO statute makes it unlawful:

- (a) for any person who has derived income from a pattern of racketeering activity to use or invest such income in the establishment or operation of an enterprise engaged in or affecting interstate or foreign commerce;
- (b) for any person through a pattern of racketeering activity to acquire or gain an interest in any enterprise engaged in or affecting interstate or foreign commerce;
- (c) for any person employed or associated with any enterprise engaged in or affecting interstate or foreign commerce to conduct or participate in the conduct of the enterprise's affairs through a pattern of racketeering activity;  
or

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<sup>155</sup> Id. at §3-4, p. 97.

<sup>156</sup> See generally T.J. Stevenson & Co., Inc. v. 81,193 Bags of Flour, 629 F.2d 338 (5th Cir. 1980).

- (d) for any person to conspire to violate any of the foregoing prohibitions.<sup>157</sup>

In this context, "racketeering activity" includes:

- (a) any act or threat involving murder, kidnaping, gambling, arson, robbery, bribery, extortion, dealing in obscene material or dealing in drugs which constitutes a felony under state law; and
- (b) any act indictable under a variety of federal criminal statutes including those prohibiting wire fraud, mail fraud, bribery, theft from interstate shipment, obstruction of justice, and interstate transportation of stolen merchandise.

An "enterprise" includes any individual, union, partnership, corporation, association or other legal entity, as well as a group of individuals associated in fact although not a legal entity. A "pattern of racketeering activity" requires at least two acts of racketeering activity within a ten-year period.

Violators of the RICO statute are subject to criminal penalties including fines (up to two times the proceeds of the racketeering activity), imprisonment (up to 20 years), and the forfeiture to the United States of any property obtained using the proceeds of the racketeering activity. In addition, any person injured by reason of a violation of the RICO statute may commence a civil action against the violators. In a private RICO action, the injured party may obtain injunctive relief and recover treble damages plus the costs of the suit, including a reasonable attorney's fee.

Civil RICO actions are subject to a four-year period of limitation,<sup>158</sup> with the cause of action accruing on the date of discovery. Many states, including New York and New Jersey, have enacted laws patterned after the federal RICO statute.

The RICO statute has been used successfully in gray market and diversion cases. In Shulton, Inc. v. Optel Corp., et al.,<sup>159</sup> Shulton brought a civil RICO action against numerous defendants alleging that they were engaged in a fraudulent scheme to induce Shulton to sell health and beauty products (e.g., Old Spice, Nina Ricci, Breck Shampoo) at substantially reduced export prices. In fact, the products were never shipped overseas. Instead, the products were sold to four large wholesale distributors in the United States. The defendants named in the suit included two Shulton employees who were bribed to participate in the scheme, the corporate entities that purchased the

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<sup>157</sup> 19 U.S.C. § 1962.

<sup>158</sup> 28 U.S.C. § 1658.

<sup>159</sup> No. 85-2925 (NHP) (D.N.J. September 29, 1986), 4 RICO L. Rep. 800 (RICO L. Rp. Inc.) (Nov. 1986). See also Shulton, Inc. v. Optel Corp., 698 F. Supp. 61 (D.N.J. 1988).

products from Shulton, the wholesale distributors who ultimately received the products, and the individuals who directed the corporate defendants.<sup>160</sup> After the defendants' various motions to dismiss were denied, the district court determined that if liability were proven the measure of damages would be the difference between the fraud induced export price and the domestic price Shulton would have received absent the defendants' misrepresentations.<sup>161</sup> Prior to trial, the defendants in Shulton agreed to a multimillion dollar settlement and consented to broad injunctive relief prohibiting them from dealing in Shulton products.

In Shulton, the predicate acts which were deemed to constitute racketeering activity included repeated instances of mail fraud and wire fraud, interstate transportation of fraudulently obtained merchandise, and bribery. The facts developed to date indicate that all of these predicate acts may be present in the APEX matter. The facts in Shulton describe a scheme in which large U.S. wholesalers were providing up front financing for the fraudulent purchases. Since the APEX matter may involve parties related to the Shulton defendants, counsel should explore the possibility that the same scheme is being used to purchase APEX products. Counsel should also be aware of the possibility that APEX employees, freight forwarders and other persons involved in these transactions may have been asked to participate in these schemes.

Another predicate act of “racketeering activity” commonly involved in a diversion scheme is money laundering.<sup>162</sup> Diversion is an ideal device for an offshore diverter to easily launder money through a “legitimate” sale of consumer goods. A diverter can simply wire the money to be laundered to the U.S. manufacturer as payment for the goods. In turn, the diverter sells the goods to a U. S. customer who wires the purchase price to an account selected by the diverter. The money has been laundered and there is a violation of 18 U.S.C. §1956 and another predicate act to trigger the civil RICO remedies of injunctive relief and treble damages.

## **7. Breach of Contract**

The elements essential to pleading a breach of contract claim are a valid contract, defective performance by the defendant, and resulting damages.<sup>163</sup> If there is a violation of a contractual restriction against domestic sales, relief can be sought in this area. Moreover, there is a duty to act

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<sup>160</sup> The defendants named in Shulton, Inc. v. Optel Corp. included Interstate Cigar and Sidney Spielfogel.

<sup>161</sup> Shulton, Inc. v. Optel Corp., 698 F. Supp. 61 (D.N.J. 1988).

<sup>162</sup> See 18 U.S.C. §1961

<sup>163</sup> Coyle v. Englander's, 199 N.J. Super. 212, 223, 488 A.2d 1083, 1088 (App. Div. 1985).

in good faith implicit in every contractual relationship under common law.<sup>164</sup>

So, while in this particular case APEX has not fashioned a contractual provision prohibiting domestic sales, it may still pursue a breach of contract claim in certain jurisdictions. In the Kentwood case, the court interpreted the duty of good faith as requiring that "neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract."<sup>165</sup> By improperly selling APEX products that were purposely intended for export, GONZO is destroying APEX's benefit from the sales.

#### **D. WHO HAS TITLE?**

One issue which generally arises in cases such as the one described herein is a question of title to the products. This is unfortunate in that it implies that the actions of GONZO and DIVCO are under the Uniform Commercial Code ("UCC") as an initial question. In fact, the diversion scheme outlined herein is properly addressed under the rubric of fraud, theft and criminal conversion. However, as title is a recurring question, this article will briefly address the issue.

First, title to the products returned to the United States belongs to the U.S. manufacturer (APEX) because the products constitute stolen property under the National Stolen Property Act.<sup>166</sup> Thus, APEX was never divested of its original title. Second, even if this act is not invoked, the consignor or its agents merely have voidable title because the products were obtained through fraud. The American importer acquires valid title only if it is a bona fide purchaser. However, the facts and case law suggest that in a situation such as our example, DIVCO does not fit the definition of a bona fide purchaser. Therefore, it does not have valid and marketable title. Finally, APEX retains title to the goods pursuant to the terms of the invoice.

##### **1. Title to Diverted Merchandise Never Vests in the Putative Buyer or U.S. Importer**

Title to the APEX products is vested in APEX because the products are classified as stolen as a matter of law. As discussed infra, diverted goods may be properly characterized as "stolen"

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<sup>164</sup> See Otto v. Prudential Property and Casualty Insurance Company, 278 N.J. Super. 176, 181, 650 A.2d 832, 834 (App. Div. 1994). See also M.T. Kentwood Construction Company, 278 N.J. Super. 346, 349, 651 A.2d 101, 103 (App. Div. 1994).

<sup>165</sup> Id.

<sup>166</sup> See discussion supra part I.A.1.a.

property within the meaning of the National Stolen Property Act.<sup>167</sup> APEX may not be divested of title by theft.<sup>168</sup> As such, title never vested in the putative buyer (GONZO) or its agents. Accordingly, APEX is the true owner of the products entering the United States.

The American importer (DIVCO) or any other party involved in the transportation or receipt of the stolen products may not claim valid title as a bona fide purchaser. One who steals cannot pass good title, even to a bona fide purchaser.<sup>169</sup> Therefore, because GONZO "stole" APEX products in the first instance, it may not pass any title to DIVCO or any other party.<sup>170</sup> APEX retains title to the products as against all subsequent possessors of the products. Because GONZO may not give title that it does not have, neither DIVCO, nor any other party, may claim title to such products. Therefore, APEX remains the valid owner of the products.

## **2. Any Title Claimed by the Foreign Exporter or U.S. Importer is Voidable Title**

Even if the National Stolen Property Act is not invoked, title acquired by a U.S. importer is merely voidable title because the products were procured by fraud. As stated above, APEX was fraudulently induced to sell to various buyers.

The U.S. importer may have valid title only if it is a "good faith" purchaser of the diverted products. Good faith is defined as "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."<sup>171</sup> Good faith is determined by looking into the mind of the person claiming to be a bona fide purchaser.<sup>172</sup> Accordingly, whether the American importer is a good faith purchaser is determined by looking into the mind of the American importer and not to

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<sup>167</sup> See id.

<sup>168</sup> See Textile Supplies, Inc. v. Garrett 687 F.2d 123, 127 (5th Cir. 1982) (Manufacturing company retained title to stolen products even though stolen products had been sold to a bona fide purchaser).

<sup>169</sup> See id. at 127 (one who stole from employer acquired only "void" title and could not pass valid title to a bona fide purchaser); In re Universal Clearing House, 62 B.R. 118 (D. Utah 1986).

<sup>170</sup> See UCC §2-403(1) ("A purchaser of goods acquires all title which his transferor had or had power to transfer....").

<sup>171</sup> UCC §2-103(1)(b); see also N.J.S.A. 12A:1-201(1) (defining good faith as "honesty in fact in the conduct or transaction involved").

<sup>172</sup> Johnson & Johnson Prod., Inc. v. Dal Int'l Trading Co., 798 F.2d 100, 104 (3rd Cir. 1986).

"what the state of mind of a prudent man should have been."<sup>173</sup>

In looking into the actions of GONZO and DIVCO, the good faith test is not met. One cannot meet the standard of "honesty in fact" when the transaction has been effected through false statements and fraudulent practices. If DIVCO has connected itself with the conspiracy to defraud APEX it cannot acquire clear title. DIVCO may be held liable for common law fraud or fraudulent inducement even if it "did not utter a specific misrepresentation itself, where [such person] has 'understandingly connected itself with the conspiracy [of others] to defraud the [seller] and [make] possible the accomplishment of the fraudulent scheme."<sup>174</sup> Such connection with the conspiracy to defraud disqualifies DIVCO as a bona fide purchaser, therefore only granting it voidable title in the products.

### **3. U. S. Producer Retains Title Pursuant to the Language on the Commercial Invoice**

APEX retains title to these products because, as the language on the commercial invoice provides, "beneficial and legal title to ... the merchandise shall remain with the seller until the shipment physically arrives..." at the ultimate destination. Therefore, title remains vested in APEX until the products reach Mozambique.

The UCC states that "[a]ny retention or reservation by the seller of the title in goods shipped or delivered to the buyer is limited in effect to a reservation of a security interest."<sup>175</sup> However, UCC §2-401(2) provides, "[u]nless otherwise explicitly agreed title passes to the buyer at the time and place at which seller completes his performance with reference to the physical delivery of goods, despite any reservation of a security interest and even though a document of title is to be delivered at a different time or place."<sup>176</sup>

A New York court has held that language reserving title in the seller until certain events occurred is a statement within the contemplation of §2-401(2) which alters the normal title transfer

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<sup>173</sup> Id.

<sup>174</sup> Shulton, Inc. v. Optel Corp., 1986 WL 15617 (D.N.J.) (quoting Judson v. Peoples Bank & Trust Co. of Westfield, 25 N.J. 17, 29 (1957) (appeal after remand).

<sup>175</sup> UCC §2-401(1).

<sup>176</sup> UCC §2-401(2)(emphasis added).

process.<sup>177</sup> Although the plaintiff in Silver argued that title passes on tender of goods where the contract requires delivery at destination under UCC §2-401(2)(b), the court stated that the contract provision on title transfer does not conflict with the UCC since that section specifically allows for parties to determine when title passes.<sup>178</sup>

Pursuant to the title retention agreement contained on the international commercial invoice, APEX retains title to the products until they reach their nominal destination (Mozambique). The buyer (GONZO) has "otherwise agreed" to this provision on the transfer of title. Therefore, title will transfer only in accordance with the provisions of the clause. Because the products did not reach the nominal destination, title never transferred from APEX to GONZO. Accordingly, APEX retains title to its goods pursuant to the language of the invoice.<sup>179</sup>

## II. DIVERSION: STOP IT BEFORE IT STOPS YOU

### A. PREVENTION

As noted supra, diversion can have extremely pernicious effects upon the marketing efforts of U.S. manufacturers. It is almost always advantageous for U.S. producers to prevent diversion from taking place rather than to seek remedies after it has already occurred. There are a number of methods by which U.S. companies can discourage or prevent diversion from occurring, all of which are rather simple and inexpensive to implement. As noted previously, criminal prosecution of diverters is, while possible, a rather rare event. Civil litigation, by its very nature, can be expensive and time-consuming. Further, there is little guarantee that at the end of such litigation the plaintiff will actually be able to recover damages from diverters notorious for both hiding assets and ignoring judgments. Companies should therefore take at least the following steps to protect themselves.

#### 1. Title Retention Clauses

One of the easiest and most effective means of discouraging diversion is to include a "Title Retention" clause on all documents related to international sales. This includes, quotations, pro forma invoices, bills of lading, packing lists, etc. Such a "Title Retention Clause" puts subsequent

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<sup>177</sup> See Silver v. Sloop Silver Cloud, 259 F. Supp. 187 (S.D.N.Y. 1966) (language in this case stated that "[t]itle to the vessel hereby ordered shall not pass to purchaser until the entire purchase price and any extra or additional charges have been paid in full or security acceptable to builder given therefor, and builder has delivered its bill of sale therein after provided").

<sup>178</sup> Id. at 192.

<sup>179</sup> See infra notes 180-186 and accompanying text.

purchasers on notice that the manufacturing company does not give up title until the goods are received in the intended country of destination. This has the effect of preventing diverters from claiming that they were unaware of any title claimed by the manufacturer when they reimport the products. This is powerful evidence to defeat claims that they are bona fide purchasers as a matter of commercial or Customs law.

It is important that this clause be on the face of documents, in that often, subsequent purchasers will claim they have only received photocopies of documents. If the Title Retention Clause is on the back of the document, they can claim they were never made aware of its existence.

Nonetheless, you should recognize that title retention clauses sometimes do not provide total protection against diversion. They are subject to many vagaries of law and practice, and are sometimes difficult to enforce. Your best initial defense against diversion is to sell goods on a "delivered" basis, retaining title and risk of loss until the merchandise reaches its final destination. We recognize, however, that this is not a commercially attractive option due to the fact that it raises costs generally reflected in final (delivered) prices. This sometimes makes a sale problematic, and also complicates letter-of-credit sales, which are better geared to "shipment" transactions.

A sample Title Retention Clause is as follows:

It is expressly agreed between the seller and the buyer that on all sales, beneficial and legal title to, ownership of, and right of possession to the merchandise shall remain with the seller until the shipment physically arrives ex-ship, at the port of entry in the country of ultimate destination. The time of payment, whether before or after shipment; the place or medium of payment; the method of shipment; the manner of consignment, whether to seller, or its agent, to buyer or its agent, or an agent for both; or any document in relation to any sale under this agreement shall in no way limit or modify the right of the seller as the legal and beneficial owner of the goods, its right to possession of such goods until they physically arrive ex-ship, at said port of entry in the country of ultimate destination. It is expressly agreed that transshipment through intermediate ports or consignees wherever located, shall in no way affect the retention of title by seller to the merchandise. The country of ultimate destination, as used in this Title Retention Agreement, is the country indicated on the Shipper's Export Declaration in box 33, "Country of Ultimate Destination." Further, it is expressly agreed between the seller and the buyer that the terms of this Title Retention Agreement are superior to and take precedence over any provisions of the Uniform Commercial Code or the Convention on the International Sale of Goods which may be otherwise inconsistent with the terms contained herein.

**IT IS SPECIFICALLY AGREED THAT NO THIRD PARTY MAY ACQUIRE ANY TITLE WHATSOEVER TO THE MERCHANDISE UNTIL SUCH MERCHANDISE PHYSICALLY ARRIVES (EX-SHIP) AT THE PORT OF ENTRY IN THE COUNTRY**

## **OF ULTIMATE DESTINATION AS DESCRIBED HEREIN.**

### **2. Reclaiming Title**

#### **UCC versus Convention on Contracts for the International Sale of Goods**

Unless the contracting parties explicitly exclude its application, a contract for the sale of goods for export by a United States company is automatically governed by the United Nations Convention on Contracts for the International Sale of Goods ("CISG"), if the purchaser is from a country which is also a signatory to the CISG. If the purchaser is not from a signatory country, the parties may nevertheless choose to make the CISG applicable to the contract. If the CISG does not apply for any reason, the contract will in all likelihood be interpreted in accordance with Article 2 of the Uniform Commercial Code ("UCC") as adopted by the state in which the exporter resides.

Even when the CISG does apply, its provisions will not resolve a question regarding passage of title. The CISG provides that it "governs only the formation of the contract of sale and the rights and obligations of the seller and the buyer arising from such a contract." Specifically, the Convention states that it is not concerned with:

- (a) the validity of the contract or of any of its provisions or of any usage;
- (b) the effect which the contract may have on the property [i.e., title] in the goods sold.

With respect to exported merchandise which the seller suspects may be fraudulently diverted back to the United States market, it may be difficult to know what law will govern the contract. The putative purchaser may, in fact, be a fictitious entity. The real purchaser may be a U.S. company or it may be a resident of a country other than the one identified in the contract. Also, the CISG, by its own terms, does not address issues of contract validity or title transfer. Consequently, even if the seller insists with respect to each sale on a stipulation that the CISG applies, the contract language must allow for the possibility that both the UCC and the CISG will apply.

Under the UCC, a fraudulently-obtained contract of sale conveys voidable title.<sup>180</sup> Where the buyer breaches a contract of sale, the UCC allows the seller to cancel or rescind the contract, stop delivery of goods in transit, and reclaim goods.<sup>181</sup> In the case of a fraudulent contract, such rescission should be effective to void the transfer of title to the purchaser and restore title to the

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<sup>180</sup> See UCC Art. 2-403.

<sup>181</sup> UCC Art. 2-703, 2-705.

goods to the seller.<sup>182</sup> Such rescission will not impair the seller's right to pursue claims for damages.<sup>183</sup>

Under the CISG, the seller has the right to "avoid" a contract if the buyer commits a fundamental breach of the contract, provided the seller gives timely notice of the breach.<sup>184</sup> Although the CISG does not address the concept of passage of title in its provisions, avoidance of a fraudulent contract should allow the seller to reclaim the goods. Avoidance of a contract will not impair a seller's right to pursue a claim for damages.<sup>185</sup>

Reclaiming title is preferable to retaining title for many reasons. The UCC explicitly provides: "Any retention or reservation by the seller of the title (property) in goods shipped or delivered to the buyer is limited in effect to a reservation of a security interest."<sup>186</sup> Thus, under the UCC a title retention clause may not be given effect. Moreover, a security interest in the goods may not be very useful in mitigating the harm caused by a diversion scheme. In a typical diversion scheme, the buyer pays for the goods prior to exportation. A judge may be reluctant to seize goods to protect the security interest of a seller who has already been paid. Enforcement of the security interest could also lead to a public auction of the diverted goods which could result in the introduction of the goods into the United States market at very low prices.

In contracts for the sale of goods, passage of title is closely connected to passage of risk of loss. Risk of loss is governed by the terms of sale, e.g., FOB, CIF, etc... A title retention clause which appears to conflict with well-understood commercial terms of sale may confuse the question of who bears the risk of loss and possibly expose the seller to unwarranted claims for damages should the goods be lost or damaged in transit. In contrast, a provision allowing the seller to void the contract and reclaim title under specified conditions would allow the seller to agree to whatever terms of sale it finds most advantageous. Risk of loss would not become an issue unless and until the seller exercised its right to void the contract.

The language suggested for the bills of lading, packing lists, and pro forma invoices is intended to put shippers, freight forwarder, brokers, prospective purchasers and others on notice that diversion of the goods is not authorized and could make them liable for misdelivery of goods in

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<sup>182</sup> UCC Art. 2-721.

<sup>183</sup> UCC Art. 2-720, 2-721.

<sup>184</sup> CISG Art. 64.

<sup>185</sup> CISG Art. 61.2.

<sup>186</sup> UCC Art.2-401(1).

which the seller may have an ownership interest. To the extent the documents are used in a resale transaction, the statements could also undermine claims that the goods are not recoverable because they have been transferred to a bona fide purchaser ("BFP") without notice of the diversion.

### Recommended Language

In contracts of sale:

"Buyer agrees that diversion of the goods which are the subject of this transaction from the destinations identified in this contract of sale, i.e., \_\_\_\_\_, constitutes a fundamental and material breach of the contract of sale. If the goods are diverted from the intended destinations, then, in accordance with Article 2 of the Uniform Commercial Code and/or Articles 61 and 64 of the United Nations Convention on Contracts for the International Sale of Goods, the contract of sale may be voided in the sole discretion of the seller, and all right, title and interest in the goods that passed thereunder shall revert to the seller. In the event of such a breach, the buyer shall be liable to the seller for all costs, fees and expenses incurred by the seller in connection with the recovery of the goods, including reasonable attorney fees. This provision may not be waived except in a writing signed by the seller."

On bills of lading/packing lists/ pro forma invoices:

"Diversion of these goods from their intended destination, i.e., \_\_\_\_\_, without the written consent of the seller constitutes a fundamental and material breach of the contract of sale entitling the seller to ownership and possession of the goods. The parties responsible for diverting the goods will be subject to claims for monetary damages."

### **3. "Poison labels"**

"Poison labeling" is a practice of marking products destined for export markets in a manner which is inconsistent with U.S. requirements for products sold in the United States. For example export products can be marked:

- \* Only in metric units;
- \* Only in a foreign language;
- \* "Made in U.S.A.", especially if the goods would not comply with the definition of this term under U.S. law;

- \* Without safety or ingredient warnings required by U.S. law (be careful about using this method with hazardous substances, however, since U.S. law requires even exported products to contain warnings).

These are only examples of "Poison labeling" which may result in the products being excluded by the U.S. Customs Service if the diverter attempts to reimport them. Some companies also include language on the label that the goods are "For Export only". While this language can be somewhat helpful, especially for goods subject to excise taxes (such as cigarettes and alcoholic beverages), in general, it does not give the protection of "genuine" poison labels for other consumer goods.

#### **4. Offshore Pricing**

If diversion appears to be a major problem with a company, its sales executives might consider reducing the pricing differential between domestically-sold goods and those destined for sale in Third-world markets. While this may be a difficult competitive decision, raising the price for certain export markets reduces the incentives for diversion. Further, since the goods are often not actually destined for third countries in any event, the competitive considerations sometimes become moot.

#### **5. Salting**

One of the best methods of detecting diversion is to "salt" random cartons of products with identification envelopes. These envelopes are placed in a conspicuous place on the inside of the carton. When the carton is opened in the stock room of the final purchaser, the employee doing so will notice a \$5.00 note taped to the outside of an envelope. People notice things like that. Almost invariably, the stocker will then open the envelope, and discover a questionnaire, which asks numerous questions concerning the identity of the buyer. It also promises to send the person filling out the questionnaire \$50.00 if they complete the document and send it back immediately. This method has around a 75% success rate on locating the real destination of goods. Of course, "salting" does not prevent diversion, but is a reliable indicator that it is actually taking place.

#### **6. Altering UPCs**

One of the most effective means of discovering diversion is to alter export UPC labels. This alteration creates havoc if the products are scanned in a U.S. retail store, and strongly discourages such outlets from dealing with certain diverters. This method, however, entails obvious risks. Often, major U.S. retail chains inadvertently purchase diverted merchandise, and do not take it kindly when their computers register incorrect information.

## 7. Intellectual Property Registration

One of the simplest, cheapest and most effective means of preventing diversion is the most often overlooked. If the goods in question incorporate a trademark, or if the labels are copyrighted, a simple re-registration of the marks with the U.S. Customs Service can be a significant deterrent to unauthorized importation. This process can be done "in house" and is very inexpensive (around \$200 per registration).

As a matter of policy, every company should automatically register labels of their products with the Copyright Office. This can take as little as a week per label to accomplish. Once the registration is complete, companies should re-register each copyright with Customs. The procedure for trademarks is similar, but takes a bit longer, and generally requires the assistance of trademark counsel for the initial registration of the mark with the Patent and Trademark Office (PTO). After the PTO registration process is completed, however, re-registration of the mark with Customs follows the same procedures as with copyrights.

The rights accorded by Customs registration are somewhat different for copyrights and trademarks. Copyrighted goods may be excluded altogether by the legitimate copyright holder; legitimate trademarked goods present some rather technical problems, but if trademarked goods are detained by the Customs Service, it can give the legitimate trademark holder an opportunity to take action to prevent entry.

When the Customs Service detains unauthorized imports, it can exclude the goods entirely from the U.S. market, and in some cases, seize the products. Customs has statutory authority to take these actions<sup>187</sup> and it is entirely an administrative proceeding.<sup>188</sup>

## 8. Shipping

Companies which are regularly involved with international sales should seriously consider acting as their own shipper. This need not involve much more than hiring (or training) a single individual to make all arrangements for the transportation of the products. The company can then familiarize itself with reliable trucking, warehouse and ocean shipping firms, and often negotiate favorable rates. Further, acting as a shipper gives the exporting company significantly more control over the destination of the goods than allowing customers to specify carriers and warehouses. To the extent that diverters can take possession of the product at the plant gate, they often do not need to go through elaborate means of transshipping the goods to an intermediate offshore destination --

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<sup>187</sup> See discussion supra part I.B.2.

<sup>188</sup> See 19 C.F.R. Part 171.

they merely steal the goods before they even leave the United States. If for some reason the company uses the carrier selected by the customer, the company should perform a good amount of due diligence on the carrier. A company should check the credentials of the proposed shipper including if the shipper runs criminal record and reference checks on its employees.

## **9. Buyer Scrutiny**

By far the best approach for avoiding diversion is to carefully scrutinize prospective purchasers, and to be alert to "Red Flags" which often signal that a diversion scheme is present. Among the items a company should watch for are:

- \* Are the principals of the buyer personally known to the manufacturer? If not, can the potential purchaser supply references of other firms with which it has dealt? Even if company personnel are familiar with the prospective buyers, exporters should be cautious. Diverters are infamous for the number of aliases they carry. Often, an individual will be known to a company under one name, and known to the Customs Service and other law enforcement authorities under others.
- \* Is the order unusual for its described destination? An order of 100,000 cases of cat food may not be unusual for Canada, but the exporter should question a similar order allegedly coming from Azerbaijan.
- \* Do the prospective buyers, freight forwarding companies or warehouses appear on any of the data bases of known diverters? These data bases are sometimes maintained by the Corporate Security departments of major exporting companies, and by some highly specialized law firms. You should be careful, however, of relying exclusively on such data bases. Merely because a firm does not appear on a data base, it is not automatically "clean". The individuals and companies involved with diversion schemes often change their names and addresses to avoid identification.
- \* Are you able to contact the prospective purchasers personally over the telephone, or are you told that the purchasers will call you back? The phony companies which are often involved in diversion schemes sometimes use answering services, a clear signal that all is not as it seems with the company.

- \* Are the goods destined for an intermediate port such as Rotterdam, Antwerp or Hong Kong before being forwarded to the putative "ultimate destination"? While such transfers are not unusual, particularly if goods are going to an out-of-the-way destination, these ports, along with Alexandria, Egypt, Iqueque, Chile and Naples, Italy, are famous haunts of diverters. If possible, arrange shipping direct from the United States to the country listed as the final destination. While this is not a fool-proof method, it does make life more difficult for the diverters.
  
- \* Does the putative buyer insist on acting as shipper? Diverters will stress that they have a "deal" with a shipping company or ocean carrier. Their claims are bogus and are merely a ruse to camouflage the diversion scheme.

## **B. CONTROL**

If you even suspect that your company is the victim of diversion, you should immediately contact outside professionals to assist in determining the extent of the problem. There are only about twenty law firms and Private Investigators in the country which specialize in this type of commercial fraud. It is generally advisable to use one of them, since they will have the resources and experience to handle such cases efficiently.

It is important to note that diversion schemes sometimes come in the form of misdirection of product overruns or of product marked for destruction. To prevent these type of schemes, it is important for a manufacturer to closely supervise the disposal process including performing inventory on disposed product and preferably destroying the product on site rather than risk it in the hands an outside company.

Unfortunately, many diversion schemes rely upon "inside information" from individuals within a company, and high-profile internal investigations are often reported by the "faithless employee" to the diverters even before the inquiry is underway. Further, internal investigations are sometimes ineffective given the fact that if there is a "mole", he can advise the diverters as to how to avoid detection. Outside investigators often have specific knowledge about individuals and companies which have been identified as diverters in the past, and there is little "learning curve" to pay for.

It is extremely important during the investigation period that as few people as possible within the company be aware of the inquiry. Even if no "mole" exists, rumors of an investigation often leak to the wrong people, and the investigator's job is made much more difficult. In many cases, it is

possible for the investigators to reclaim at least part of the diverted goods if the diverters are kept in the dark about the investigation.

Once possible diverters have been identified, companies should not hesitate to suspend shipments to them regardless of whether they decide to pursue other legal remedies. Although there are minor antitrust concerns which should be addressed by counsel, cutting off foreign diverters does not usually entail much legal risk.<sup>189</sup> The commercial risks associated with continuing to supply individuals who are defrauding a company can be substantial, and even from a legal perspective, continuing to ship to a company which is stealing product can weaken a subsequently-filed damages action.

### III. CONCLUSION

Diversion has become increasingly expensive for legitimate American exporters. It not only wrecks marketing plans, but provides organized crime with a simple method for laundering money. Although diversion is sometimes difficult to detect and prevent, companies can take a number of "self-help" measures which can deter diverters. Thereafter, a number of legal remedies can be employed to recover significant damages from the perpetrators of these schemes.

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<sup>189</sup> It is settled that a manufacturer or other seller is free to "exercise his own independent discretion as to parties with whom he will deal." United States v. Colgate & Co., 250 U.S. 300, 307 (1919). Suppliers are free to act unilaterally in selecting dealers, changing dealers and cutting off existing dealers. See Business Electronics Corp. v. Sharp Electronics Corp., 485 U.S. 717 (1988); Burdett Sound, Inc. v. Altec Corp., 515 F.2d 1245, 1249 (5th Cir. 1975). A group boycott, or concerted refusal to deal, to eliminate competition violates antitrust law, but parallel unilateral behavior does not, especially where the manufacturers or suppliers had a legitimate business purpose. See, William C. Holmes, Antitrust Law Handbook (1993), pp.283-285.