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Can We Keep Those Gray Market Goods Out of Here? The Unresolved Tension Between §§ 109 and 602 of the Copyright Act Following the 4-4 Split in *Costco v. Omega*

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Does the first-sale doctrine apply to gray market goods—those made overseas and imported without the permission of the copyright holder? This is an issue that the Supreme Court in *Quality King Distributors Inc. v. L'Anza Research International* never decided.[1] But with the gray market now a multi-billion industry, the copyright supply chain—those who make, distribute, import and sell copyrighted goods—were hoping that the Supreme Court in *Costco Wholesale*

[1] 523 U.S. 135, 45 USPQ2d 1961 (1998)

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Corp. v. Omega S.A. would now finally decide this issue. Well, wait some more.

The Supreme Court's 4-4 deadlock (with Justice Elena Kagan taking no part) in *Costco* leaves us where we were with lots of questions and no definitive guidance.[2] The court in *Costco* issued a per curiam opinion affirming the decision in the U.S. Court of Appeals for the Ninth Circuit, which ruled in favor of the copyright holders.[3] As a result, the Ninth Circuit's decision only has precedential value in that circuit.

How sound is the Ninth Circuit's opinion? Will the Second Circuit follow it in the three pending cases raising the same issue now before that court? What guidance does the present state of the law give importers and domestic copyright holders following the deadlock? Some answers below.

The Interplay Between the Importation Right and the First Sale Doctrine

At issue in *Costco* is the tension between two statutory rights in the Copyright Act. Think of a seesaw, that narrow board in the playground where, if one side goes up, the other goes down. Instead of your young kids at either end, there are competing sections of the act. Which will the court consider the weightiest?

On the one hand, the copyright holder has the right to regulate the importation of its goods by Sections 602(a)(1) and 106(3) of the act. Section 602(a)(1) provides that ''[i]mportation into the United States, without the authority of the owner of the copyright under this title, of copies . . . of a work that have been acquired outside the United States is an infringement of the exclusive right to distribute copies . . . under section 106.''

Section 106(3), in turn, states that ''[s]ubject to sections 107 through 122, the owner of copyright under this title has the exclusive rights to do and to authorize . . . [the] distribut[ion] [of] copies . . . of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending.''

At the other end of the seesaw is Section 109(a), known as the first sale doctrine. It states that the owner of a copyrighted work ''lawfully made under this Title'' has the right to sell the work without the permission of the copyright holder. In essence, this section provides that, when the copyright owner sells a particular work lawfully manufactured with its authorization, the copyright owner loses or exhausts its Section 106(3) distribution right and can no longer control the further distribution of that work.

If imported goods made abroad and imported without the permission of the copyright holder are protected by the first sale doctrine, the owner of those goods is exempt from Section 602 liability. But, if that section trumps the first sale doctrine, owners of these gray market face Section 602 exposure. Let's see how the courts have resolved this issue.

The Facts in *Costco v. Omega*

Omega made watches in Switzerland and sold them for exclusive distribution outside the United States. To gain copyright protection, Omega engraved on the back of the watches a small copyrighted logo called the Omega Globe Design that Omega registered with the Copyright Office.

Unidentified third parties imported the watches without Omega's authority into the United States, where they sold them to Costco, which retailed them to consumers at prices far below those Omega charged for the same watches it manufactured domestically.[4]

When Omega discovered that Costco was undercutting its market, Omega sued Costco for copyright infringement under Sections 106(3) and 602 of the Copyright Act. Costco defended on the ground that its sales were protected by the first sale doctrine.[5]

The Ninth Circuit Finds for Omega

The district court without explanation granted Costco summary judgment. It is hard to believe the district court dismissed a case of this importance without an opinion; but that is what apparently happened. The Ninth Circuit reversed. It held that under circuit precedent, Section 109(a) does not provide a defense to an infringement claim under Sections 106(3) and 602(a)(1) for imported copies made abroad and intended only for overseas distribution.[6] The circuit court explained that the holding in *Quality King* neither overruled Ninth Circuit precedent nor undercut the theory or reasoning of its prior cases on this subject.[7]

Quality King Involved Roundtrip Importation

The circuit court observed that *Quality King* rested on different facts—a roundtrip importation involving copies made in the United States, sold to a third party overseas and then shipped back into this country. The Ninth Circuit stated that, because *Quality King* only involved domestically made goods, it did not address the effect of Section 109(a) on gray market goods.[8]

The Presumption Against Extraterritoriality

The Ninth Circuit indicated that the reasoning of *Quality King* also did not undermine circuit precedent. Its earlier cases recognized that finding a copy made overseas as ''lawfully made under this title'' ''would violate the presumption against the extraterritorial application of the act.''[9] *Quality King* in a cryptic footnote 14 dismissed a similar concern with respect to foreign sales, stating that protecting them under the first sale doctrine ''does not require the extraterritorial application of the Act.''[10] The court never explained why extending that doctrine to a foreign sale is not an extraterritorial application.

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[2] 131 S. Ct. 565, 96 USPQ2d 2025 (2010)(81 PTCJ 205, 12/17/10).

[3] 541 F.3d 982 (9th Cir. 2008).

[4] 541 F.3d at 984.

[5] *Id.*

[6] *Id.* at 986.

[7] *Id.* at 987-990.

[8] *Id.* at 988-990.

[9] See *BMG Music v. Perez*, 952 F.2d 318, 21 USPQ2d 1315 (9th Cir. 1991), *Parfums Givenchy Inc. v. Drug Emporium, Inc.*, 38 F.3d 477, 32 USPQ2d 1512 (9th Cir. 1994), and *Denbicare U.S.A Inc. v. Toys ''R'' Us Inc.*, 84 F.3d 1143, 38 USPQ2d 1865 (9th Cir. 1996)

[10] 523 U.S. at 264 n.14.

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But the Ninth Circuit found that applying the first sale doctrine to foreign-made copies went too far. The circuit court said that to extend that doctrine to foreign manufacturing ''would impermissibly apply the Copyright Act extraterritorially in a way that the application of the statute after foreign sales does not.''[11] The circuit court explained, ''To characterize the making of copies overseas as 'lawful[] . . . under [Title 17]' would be to ascribe legality under the Copyright Act to conduct that occurs entirely outside the United States.''[12]

I don't see a distinction between sales abroad (no extraterritorial application of the first sale doctrine) and manufacturing abroad (extraterritorial application of that doctrine); but the Ninth Circuit apparently felt it had to create a distinction to escape the application of footnote 14 in *Quality King*.

'Lawfully Made' Refers to Those Goods Made in the U.S: The British Example

The circuit court added that *Quality King* had distinguished between copies lawfully made under U.S. versus foreign law.[13]

In much-cited and followed dicta, *Quality King* gave an example involving a U.S. copyright owner's division of its distribution rights between an American and British publisher. In this example, the court stated that, if an author gave exclusive U.S. distribution rights to a publisher of the U.S. edition and exclusive British distribution rights to the publisher of British edition, who then decided to sell in the American market, only the copies made by the publisher of the U.S. edition would be 'lawfully made under this title.' ''

The court never explained why the copies made by the British publisher would not be lawfully made. But as the solicitor general argued in his amicus brief in *Costco* at p. 14,[14] the most ''natural explanation'' for the court's conclusion is that the British copies would not be lawfully made because they would be made in a jurisdiction where the act does not apply.

Relying on that distinction, the Ninth Circuit concluded that ''copies covered by the phrase 'lawfully made' in § 109(a) are not those simply made by the owner of a U.S. copyright''; they are those made ''within the United States, where the Copyright Act applies.''[15]

The Ninth Circuit also cited Justice Ruth Bader Ginsburg's concurring opinion in *Quality King*, which noted that the goods in that case involved a ''round trip journey'' and which ''recogniz[ed] that we do not today resolve cases in which the allegedly infringing imports were manufactured abroad.''[16]

The Court Divides 4-4

In response to Costco's certiorari petition, the court in October 2009 invited the views of the solicitor general, who urged the court not to take the case, stating that the Ninth Circuit's decision was consistent with *Quality King* and did not conflict with any circuit precedent (79 PTCJ 702, 4/9/10). The court rejected then-Solicitor General Elena Kagan's recommendation and granted certiorari in April 2010, forcing her to withdraw from the case when she joined the Court.

Two Approaches for Determining When a Work Is 'Lawfully Made Under This Title' Under Section 109(a)

Section 109(a) only applies to goods ''lawfully made under this title.'' But what does ''lawfully made'' mean? There is no clear definition. Almost all courts conclude, with considerable reluctance, that ''lawfully made'' refers to the place of manufacture.

Under this view, a copy can be lawfully made only if the copyright statute governs the act of manufacture. Because the rights granted by the Copyright Act extend no further than the nation's borders, a copy manufactured outside the United States cannot be governed by the statute. In other words, under this view, the making of a copy abroad for distribution there does not implicate any of the exclusive rights granted under Section 106 and therefore is neither lawfully nor unlawfully made ''under this title.'' The foreign copy instead is in legal limbo.

Omega in its brief to the court argued this view, and four justices agreed.[17]

A few courts, including the Third Circuit in *Sebastian International Inc. v. Consumer Contacts Ltd.*, are uneasy with the conclusion that ''lawfully made'' is territorial and refers to where the work is manufactured.[18] These courts urge that ''lawfully made'' should instead be determined by the lawfulness of the work's manufacture. This is the view that Costco urged the court to adopt.[19]

Under this view, if the copyright holder authorizes the making of the copies, they are lawfully made and thus governed by the statute wherever manufactured. Courts taking this view conclude that goods made abroad at the request of the copyright holder are therefore lawfully made, and their sale abroad exhausts the copyright owner's exclusive right under Section 602 (a)(1) to control importation into the United States.

Quality King appears to offer support for this view. It broadly stated that ''the literal text of § 602(a) is simply inapplicable to both domestic and foreign owners of L'anza's products who decide to import them and resell them in the United States.''[20] Further, as Justice Antonin Scalia rhetorically asked during oral argument in *Costco*, if Congress intended that lawfully made under this title meant lawfully made in the United States, ''why didn't they [Congress] say'' that?[21]

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[11] 541 F.3d at 988.

[12] *Id.*

[13] *Id.* at 988-89.

[14] The brief is at http://www.ipinbrief.com/wp-content/uploads/2011/03/sg-brief.pdf. The Ninth Circuit assumed the same conclusion; 541 F.3d at 989/

[15] *Id.* at 988.

[16] *Id.* at 989.

[17] Omega's brief may be found at http://www.ipinbrief.com/wp-content/uploads/2011/03/omega-brief.pdf.

[18] 847 F.2d 1093, 7 USPQ2d 1077 (3d Cir. 1988).

[19] Costco's main brief may be found at http://www.ipinbrief.com/wp-content/uploads/2011/03/costco-brief.pdf.

[20] 523 U.S. at 145

[21] The transcript of the oral argument is at http://www.supremecourt.gov/oral_arguments/argument_transcripts/08-1423.pdf.

Nevertheless, almost all courts that have wrestled with this issue ultimately conclude, based on the British example in *Quality King*, that the first sale doctrine does not extend to copies manufactured abroad.

Southern District of New York Judges Have Applied Section 602 to Bar Importation of Works Made Abroad and Imported Without Authorization

Judges in a number of copyright cases in the U.S. District Court for the Southern District of New York involving textbook arbitrage have, as Judge Shira Scheindlin stated in *Pearson Education Inc. v. Arora*, ''unenthusiastically'' applied the British example to reject Section 109(a) defenses.[22] In each case, the arbitrage was the same: small importers bought lower prices textbooks made abroad for distribution overseas and resold them here in competition with the more expensive U.S. edition.

In finding infringement under Sections 106(3) and 602, the Southern District stated its reluctance with this result in different ways. In *Pearson Education Inc. v. Liu*, Judge Richard J. Holwell stated that ''nothing . . . in the history and purposes of the first-sale doctrine . . . suggests that the doctrine should not apply when a copy is manufactured abroad. First, the common law policy against restraints on trade and alienation which is not limited where a good is manufactured; a prohibition against selling books manufactured in China is just as much a restraint on trade and alienation as a prohibition against selling books manufactured in Chicago.''[23]

Judge Donald C. Pogue in *John Wiley v. Kirtsaeng* noted that the ''legislative history surrounding sections 109 and 602'' was ''inconclusive.[24] The court was also concerned about a ''bright-line rule'' that would result ''in the phenomenon that, once imported, the goods manufactured abroad could provide the U.S. copyright holder with never-ending section 106(3) 'exclusive distribution' protection against any subsequent sale, no matter how legitimate . . . such goods, he or she would be subject to liability for copyright infringement regardless of how far that sale is removed from the first-sale after importation.''[25]

Nevertheless *Kirtsaeng*, relying on the British example, prohibited defendant from relying on the first sale defense at trial. A jury assessed the defendant statutory damages of $600,000 for the defendant's willful infringement of eight textbooks.

The Three Second Circuit Appeals

All three cases are now before the Second Circuit. *Kirtsaeng* was argued on May 19, 2010. *Arora* was argued on Jan. 19, 2011, and *Lui* was argued on March 21. The Second Circuit had delayed decision in *Kirtsaeng* after the Supreme Court granted certiorari in *Costco*. Now that *Costco* issued no guidance, a decision in *Kirtsaeng* is expected shortly.

These three cases all deal with the heart of copyright— educational textbooks. Whether this element will tip the seesaw in favor of the first sale doctrine is an open question.

The Two-Sides of the Policy Debate

The policy issues divide the copyright community, with each side making arguments that resonate.

Those favoring the first sale doctrine argue that granting greater protection via Section 602(a) to goods made abroad creates perverse incentives for U.S. copyright holders to manufacture their copyrighted works overseas, thereby eliminating American jobs. The problem is enhanced by the ease by which manufacturers can apply a copyrighted symbol or label to almost any package offered for sale here and thereby gain import protection under Section 602(a).

Failing to shelter gray market goods with the first sale defense also distorts incentives for downstream retailers. That is because they often do not know nor can they ascertain whether the goods they distribute are subject to claims under Section 602(a).

Further, consumers are also hurt by the absence of the first sale defense. That is because imposing Section 602(a) liability on gray market goods subjugates retailer competition to copyright owner price controls resulting in fewer goods offered and at higher prices. Moreover, although Congress may have the power to create an incentive for foreign outsourcing, how does sending jobs to foreign countries ''promote the Progress of Science and useful Arts'' in the United States?

Arguments in Favor of Applying Section 602(a)

Those opposing application of the first sale defense to gray market goods argue that the defense would undermine the value of U.S. copyrights harming copyright owners and consumers for several reasons. First, gray market imports ''free ride'' on the recognition and goodwill generated by a copyright owner's investment in its copyrighted work. Businesses make significant investment in product design, services, and promotion to gain brand recognition and consumer confidence. Free riders exploit this brand recognition and product appeal.

Second, consumer dissatisfaction arising from gray market imports, which can differ in design, quality and intended usage, and warranty protection, further diminishes the value of U.S. copyrights. Consumer dissatisfaction arises because gray market goods are designed to conform to the law, standards, and culture of the foreign country in which they are manufactured. Thus, as *Pearson v. Liu* noted, foreign edition textbooks are printed on ''thinner paper'' with ''fewer ink colors and lower quality photographs and graphics.''[26]

Consumer dissatisfaction is compounded because the manufacturer's domestic warranty almost never covers gray market goods. In addition, despite the significant differences that may exist between authorized and gray market good, consumers are almost never told that the goods they are buying were not intended for sale in this country.

[22] 717 F. Supp. 2d 374, 379 (S.D.N.Y. 2010)

[23] 656 F. Supp. 2d 407, 413, 93 USPQ2d 1139 (S.D.N.Y. 2009).

[24] 2009 WL 3364037 * 11, 93 USPQ2d 1432 (S.D.N.Y.) (79 PTCJ 6, 11/6/09).

[25] *Id*. at 15 n. 25.

[26] 656 F. Supp. 2d at 408.

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Third, the gray market devalues a copyright associated with an unauthorized import by depriving the copyright owner of the opportunity to control the manner and scope of distribution of the copyrighted work.

Fourth, Section 602 makes for market segmentation, allowing companies to sell their products in different markets at different prices to reflect varying demand conditions and distribution strategies. This segmentation permits distribution in lower-priced markets without undercutting the value of distribution rights in higher-price markets. This price discrimination enhances the value of a creator's U.S. copyright.[27]

Finally, contract remedies are also inadequate. The U.S. copyright holder is often not in privity of contract with the foreign importer who is not bound by the restrictions placed on distribution by the copyright holder.

Some Guarded Predictions and Guidance for the Future

Absent additional Supreme Court guidance or congressional action, courts and litigants will continue to struggle to reconcile Sections 109(a) and 602. But some guidance is possible.

First, goods involved in a roundtrip journey, as in *Quality King*, will continue to enjoy the first sale doctrine. Second, goods manufactured abroad and imported by the copyright holder will also enjoy the first sale defense because Section 602 by its express terms only extends to goods imported without the authorization of the copyright holder.

Third, goods made abroad and then licensed by the copyright holder to third parties abroad for overseas use will not be sheltered by the first-sale doctrine because, as the court stated in *Quality King*, that doctrine does ''not provide a defense to a § 602(a) action against a nonowner such as a . . . licensee.''[28] Fourth, although there are significant countervailing policy interests, it is likely that courts will continue to follow the Ninth Circuit's *Costco* decision and subject gray market goods to Section 602(a) liability based on the British example in *Quality King*, unless the court indicates otherwise.

But what will the Supreme Court do with the next case that raises this issue? Although predictions on how the court will rule are not for the faint of heart, four justices sided with Costco. If the result in that case drives more copyright holders to manufacture overseas to gain Section 602(a) protection as Costco warned, more than four justices may be inclined next time to broaden the first sale doctrine beyond the reach given it in *Quality King*.

[27] The American Watch Association presented these arguments to the court in *Costco* in a well drafted amicus brief which may be found at http://www.ipinbrief.com/wp-content/uploads/2011/03/american-watch.pdf.

[28] 543 U.S. at 147.