"Costco v. Omega, 562 US __, *Per Curiam*: Are foreign-sold gray market goods exempt from the first sale doctrine?

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I. INTRODUCTION

In *Costco v. Omega* the Ninth Circuit held that the first sale doctrine was not available as a defense to unauthorized importation and distribution of a U.S. copyrighted work that was first made or sold outside of the U.S. under the authorization of the copyright owner because the Copyright Act does not extend to activity outside the U.S. The Supreme Court granted certiorari and heard argument in November 2010. The Court's review of *Costco* had the potential to dramatically affect intellectual property rights because a broad holding on exhaustion of copyright could potentially extend to patent and trademark rights.

In December of 2010, the Supreme Court issued a per curiam opinion affirming the Ninth Circuit's holding in *Costco*. The Court's opinion is non-binding because the Court split 4-4. Justice Kagan did not participate. As a result, the issues of whether the first sale doctrine extends to extraterritorial activity and whether the *Costco* extraterritorial limitation applies to other areas of intellectual property law were not decided by the Court. This paper first discusses *Costco* and its relation to the Court's earlier holding in *Quality King*. Next, it addresses the exhaustion doctrine in patent law and how a decision in the context of copyright law could affect patent rights.

II. *COSTCO V. OMEGA.*

Section 106(3) of Title 17 provides a copyright owner the exclusive right to distribute copies of a copyrighted work, subject to Sections 107 through 122. 17 U.S.C. § 106(3). Section 602(a)(1) provides that importation into the U.S. of copies of a work that have been acquired outside of the U.S. without the authority of the copyright owner is an infringement of the exclusive right to distribute under Section 106. 17 U.S.C. § 602(a)(1). Section 109(a) states that "[n]otwithstanding the provisions of Section 106(3), the owner of a particular copy or phonorecord lawfully made under this title, or any person authorized by such owner, is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy or phonorecord." 17 U.S.C. § 109(a). Section 109(a) is the codification of the "first sale" doctrine established by the Supreme Court in *Bobbs-Merrill Co. v. Straus*, 210 U.S. 339 (1908). Under the first sale doctrine,

once the copyright owner places a copyrighted item in the stream of commerce by selling it, she exhausts her exclusive statutory right to control its distribution.

In *Quality King*, the Supreme Court considered whether the first sale doctrine applied to "round trip" importation in which a copyrighted product was made in the U.S., exported to an authorized foreign distributor, sold abroad to a third-party, shipped backed to the U.S. without the copyright owner's permission, and sold in the U.S. by an unauthorized retailer. *Quality King Distributors, Inc. v. L'anza Research Int'l, Inc.*, 523 US 135, 138-39 (1998). In that case, the unauthorized retailers were able to sell "round trip" products at a discount by taking advantage of discrepancies in the manufacture's global pricing schemes. *Id*. at 139. The copyright holder sued for infringement. *Id*. at 139-40.

First, the Supreme Court considered and determined that the first sale doctrine of Section 109(a) established a defense to Section 602(a)(1)'s general ban on unauthorized imports. *Id.* at 143-53. Next, the Court considered whether the first sale doctrine established a defense to the authorized resale in the United States to the round trip products. The Court explained that the first sale doctrine, as codified in § 109(a), "applies only to copies that are 'lawfully made under this title.'" *Id*. at 153. Applying this rationale, the Court held that the first sale doctrine barred the infringement claim against the round trip products because the products were first lawfully made under the Copyright Act, i.e. within the territory of the U.S., before they were exported, and then imported back into the U.S. *Id*.

In *Costco v. Omega*, the Court again addressed the issue of unauthorized copyrighted imports, albeit in a slightly different context than *Quality King*. Specifically, the Court addressed the question of whether the first sale doctrine established a defense to unauthorized importation of a copyrighted product made entirely outside of the U.S. Respondent Omega manufactured watches in Switzerland and sold them internationally through a network of distributors and retailers. *Omega S.A. v. Costco Wholesale Corporation*, 541 F. 3d 982, 983-84 (9th Cir. 2008). The rear-panel of each watch included a design registered as a U.S. copyright. *Id*. Omega sold a group of the watches outside of the U.S. to an authorized distributor under agreement to limit resale to territories outside of the U.S. *Id*. Some of these watches were imported into the U.S. and sold by Costco without the authorization of the Omega. *Id*. Costco was able to sell the Omega watches for $1,299, despite the manufacturer suggested retail price of $1,995. Stohr, Greg, *Supreme Court hears Costco case over Swatch sales*, Wash. Post., November 8, 2010.

Omega brought suit for unauthorized distribution and importation under 17 U.S.C. §§ 106(a) and 602(a)(1). *Omega*, 541 at 984. In defense, Costco argued that under Section 109(a) Omega's first authorized sale of the watches,

which occurred entirely abroad, exhausted Omega's right to control the distribution or importation of the watches. *Id*. The district court ruled in favor of Costco without explanation. *Id*. On appeal, the Ninth Circuit held that the first sale doctrine was unavailable as a defense to the claims under §§ 106(3) and 602(a) because Omega's authorized copyright activity occurred outside the U.S. *Id*. at 990. The Ninth Circuit distinguished *Quality King* on the basis that it dealt with round trip importation and did not address unauthorized importation of copies made abroad. *Id*. at 987. The court further reasoned that the application of § 109(a) to foreign-made copies would impermissibly extend the Copyright Act and would ascribe legality under the Copyright Act to conduct that occurs entirely outside the United States, notwithstanding the absence of a clear expression of congressional intent in favor of extraterritoriality. *Id*. at 988.

Costco appealed and the Supreme Court granted *certiorari*. Justice Kagan recused herself because she had previously filed a brief on behalf of the government as Solicitor General. In December, the Court issued a 4-4 split *per curiam* decision affirming the Ninth Circuit. The Court's order does not establish a precedent since it was a split decision. In other words, it is as if the Supreme Court never took this case.

III. THE IMPLICATIONS OF *COSTCO V. OMEGA*.

The implications of a potential Supreme Court precedent extending the first sale doctrine to international activity or limiting the doctrine to activity in the U.S. were discussed in the amicus briefs filed with the Court. Copies of the briefs are available at http://www.scotusblog.com/case-files/cases/costco-v-omega/.

Retailers and wholesalers argued that the first sale doctrine should extend to activity outside of the U.S. because it provided importers, distributors, and retailers welcome certainty that lawfully produced, non-piratical goods could be imported and resold in the U.S. The retailers further argued that limiting the territorial scope of the first sale doctrine would harm American businesses and consumers that benefit from discount pricing of genuine parallel imported goods. (*See* Br. of Retail Indus. et al.; Br. of eBay et al.; Br. of Public Citizen; Br. of Entertain Merchants Association et al; Br. for American Library Association.)

On the other hand many manufacturers argued that the first sale doctrine should be limited to activity within the territorial boundaries of the United States. They argued that applying the first sale doctrine to activity outside the U.S. would allow a gray market to develop because manufacturers would have a more difficult time preventing unauthorized importation of productions intended for foreign markets. The gray market would undermine the copyright owner's exclusive right to distribute the copyrighted work in the U.S., harming businesses and consumers. Publishes argued that the effect of broadening the availability of

the first sale doctrine to an unauthorized importer would likely be that copyright owners would only authorize sales of copies of their works in jurisdictions in which they command a relatively high price and would refuse to sell them anywhere else because this would undercut the market for their works. (*See* Br. of Am. Watch Association; Br. of Intellectual Property Owners Association.)

Since the Supreme Court issued a split-opinion, the Ninth Circuit's decision in *Costco* is binding precedent in the Ninth Circuit, while this issue of law remains mainly unresolved outside the Ninth Circuit. The Third Circuit has indicated the first sale doctrine would apply if the copyright right holder authorized the initial manufacturer, regardless of the location. *See Sebastian Intl. v. Consumer contacts, Ltd.*, 847 F.2d 1093, 1098 n.1 (3d Cir. 1988) (stating in dicta that "[w]e confess some uneasiness with this construction of 'lawfully made' because it does not fit comfortably within the scheme of the Copyright Act. When Congress considered the place of manufacture to be important, as it did in the manufacturing requirement of section 601(a), the statutory language clearly expresses that concern.") In contrast, a number of district courts opinions in the Second Circuit have limited the extraterritorial effect of the first sale doctrine. *See e.g.*, *Pearson Education, Inc. v. Arora*, 717 F. Supp. 2d 374, 379 (S.D.N.Y. 2010). This issue is currently pending on appeal before the Second Circuit, and is expected to be decided shortly. The issue of whether the first sale doctrine extends internationally may likely reach the Supreme Court once again, although it is difficult to predict the result given that split between the justices. In *Costco*, Solicitor General Kagan argued that the Court should not to take the case because the Ninth Circuit's decision was consistent with *Quality King* and did not conflict with any circuit precedent. (Br. of U.S.) It is difficult to predict whether Justice Kagan would adopt a similar position in her capacity as Justice if she had the opportunity to consider this issue from the bench.

The common law doctrine of exhaustion in patent law is similar to the statutory first sale doctrine in copyright law. Under the exhaustion doctrine, the initial authorized sale of a patented item terminates all patent rights to that item. *Quanta Computer, Inc. v. LG Electronics, Inc.*, 553 U.S. 617, 625 (2008).

In *Costco*, Intel filed an amicus brief and argued that in addition to extending copyright's first sale doctrine to international activity, the Court should likewise extend the patent exhaustion doctrine to activity outside of the U.S. Intel argued that the Court's decision in *Quanta* made clear that application of the exhaustion doctrine to goods manufactured and sold abroad does not violate the presumption again extraterritorial effect. (*See* Br. of Intel.)

On the other hand, a number of amici curie strongly urged the Court to decline Intel's invitation to extend the scope of patent exhaustion because that question was not properly before the Court. In addition, these parties argued that

the Court has never held that a foreign sale, authorized by the U.S. patent owner, exhausts the U.S. patent if resale in the U.S. is not also authorized, and that the law of this country has always been that patent laws are not extraterritorial in scope. In addition, the parties argued that three times, over nine years, the Federal Circuit has confirmed that foreign sales of a product under the authority of the U.S. patent owner do not exhaust a U.S. patent, absent the patent owner authorizing the importation of the patented article. *Fujifilm Photo Film Co., Ltd., v. Benun*, 463 F.3d 1252 (Fed. Cir. 2006); *Fujifilm Photo Film Co., Ltd. v. Jazz Photo Corp.*, 394 F.3d 1368, 1376 (Fed. Cir. 2005); *Jazz Photo Corp. v. ITC*, 264 F.3d 1094, 1105 (Fed. Cir. 2001). (*See* Br. of Fuji et al.)

In *Jazz Photo* the Federal Circuit addressed the issue of patent exhaustion based on activity outside of the U.S. *Jazz Photo Corp.*, 264 F.3d at 1105. The court held that a first sale of the patented product outside the U.S. does not trigger the exhaustion doctrine because sale did not occur under the United States patent since that sale occurred outside of the territory of the United States. *Id*. at 1105. In support of its decision, the Federal Circuit cited to the 1890 Supreme Court's decision of *Boesch v. Graff*, for the proposition that to invoke the exhaustion doctrine, the authorized first sale must have occurred under the United States patent. *Id*. (citing *Boesch v. Graff*, 133 U.S. 697, 701-703 (1890)). Since *Jazz Photo*, some commentators have suggested that the Supreme Court has never considered international patent exhaustion and that *Boesch v. Graff* was incorrectly cited by the Federal Circuit. While the question of whether the Supreme Court has established a precedent for international patent exhaustion may be open to debate, the Federal Circuit has squarely confirmed its holding in *Jazz Photo*. In view of the split decision in *Costco v. Omega*, the Federal Circuit's holding in *Jazz Photo*—that first sale of a patented product outside the U.S. does not trigger the exhaustion—remains binding precedent.

IV. CONCLUSION

In summary, the Supreme Court's split decision in *Costco v. Omega* did create a precedent in regard to the first sale doctrine in copyright law, or any other doctrine of exhaustion. The Ninth Circuit *Costco v. Omega* decision, declining to extend the first sale doctrine to activity outside the U.S., is binding in the Ninth Circuit. Outside of the Ninth Circuit this issue is subject to law of each circuit. It is likely that the Supreme Court may take an opportunity to consider this issue again as the circuits appear to be split on this issue. In regard to patent law, the Federal Circuit's decision in *Jazz Photo* limiting the exhaustion doctrine to activity in this country is binding precedent.