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Parallel Trade and International Harmonization of the Exhaustion of Rights Doctrine

Darren E. Donnelly

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PARALLEL TRADE AND INTERNATIONAL HARMONIZATION OF THE EXHAUSTION OF RIGHTS DOCTRINE*

Darren E. Donnelly†

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I. INTRODUCTION

The exhaustion of rights doctrine is one of the most fundamental limitations on intellectual property rights. It provides, in general terms, that when an intellectual property right holder sells an article embodying those rights, they are exhausted with respect to that article. Thus, a purchaser can resell the article without being liable for infringement. The exhaustion of rights doctrine takes on its greatest significance when goods embodying intellectual property rights are traded internationally.

When rights are held in multiple nations for the same piece of intellectual property, the question arises whether, and which of, these rights are exhausted by sale of the article. If all rights are exhausted, intellectual property right holders will be frustrated in their attempts to maintain differential pricing schemes across nations; if they are not, then free trade in previously-sold goods may be stopped internationally for goods which could freely circulate within a nation. Indeed, some courts even suggest that goods sold in a nation which are exported cannot be reimported without infringing. When goods are traded in contravention of the marketing scheme of the intellectual property right holder (or its licensee), they are called as “gray market” goods or “parallel imports.” Thus there is an inextricable link between parallel imports and the exhaustion of rights: whether goods can be parallel imported depends on whether the intellectual property rights they embody were exhausted by previous sales.

Ordinarily, a party with authorization from the right holder to sell the product in the region objects to parallel importation when the unauthorized party markets the parallel imports at a lower price. The unauthorized party is able to offer the same product at this lower price because the product is available in some other country at a

3. See infra note 101 and accompanying text (discussing L'anza case).
5. See infra Parts II-IV. In the international arena, which is the subject of this comment, issues surrounding parallel trade and exhaustion of rights are essentially the same issue. The terms are used interchangeably unless the context lends itself to one term or the other.
lower price. The reasons such price discrepancies arise has been the subject of considerable debate, and generalizations, across time, trading areas, and intellectual property rights, are most likely inappropriate.

In precisely what instances right holders may use intellectual property law against parallel imports has been the subject of much litigation, both in the United States and abroad. The considerable economic stakes of the gray market has also prompted economic analyses of the parallel importation. As a trade-related aspect of intellectual property, one might suspect that international initiatives to harmonize intellectual property rights would have harmonized the law of the exhaustion of rights. The contrary is, in fact, the case. This has resulted in markedly different regimes in the United States and its major trading partners. Moreover, U.S. law on exhaustion of rights is itself widely disparate across patents, copyrights, and trademarks.

As the law has diverged, it has ignored the economic insights an analysis of the exhaustion of rights problem provides. As trading and intellectual property regimes converge, the law of parallel imports must harmonize. This comment reveals, however, that exhaustion of rights regimes are diverging. It is the position of this comment that deliberate attempts at harmonization should begin, lest reliance on divergent regimes prove an insurmountable hurdle to harmonization. The significant effects parallel import law has on the welfare of consumers and producers around the world evince this need.

This comment first describes the exhaustion of rights law in the United States, Europe, and Japan. The need for harmonization revealed by these nation's laws is then analyzed in more detail. The economics of parallel trade are examined and suggestions for the appropriate type of harmonization made.

6. See, e.g., supra note 174 and accompanying text (describing European cases involving parallel trade in pharmaceuticals).

7. The three most common reasons commentators cite as the basis for international price discrepancies are: differences in costs of marketing and after sales support; currency fluctuations; and deliberate price discrimination by a firm with market power. David A. Maleug & Marion Schwartz, Parallel Imports, Demand Dispersion, and International Price Discrimination., 37 J. Irr'l. Econ. 167, 172-174 (1994).

8. See infra Parts II-IV.

9. See infra Part II.

10. See infra Parts III and IV.

11. See infra Part V.

12. See infra Part VI.

13. See infra Part VII.
First, however, further explanation of a key concept is in order. As noted, the doctrine of exhaustion of rights provides that the sale of an article embodying intellectual property rights ("IPRs") exhausts those rights with respect to that article.\textsuperscript{14} A related, but distinct, concept is that of the territoriality of IPRs. The notion here is that intellectual property rights are limited to the territory of the nation granting them.\textsuperscript{15} For example, under this doctrine, trademark rights in Canada could not block imports into the United States.

The two concepts are closely related, though. Whether a right holder has exhausted her IPR may depend on whether those rights were territorial or universal. For example, if rights under a Japanese patent were not territorial, then sale of an article embodying the underlying invention would exhaust the Japanese rights even if the sale were in another nation.\textsuperscript{16} Conversely, if U.S. copyrights were territorial, then sale of a copy of a copyrighted work by a U.S. copyright holder outside the United States would not exhaust the U.S. copyrights.\textsuperscript{17}

\section*{II. Exhaustion of Rights Under U. S. Law}

The primary laws controlling parallel imports into the United States are the federal intellectual property laws,\textsuperscript{18} although state law may also regulate the area.\textsuperscript{19} As the following sections illustrate,

\begin{itemize}
\item \textsuperscript{14} See, e.g., United States v. Univis Lens Co., Inc., 316 U.S. 241 (1942).
\item \textsuperscript{15} See, e.g., Person's Co., Ltd. v. Catherine Christman, 900 F.2d 1565 (Fed. Cir. 1990).
\item \textsuperscript{16} See infra Part IV (describing Japanese parallel import law).
\item \textsuperscript{17} See infra Part II.C (describing U.S. parallel import law under copyright).
\item \textsuperscript{19} See, e.g., CAL. CIV. CODE § 1797.81(a) (West 1992):
\begin{itemize}
\item Every retail seller who offers grey market goods for sale shall post a conspicuous sign at the product's point of display and affix to the product or its package a conspicuous ticket, label, or tag disclosing any or all of the following, whichever is applicable:
\begin{itemize}
\item (1) The item is not covered by a manufacturer's express written warranty valid in the United States (however, any implied warranty provided by law still exists).
\item (2) The item is not compatible with United States electrical currents.
\item (3) The item is not compatible with United States broadcast frequencies.
\item (4) Replacement parts are not available through the manufacturer's United States distributors.
\item (5) Compatible accessories are not available through the manufacturer's United States distributors.
\item (6) The item is not accompanied by instructions in English.
\item (7) The item is not eligible for a manufacturer's rebate.
\item (8) Any other incompatibility or nonconformity with relevant domestic
\end{itemize}
\end{itemize}

there is little uniformity across the federal intellectual property laws with respect to parallel imports.

A. Exhaustion of U.S. Patent Rights

Section 271 of the Patent Act provides that, "whoever without authority. . . offers to sell, or sells any patented invention, within the United States or imports into the United States any patented invention during the term of the patent therefor, infringes the patent." This section would appear to proscribe all parallel imports as, by hypothesis, "without authority." However, it is constrained by the exhaustion of rights principle, which provides that the first lawful sale effectively exhausts the patentee's rights. Thus, when there has been a lawful sale of the patented article which exhausts the patentee's rights, the patentee, or their licensee, is without recourse against subsequent parallel imports of that article.

When a U.S. patentee holds patents for the same invention in several nations ("parallel patents") unauthorized first sales under foreign patents do not exhaust U.S. patent rights. In Boesch v. Graff a third party manufactured lamp burners in Germany which infringed a U.S. patent. The U.S. patentee, Graff, held a parallel patent in Germany. Under German law of the time, the sale and manufacture of the burners were lawful because they occurred prior to Graff's

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20. 35 U.S.C.A. § 271(a) (West Supp. 1996). Section 271 also bars importation of products made by processes patented within the United States (§ 271(g)) as well as certain components for practicing a patented invention or process. § 271 (c).

21. The right to import was added by a 1994 law, effective January 1, 1996. See 35 U.S.C.A. § 271 (West Supp. 1997) (tracing amendments). There is no reason to believe that this right would be any less subject to exhaustion than the others. See United States v. Univis Lens Co., Inc., 316 U.S. 241 (1942). In Univis Lens, the holder of a patent on eyeglass lenses licensed the patent to another to manufacture the blanks and sell them to licensed wholesalers, finishing retailers and prescription retailers. Id. at 243. As part of a system of resale price maintenance, the licenses contained restrictions on the ability of the wholesalers and lens-finishing retailers to sell the processed lens blanks. Id. at 244-45. The Supreme Court held such restrictions illegal because the patentee had reaped the benefits which the patent conferred him with the first sale. Id. at 251-52. "[The patentee's] monopoly remains so long as he retains the ownership of the patented article. But sale of it exhausts the monopoly in that the article and the patentee may not thereafter, by virtue of his patent control the use or disposition of the article." Id. at 250.

22. The qualification of a sale that exhausts the patentee's rights is important here. Whether a sale exhausts the rights of the party trying to block the parallel import depends on who made it and where it was made. See also infra Part ILC (discussing relevance of location of sale under copyright law).

23. 133 U.S. 697 (1890).

24. Id. at 699.
The Court held that Boesch infringed the U.S. patent by importing the burners into the United States.\(^{26}\)

While Boesch held that lawful sales abroad by one unrelated to the patentee did not exhaust U.S. patent rights, how closely tied to its particular facts this holding is remains unclear. \(\text{Holiday v. Matthe-son,}^{27}\) a lower court case decided five years earlier, held that authorized sales abroad without prohibitions on reimportation exhausted U.S. patent rights.\(^{28}\) In \(\text{Holiday,}\) the plaintiff (owner of the U.S. patent) sold the patented article in England, where it was acquired by the defendant.\(^{29}\) The court held the sale abroad exhausted all of plaintiff's patent rights around the world.\(^{30}\) The Court in Boesch made no mention of \(\text{Holiday}\) and subsequent courts have not agreed on the reach of its holding after Boesch.

In \(\text{Curtiss Aeroplane,}^{31}\) the U.S. patentee authorized the British

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25. Id. at 701-702.
26. "The right which [the German producer] had to make and sell the burners in Germany was allowed him under the laws of that country, and purchasers from him could not be thereby authorized to sell the articles in the United States in defiance of the rights of patentees under a United States patent." Id. at 703 (emphasis added).
27. 24 F. 185 (S.D.N.Y. 1885).
28. \(\text{Holiday,}\) 24 F. at 185-86. See generally Adams v. Burke, 84 U.S. (17 Wall.) 453 (1873) (where patentee transferred exclusive right to make, use, or sell patented article within an area around Boston to one party and the remaining rights to plaintiff, plaintiff could not bar use of patented article in his territory by those who acquired the article from in Boston from authorized seller: "When the patentee, or the person having his rights sells a machine or instrument whose sole value is in its use, he receives the consideration for its uses and he parts with the right to restrict that use. The article ... passes without the limit of the monopoly."). See also Bloomer v. McQuewan, 55 U.S. (14 How.) 539, 549-50 (1852) ("[T]he purchaser of the implement or machine for the purpose of using it in the ordinary pursuits of life ... exercises no rights created by the act of Congress ... When the machine passes to the hands of the purchaser, it is no longer within the limits of the monopoly. It passes outside of it, and is no longer under the protection of the act of Congress ... The implement or machine becomes his private, individual property, not protected by the laws of the United States, but by the laws of the State in which it is situated.").
29. \(\text{Holiday v. Mattheson,}\) 24 F. 185 (S.D.N.Y. 1885).
30. Id. It was immaterial to the court that the sale occurred abroad:

The presumption arising from such a sale [without restrictions] is that the vendor intends to part with all his rights in the thing sold, and that the purchaser is to acquire an unqualified property right in it; and it would be inconsistent with the presumed understanding of the parties to permit the vendor to retain the power of restricting the purchaser to using the thing bought in a particular way, or in a particular place.

\(\text{Id.}\)

The doctrine that a IP right holder's first sale exhausts all parallel rights around the world is known as "international exhaustion."

31. \(\text{Curtiss Aeroplane & Motor Corp. v. United Aircraft Eng'g Corp.},\) 266 F. 71 (2d Cir. 1920).
government to practice its patents on airplanes and motors without restriction.\textsuperscript{32} A Canadian company was set up to manufacture the planes during World War I, and the defendant purchased the planes after the war for sale in the United States.\textsuperscript{33} The court made clear the international exhaustion principle:

If a patentee or his assignee sells a patented article, that article is freed from the monopoly of any patents which the vendor may possess. If the thing sold contains inventions of several United States patents owned by the vendor, the article is freed from each and all of them; and if the vendor has divided his monopoly into different territorial monopolies, his sale frees the article from them all. If a vendor's patent monopoly consists of foreign and domestic patents, the sale frees the article from the monopoly of both his foreign and his domestic patents.\textsuperscript{34}

Other courts have reached a different conclusion and ruled that when parallel patents are held in the United States and abroad, sales under the foreign patents will not exhaust U.S. patent rights.\textsuperscript{35} In Griffin, the plaintiff held parallel patents on machinery in the United States and Italy.\textsuperscript{36} Defendant acquired the patented machine from the exclusive Italian licensee\textsuperscript{37} and sought to reimport them into the United States.\textsuperscript{38} Finding Boesch controlling and stressing the territoriality of patents, the court rejected adopting the international exhaustion rationale: "We are not persuaded by the defendant's logic, however, and we find no authority supporting the position, that the identity of the plaintiff as the patentee in both the United States and Italy justified a departure from the Boesch rule."\textsuperscript{39}

\textsuperscript{32} Id. at 72-73.
\textsuperscript{33} Id. at 74-75.
\textsuperscript{34} Id. at 78.
\textsuperscript{36} Id. at 1283.
\textsuperscript{37} The licensee also had the exclusive right to sell the patented item within the European Economic Community. Id. at 1284. Under European Union law, parallel importation into other Member States could not have been prevented had the patentee held patents in those States as well. See infra Part III.
\textsuperscript{38} Id.
\textsuperscript{39} Id. at 1285. The Griffin court makes no mention of Curtiss Aeroplane and it does not appear that the defendant made any argument based on applying the principle in the text quoted at note 34. The court did, however, look to Daimler Mfg. Co. v. Conklin, 170 F. 70 (2d Cir. 1909), a case in which the U.S. assignee of patent rights from a German inventor succeeded against a consumer who purchased a car embodying the patented inventions made in Germany with the authorization of the inventor and returned it to the United States. Griffin, 453 F. Supp. at 1285.
A case from the pharmaceutical industry\(^{40}\) clarifies the rights of licensees.\(^{41}\) The French pharmaceutical concern Sanofi, held the U.S. patent for the drug acerpromazine maleate, which was authorized only for veterinary use in the United States.\(^{42}\) Sanofi sold the product in Europe, the defendant later acquired it and resold it in the United States.\(^{43}\) Sanofi, and its exclusive U.S. licensee, American Home, brought suit.\(^{44}\) With respect to Sanofi, the court followed the rule of *Holiday v. Mattheson*.\(^{45}\) It distinguished *Boesch* on grounds that there, neither the patentee nor one authorized by it, made the sale abroad,\(^{46}\) and distinguished *Griffin* on the grounds that Sanofi made the sale itself without restrictions on import into the United States.\(^{47}\) The court held that Sanofi, having sold the product in Europe with the intent to part with all rights it had in the product, could not enjoin the imports.\(^{48}\)

However, the exclusive U.S. licensee’s rights were not exhausted by the sale and could enjoin the imports.\(^{49}\) According to the court, Sanofi could not sell in the United States, having granted the exclusive license, and the purchasers in Europe therefore took the product subject to the outstanding U.S. license. The court rejected application of *Univis Lens* because the sale was not one which could

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40. Pharmaceuticals are a common source of exhaustion of rights litigation. Because of the costly approval process in many nations, the significant market power conferred by many pharmaceutical patents, and the fact that in some nations, no patent protection may be provided at all for certain pharmaceuticals, there are frequently wide price disparities across national borders for pharmaceuticals. See [*infra* Parts III.C-D. (discussing European cases involving pharmaceuticals)]. This market imperfection is corrected by the transnational arbitrage of the parallel importer.


42. *Id.* at 934.

43. *Id.* at 935.

44. *Id.* at 934.

45. *Id.* at 938.


47. *Griffin* too is distinguishable from this situation because here the sale abroad was made by the patent holder itself without restriction. This distinction is of crucial significance. In this case, were the purchaser to search the patent records in the United States, it would find that the holder of the patent is the very party which made the sale without restriction . . . . [A]suming Sanofi had a right to enjoin the reselling of the goods in this country, it waived that right by not placing any written restrictions upon the purchaser at the time of sale.

48. *Id.* at 938.

49. *Id.* at 941.
have been made in the United States lawfully: “If the court were to hold that Sanofi’s sale of the product exhausted the patent it would be crediting Sanofi with greater rights than the patentee actually had.”

In summary, the holding in *Boesch* has not been broadly interpreted. There is disagreement among the courts whether sales abroad authorized by a U.S. patentee exhaust U.S. patent rights. Ordinarily, when the sales are not with the patentee's authorization, the U.S. rights are not exhausted.

**B. Exhaustion of U.S. Trademark Rights**

Two sources of law may protect U.S. trademark rights after a first sale. Section 42 of the Lanham Act provides:

[N]o article of imported merchandise, which shall copy or simulate the name of the any [sic] domestic manufacture, or manufacturer... which shall copy or simulate a trademark registered in accordance with the provisions of [the Lanham Act]... shall be admitted to entry at any customhouse of the United States.51

Section 526 of the Tariff Act of 1930 provides:

[I]t shall be unlawful to import into the U.S. any merchandise of foreign manufacture if such merchandise, or the label, sign, print, package, wrapper, or receptacle, bears a trade-mark owned by a citizen of, or by a corporation or association created or organized within, the U.S., and registered in the Patent Office.52

Section 526 was enacted to overcome the Court of Appeals decision in *Bourjois v. Katzel*.53 In *Katzel*, a French cosmetic concern sold its U.S. trademark, goodwill, and business to the plaintiff.54 The defendant purchased powder from the French concern overseas and reimported it into the United States under a similar mark.55 The Supreme Court, reversing the Court of Appeals, held, per Holmes, J., that this infringed plaintiff’s trademark:

It is said that the trade mark here is that of the French house and truly indicates the origin of the goods. But that is not accurate. It is the trademark of the plaintiff only in the U.S. and indicates in

50. *Id.* at 941.
55. *Id.* at 691.
law, and, it is found, by public understanding, that the goods come
from the plaintiff although not made by it.  

The Supreme Court’s holding in *Katzel* established the territorial-
ity of trademarks, that is, they are of legal force only within the
reach of the laws of the right-granting state. As a purely doctrinal
matter, under this principal, trademark rights throughout the reach of
U.S. would be exhausted by sales within this reach, but nowhere else.
Exhaustion of U.S. trademark rights is more complicated. The Su-
preme Court has limited *Katzel* by interpreting it as a case when a
defendant sought to market goods “of one make under the trade name
of another.” Circuit courts have also interpreted it narrowly, and
the regulations enacted in the wake of lower court opinion in *Katzel*
do not always provide clear guidance.

The regulations enacted pursuant to § 526 were the subject of
*Kmart Corp. v. Cartier, Inc.* The Court found that gray market
goods arose in three different contexts. Case 1 was where a foreign
firm sold to an independent U.S. entity the rights to register and use
the foreign firm’s trademark in the United States only later to import
and distribute goods in the United States. This was the scenario in
*Katzel*, and the Court in *Kmart* held that barring the imports was le-
gitimate. A contrary ruling would work an injustice on the holder
of the mark in the United States who had invested in developing the
trademark. Case 2 was where the U.S. trademark for goods manu-

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56. *Id.* at 692.
57. *Gilson*, *supra* note 52, § 4.05[5]. Note how this situation parallels that of *Boesch*
discussed *supra* Part II.A.
59. *See Olympus Corp. v. United States*, 792 F.2d 315, 321-22 (2d Cir. 1986) (limiting
*Katzel* to its “special facts”); *NEC Elecs. v. CAL Circuit Abco, Inc.*, 810 F.2d 1506, 1510 (9th
Cir. 1987) (limiting application of *Katzel* to cases with the same equities as *Katzel*).
60. The regulations at issue were enacted by the customs service in 1972. They allowed
parallel imports where:
   (1) Both the foreign and the U.S. trademark or trade name are owned by the
       same person or business entity, or
   (2) The foreign and domestic trademark or trade name are owners are parent and
       subsidiary companies or are otherwise subject to common ownership or control;
       or
   (3) The articles of foreign manufacture bear a recorded trademark or trade name
       applied under authorization of the U.S. owner.
*Kmart Corp. v. Cartier, Inc.*, 486 U.S. 281, 288 n.2 (1988) (quoting 19 C.F.R. § 133.21(c)).
62. *Id.* at 286.
63. *Id.*
64. *Id.* at 292.
factured abroad is registered by a domestic firm that is either (a) a subsidiary of the foreign manufacturer, (b) the parent of the foreign manufacturer, or (c) the same as the foreign manufacturer. The Court upheld the regulations in this case, thus allowing parallel imports when the foreign and domestic entities were under "common control." Case 3 was where the allegedly infringing imports bore a registered U.S. trademark and were manufactured by an independent foreign entity under the authorization of the U.S. mark holder. This situation typically arose when a U.S. entity owned the same mark in the United States and in foreign countries and licensed use of the mark to a foreign manufacturer in the foreign countries. Under the Customs Regulations, these goods could not be stopped from entering the United States, and the Supreme Court struck down the regulations as inconsistent with the plain language of § 526. Thus, where the foreign entity is not under common control with the U.S. mark holder, sales by a licensee of the U.S. mark owner do not exhaust the U.S. rights under § 526. The Supreme Court left considerable room for parallel trade to continue under § 526. However, the Supreme Court was only addressing the validity of the Customs regulations in *Kmart*, and it was left to later cases to specify when § 42 of the Lanham Act provided other rights.

Subsequent case law has established the rule that otherwise legal parallel imports cannot be stopped unless they are "materially different" from those authorized to be sold in the United States. The

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66. I.e., the situation envisioned under part 2 of the customs service regulations in *supra* note 60.
68. This is frequently referred to as the "common control exception." For a good illustration, see Weil Ceramics and Glass, Inc. v. Dash, 878 F.2d 659 (3d Cir. 1989).
70. *Gilson*, *supra* note 52, § 4.05[6].
71. *See supra* note 60.
73. Justices Brennan, Marshall, White and Stevens dissented from this holding. *Id.* at 295.
courts confronting the issue revert to the fundamental trademark infringement analysis of likelihood of confusion. However, in this context, consumers are likely to be confused whenever there are "material differences" between the genuine and gray goods. In Societe des Produits Nestle, S.A. v. Casa Helvetia, Inc., the products at issue were PERUGINA brand chocolates. The owners of the U.S. registration sought to enjoin imports purchased from another authorized licensee in Venezuela. The plaintiff's chocolates came from Italy, had five percent more milk fat, were made from sugar syrup rather than crystalline sugar, were made from cocoa beans from different countries, and were selling for $5.00 more per box than the parallel imports. The First Circuit, reversing the trial court's finding of no infringement, adopted a very low standard for materiality:

We conclude that the existence of any difference between the registrant's product and the allegedly infringing grey good that consumers would likely consider to be relevant when purchasing a product creates a presumption of consumer confusion sufficient to support a Lanham Trade-Mark Act claim. Any higher threshold would endanger a manufacturer's investment in product goodwill and unduly subject consumers to potential confusion by severing the tie between a manufacturer's protected mark and its associated bundle of traits.

Section 42 of the Lanham Act thus provides that U.S. trademark rights will not be exhausted by sales of products bearing those marks that differ in ways material to consumers from those sold in the

flour not used as per regulation, and labels did not bear standard nutritional information); Helene Curtis, Inc. v. National Wholesale Liquidators, Inc., 890 F. Supp. 152, 159 (E.D.N.Y. 1995) (gray market product differed materially from authorized product because it contained ingredients that did not meet New York and California state requirements); Original Appalachian Artworks, Inc. v. Granada Elecs., Inc., 816 F.2d 68 (2d Cir. 1987) (Cabbage Patch Kids dolls with "adoption" certificates in Spanish which were not accepted by U.S. doll adoption agency materially differed); Ferrero U.S.A., Inc. v. Ozak Trading, Inc., 753 F. Supp. 1240, 1244 (D.N.J.), aff'd, 19 U.S.P.Q.2d (BNA) 1468 (3d Cir. 1991), rev'd on other grounds, 952 F.2d 44 (3d Cir. 1991) (gray market TIC TAC breath mints found to materially differ when, inter alia, label did not contain information concerning serving size, servings per container, nutrient and mineral composition, gray goods had 2 calories each and genuine goods 1.5, gray goods failed to meet FDA labeling requirements, and labels used the British spelling of words such as "flavour" and "colour").


76. 982 F.2d 633 (1st Cir. 1992).
77. Id. at 635.
78. Id. at 642-43.
79. Id. at 641.
In summary, exhaustion of U.S. trademark rights differs from exhaustion of patent rights in several ways. First, there are two sources of law to prevent imports: § 42 of the Lanham Act and § 526 of the Tariff Act. More importantly, trademark law contains a significant exception to the general rule that rights are exhausted by a lawful first sale. The exception is for genuine products containing material differences from those legitimately sold in the United States under the mark. This exception makes intuitive sense in light of the fundamental policy of trademark law, the prevention of consumer source confusion. Finally, the specific provisions of § 526 and the impact they have had on the interpretation of § 42 set down some specific rules which are lacking for patents.

C. Exhaustion of U.S. Copyrights

One of the exclusive rights of copyright is the right to distribute copies of the work to the public. Section 602 (a) of the Copyright Act provides the basis for blocking parallel importation of copyrighted subject matter:

Importation into the United States, without the authority of the owner of the 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.

Analogous to the exhaustion of patent rights under Univis Lens, the distribution rights of the copyright holder are limited: “Notwithstanding 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

80. See Summit Tech. Inc. v. High-Line Medical Instruments Co., Inc., 922 F. Supp. 299 (C.D. Cal. 1996). See also Lever Bros. Co. v. United States, 981 F.2d 1330 (D.C. Cir. 1993) on remand from Lever Bros. Co. v. United States, 796 F. Supp. 1 (D.D.C. 1992) (holding that § 42 preempted the affiliate exception allowed by the Customs regulations enacted under § 526). This holding had the additional effect of broadening the class of parties with standing to object to parallel imports. Because § 42 requires neither that the mark holder be a U.S. citizen or corporation, nor that the goods to be of foreign manufacture, U.S. marks held by foreign entities may be used under § 42 to block the reimportation of U.S. made goods or the importation of foreign goods with material differences. Gilson, supra note 52, § 4.05[8] n.40.

the copyright owner, to sell or otherwise dispose of the possession of that copy or phonorecord. Application of the statutory language to the issue of whether the distribution right is exhausted by first sales of products subsequently acquired outside, and imported into, the United States has proven difficult. The circuits that have ruled on the matter are split. A reconciliation based on where the sale took place has not proven appealing to the courts.

In Sebastian International v. Consumer Contacts (PTY) Ltd., plaintiff had manufactured hair care products in the United States for shipment to South Africa. Several cases were reimported, and the plaintiff used a copyright in the labels to try to block the parallel trade. The Third Circuit, after reviewing the district court cases that had ruled on the matter, held:

Section 602(a) does not purport to create a right in addition to those conferred by section 106(3), but states that unauthorized importation is an infringement of "the exclusive [section 106(3)] right to distribute copies." Because that exclusive right is specifically limited by the first sale provisions of §109(a), it necessarily follows that once a transfer of ownership has canceled the distribution right to a copy, the right does not survive so as to be infringed by importation.

The Ninth Circuit, in a series of cases, has consistently reached

86. The customary term "first sale" is used even though it is not strictly correct under the 1976 Copyright Act. Under the current Act, exhaustion of rights would appear to be preferable to "first sale," a term which arose under the 1909 Act which used the word "sale". See infra note 124. While a first sale will exhaust the distribution right of §106(3), the current statute nowhere requires a sale, just ownership. Compare 17 U.S.C. § 109(a) ("Notwithstanding the provisions of section 106(3), the owner of a particular copy... lawfully made under this title... is entitled, without the authority of the copyright owner to sell or otherwise dispose of possession of that copy") with 17 U.S.C. § 109(d) ("The privileges prescribed by...[§109(a)] do not, unless authorized by the copyright owner, extend to any person who has acquired possession of the copy or phonorecord from the copyright owner, by rental, lease, loan, or otherwise, without acquiring ownership of it."). See also infra note 124.
87. See infra notes 88-109 and accompanying text.
88. 847 F.2d 1093 (3d Cir. 1988).
89. Id. at 1094.
90. Of note among the prior district court cases is Columbia Broadcasting Sys. v. Scorpio Music Distrib., 569 F. Supp. 47 (E.D. Pa. 1983), aff'd without opinion, 738 F.2d 424 (3d Cir. 1984) which construed the phrase in § 109(a) "lawfully made under this title" as referring only to copies legally manufactured and sold within the United States thus excluding application of the exhaustion doctrine to authorized goods of foreign manufacture. This case has been criticized by several district courts but, according to the Nimmers, "remains closest to the legislative intent underlying what is admittedly a difficult statutory juxtaposition." 2 MELVILLE B. NIMMER AND DAVID NIMMER, NIMMER ON COPYRIGHT, § 8.12[B][6] (1996).
91. Sebastian, 847 F.2d at 1099.
the opposite conclusion. The first holding in *BMG Music v. Perez* followed the *Scorpio* rationale and held that § 109(a) only exhausted the distribution right if the first sale was within the United States. In *Parfums Givenchy, Inc. v. Drug Emporium*, the court reached the same holding but changed the rationale.

*Givenchy* involved the parallel importation of perfume in boxes bearing copyrighted designs. Givenchy France had sold its interest in the U.S. copyrights to plaintiff, its wholly-owned subsidiary, who brought suit for unauthorized distribution of the perfume lawfully acquired outside the United States. The court found *BMG* controlling but added, "[t]he logical outcome of a ruling that the U.S. copyright owner is precluded from interfering with U.S. distribution of copies manufactured and lawfully sold abroad would be to deprive the U.S. copyright holders of the power to authorize or prevent imports of the copies once the copies are sold abroad." The court found this outcome contrary to policy of copyright: "[Section 602(a) in effect gives § 106(3) extraterritorial scope and] ensures that a U.S. copyright owner will gain the full value of each copy sold in the United States, by preventing the unauthorized importation of copies sold abroad from being used as a means of circumventing the copyright owner's distribution rights in the United States." Defendant also asked that the common control exception under trademark law be extended to copyright law. However, the court found neither statutory nor policy support for this proposition.

The economic rationale recently became explicit in *L'Anza Research International v. Quality King Distrib., Inc.* where the Ninth
Circuit again held that § 602(a) trumped the first sale doctrine in a different factual context — the goods were not made abroad (as in *BMG and Parfums Givenchy*) but rather manufactured in and exported from the United States. Plaintiff was the U.S. manufacturer of hair care products who distributed its products domestically through salons but internationally through foreign distributors. One shipment to its U.K. distributor was bound for Malta but was reimported and was being sold by defendant at retail stores. L’Anza alleged a violation of § 602(a) based on copyright in the labels. The court repudiated the *Scorpio* rationale that the location of the sale determined whether there was a first sale for the purposes of § 109(a) and stated that the test for whether there was a first sale for § 109(a) purposes is whether the copyright owner received the full value for the copyright. The court then reasoned that to allow parallel importation would prevent the copyright holder from receiving the full value on U.S. sales because the parallel imports would undercut the price. Thus, § 602(a) prevails over § 109(a).

102. The *BMG and Givenchy* courts had expressly declined to rule on this issue. *Givenchy*, 38 F.3d at 482 n.7.


104. *Id.* at 1114-15.

105. *Id.* at 1115 (quoting Platt & Munk, Co. v. Republic Graphics, Inc., 315 F.2d 847, 854 (2d Cir. 1963)).

106. [W]here the copyright owner sold U.S. manufactured goods at a substantial discount, with the intent that they would be sold exclusively outside of the United States[...], the unauthorized importation of these goods undercut[s] L’anza’s ability to receive the full value for L’anza products sold in the United States through authorized channels, notwithstanding the fact that the imported products were manufactured in the United States and sold by L’anza.

*Id.* at 1117.

107. It is submitted, that the statutory construction issue posed by the interplay of sections 602(a), 109(a) and 106(3) is not as complicated as the Ninth Circuit has made it. The Circuit’s line of cases have struggled to find a rationale for setting aside the plain language of § 109(a) when an understanding of § 602(a) does not necessitate it.

As the *Sebastian* court noted, section 602(a) purports to create no independent right but rather makes clear that in some cases importation “is an infringement of the exclusive right to distribute copies or phonorecords under section 106(3), actionable under section 501.” 17 U.S.C. § 602(a) (1988). The plain language of 109(a) provides “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) (1988). The authorization of the owner of a copy to sell that copy exists “[n]otwithstanding the provisions of 106(3)” — the right infringed by importation. Although the plain language of § 109(a) provides that the right to distribute copies under § 106(3) is exhausted by a transfer of ownership, statements in the legislative history of § 602(a) have caused courts to inquire further, find the sections irreconcilable, then read out the application of § 109. But see Francis J. McCaffrey, *Statutory
court held that when a U.S. concern sells a copyrighted item to a foreign entity, there is no first sale when the gray marketeer later acquires the goods outside the United States. Apparently, at least in

CONSTRUCTION 35-36 (1953) (as a principle of statutory interpretation, courts should find a meaning of provisions which will give operation and effect to every part of the statute and endeavor if at all practicable to find a harmonious reconciliation of provisions).

The legislative history which has led courts to find ambiguity refers to two types of importation § 602(a) seeks to prevent. The first is so-called “piratical” copies — “those whose making would have constituted an infringement of copyright if this title had been applicable.” 1976 U.S.C.C.A.N. 5659, 5786. “The second situation covered by section 602 is that where the copies or phonorecords were lawfully made but their distribution in the United States would infringe the U.S. copyright owner’s exclusive rights.” Id. Reconciling this second situation with § 109(a) would not seem on its face to be difficult. Section 602(a) prevented, via § 106(3), the importation into the United States of copies that were lawfully made but could not lawfully be distributed them in the United States. See, e.g., Sanofi supra text accompanying note 41 (analogous patent situation). These situations arose when parties abroad, who had not acquired a copy via a first sale, improperly transferred possession of their copies to others who would then reimport. These were substantial copyright problems before the 1976 Act for which § 602(a) the solution. Viewing the section in this light does not require negating Section 109(a). This position is in fact supported by the authority relied upon by the L’Anza court. It notes the complaints of a publisher:

[F]requently you run into a situation where there is a copyright proprietor in the United States and copies of the same work...produced in a foreign country, may be shipped over here without violating any contract of the U.S. copyright proprietor. This is either because...the [foreign] publisher sold it to an individual who in turn shipped it over here...or because of some network of contract rights.

Confusingly, the language that “there is a copyright proprietor in the United States” and the same work is being produced in a foreign country suggests that these were copies “whose making would have constituted an infringement of copyright if this title had been applicable.” Assuming the reference is to lawfully made copies, the problem is similar to one that had been occurring in the United States arising from the distribution of lawfully made copies which had not been sold with the copyright owner’s authorization. See Platt & Munk Co. v. Republic Graphics. Inc., 315 F.2d 847, 853 (1963) (quoting Henry Bill Pub. Co. v. Smythe, 27 F. 914, 917-18 (S.D. Ohio 1886), internal quotations omitted):

Thus, it has been held that sale of a book purchased from a merchant who bought it from an agent of the copyright proprietor, where the agent had been entrusted with possession of the book but not with the actual authority to sell it, is infringement; it does not matter whether the party offering to sell without [the proprietor’s] authority be a thief, or one in possession only by breach of trust, or [by]...some other less blamable means of acquisition. The absence of [the proprietor’s] authority to sell his literary property constitutes the defect of title, no matter how that want of authority arises. Owing to the peculiar character of this kind of property, the absence of the author’s authority to sell is a defect of title, and not a mere want of power.

The L’Anza court also relies on a complaint with respect to “motion picture prints, which are sent [from the United States] all over the world—legitimate prints made from the authentic negative. These prints get into illicit hands. They're stolen, and there’s no contractual relationship...Now [these] are not piratical copies.” L’Anza., 99 F.3d 1109, 1116. However, the problem most likely sought to be prevented by this complaint arose because motion picture prints were rarely sold to foreign distributors, not in spite of their sale. As the Nimmers note, "[u]ntil the advent of the videocassette era, motion picture companies rarely expressly
the Ninth Circuit, the first sale doctrine does not completely exhaust the rights of copyright if someone acquires the articles outside the United States.

The policy-oriented approach taken by the L'Anza court contrasts with a technical interpretation given to § 602(a) by a different Ninth Circuit panel in a case argued shortly after L'Anza. There the panel held that when an exclusive distributor authorized by the copyright owner, rather than the copyright owner himself, tries to block parallel imports, § 602(a) does not even apply. In Costco, DAISA held the copyright in Lladro figurines and licensed its manufacturers to sell to all countries in the world without limitation. The manufacturers sell their output to a holding company who granted geographically exclusive licenses (plaintiff held the exclusive license for the U.S.). When Costco, acquired the gray market figurines, § 602(a) was unavailable to the exclusive U.S. licensee. The license that DAISA gave placed no limitation on sales within the United States, thus implicitly authorizing them, and "[s]ection 602(a) confers power only on the 'owner of the copyright.'" Where the owner of

'sold' or transferred title in such [motion picture film] prints. The usual mode of exploitation was through the rental of such prints." Nimmer, supra note 90 § 8.12[B][1] (1996).

In light of the situations predating the 1976 Act, the provisions of §§ 109(a) and 602(a) can be harmonized. Section 109(a) applies just as well for owners of lawfully made copies abroad as it does for those in the United States, but this does not render the protections of 602(a) hollow. Section 602(a)'s protections exist to prevent against the harm that was present before the 1976 Act, the importation into the United States of copies which were abroad in the hands of parties who did not own them (see id.), copies wrongfully obtained from agents who were not authorized to transfer them (see Henry Bill Pub. Co. v. Smythe, 27 F. 914, 917-18 (S.D. Ohio 1886), and copies whose importation would violate a mere contractual right (see, e.g., Sanofi supra text accompanying note 41 ). See also 17 U.S.C. § 109(d).

108. [Defendant] appears to conflate the question of whether there was a "first sale" in the United States with the question of whether the goods were "acquired outside of the United States" for the purposes of § 602(a). These two inquiries are not necessarily the same. In fact, it is not clear from the statute which point in the chain of acquisition the requirement that a good be "acquired outside of the United States" relates to.

109. Disensos Artisticos E Industriales, S.A. v. Costco Wholesale Corp., 97 F.3d 377 (9th Cir. 1996). In other words, the court held that licensees do not have standing to sue for violation of § 602(a).

110. Id. at 380.

111. Id. at 381.

112. Id. at 380.
the goods is different from the owner of the copyright, it cannot use § 602(a) to control its distribution network.\footnote{Id. at 381-82.}

Thus on the exhaustion of copyrights under § 109(a) the circuits split. The lack of any consensus on this point is unfortunate because copyright subsists without formality\footnote{See 17 U.S.C. §§ 102(a), 104 (1988).} and its minimal creativity requirement\footnote{See Feist Pubs., Inc. v. Rural Tel. Sys., 499 U.S. 340 (1992).} will ordinarily allow most product labels and packaging to contain copyrightable subject matter. A copyright claim will therefore generally be available for the import of most products. This will allow copyright to act as a de facto trade barrier against goods formerly freely traded because of copyright in product labels—hardly a writing promoting the progress of science and the useful arts. Copyright law has the prospect of rendering the statutory provisions of the Lanham Act and the Supreme Court’s holdings in \textit{Univis Lens} and \textit{Kmart} without effect for products bearing patents, trademarks, and copyrights. Cases that raise this point have arisen. However, they do not clarify copyright’s role.

\textit{Denbicare v. Toys “R” Us}\footnote{Denbicare U.S.A., Inc. v. Toys “R” Us, Inc., 84 F.3d 1143 (9th Cir. 1996). See also Summit Technology, Inc. v. High-Line Med. Instruments Co., Inc., 922 F. Supp. 299, 307-314 (C.D. Cal. 1996) } involved the sale by a bankruptcy trustee of goods which were in a U.S. foreign trade zone.\footnote{Id. at 381-82.} The goods were patented, bore U.S. trademarks, and were in copyrighted boxes.\footnote{See Feist Pubs., Inc. v. Rural Tel. Sys., 499 U.S. 340 (1992).} The trustee had previously sold the patents, trademarks, and copyrights. The IPRs’ new owner, who had begun selling newly-manufactured product, objected to sale of the goods within the United States and Canada.\footnote{Denbicare U.S.A., Inc. v. Toys “R” Us, Inc., 84 F.3d 1143, 1145 (9th Cir. 1996).} The sale was allowed to proceed on the condition that buyers not resell within the United States or Canada.\footnote{Id.} The buyer violated the injunction and plaintiff brought suit against the retailer who eventually acquired the goods—ignorant of the in-
junction.

On the copyright claim, alleging violation of § 602, the court held that the goods were imported into the United States with the authority of the copyright holder, plaintiff's predecessor in interest—that is, the foreign trade zone is not outside the United States for purposes of § 602. The plaintiff argued that its exclusive right to distribute copies was also violated and the court went on to interpret the first sale doctrine of § 109. Construing BMG and Drug Emporium the court concluded that § 109 only applies to copies made abroad if the copies have been sold in the United States with the copyright owner's authorization. The court found that plaintiff had consented to the sale, despite having fought for, and won, an injunction against precisely this type of sale: "Thus [plaintiff] McCoy consented to the sale of the copies; the fact that the buyers later violated the conditions imposed on the sale does not negate his consent." The court rejected plaintiff's further argument that its distribution rights were not exhausted because it had not received a reward from the goods' sale on the ground that the copyright owner had consented to their sale.

121. 84 F.3d 1143.
122. Id. at 1150.
123. Id.
124. Id. at 1150-51. The plaintiff cited Platt & Munk v. Republic Graphics, Inc., 315 F.2d 847 (2d Cir. 1963), a case interpreting § 27 of the 1909 Copyright Act which was the predecessor to § 109 of the current act. The court, not even conceding that a case interpreting § 27 is relevant to the interpretation of § 109, rejected the notion of application of a reward test in this context:

Because the reward test of Platt & Munk is designed to determine when a sale that is "not... truly voluntary" is a first sale, that test is irrelevant here: the bankruptcy trustee's sale was voluntary as to Denbicare and to McCoy because McCoy consented. Just as courts will not inquire into the sufficiency of consideration, there is no justification for reexamining the adequacy of the "reward" received by the copyright owner in an alleged first sale where the owner has consented to that sale.

Id. at 1151 (citation omitted). A different panel of the Ninth Circuit relied on Platt & Munk and held the reward test was to be applied to determine whether a § 109 transfer exhausted the § 106(3) rights conferred by § 602(a). See infra notes 95-100 and accompanying text (describing L'Anza v. Quality King).

The L'Anza court's reliance on the Platt & Munk case and the belief that the copyright owner get the "full value" for a copy in order for § 109(a) to exhaust the distribution right is likely misplaced. Under the plain language of § 109(a) no value whatsoever need be received by the transferor in order for the distribution right to be exhausted with respect to that copy. The section applies to "the owner of a particular copy or phonorecord lawfully made under this title." 17 U.S.C. § 109(a). Had full-value purchaser been intended, it is unlikely such an oversight in drafting would have occurred. Indeed, it would seem anomalous and strained to believe that Congress intended that someone who received a copy as a gift from the copyright owner, such as a painting or a shampoo sample bearing a copyrighted label, could not transfer
Having found a first sale under the copyright laws, first sale was also found under trademark law: "Since the trustee's sale qualified as a first sale for copyright purposes, it is a trademark first sale as

the copy without infringing § 106(3). Rather the notion of full value sale comes from ill-chosen language in a section of the 1909 act which was being construed in Platt & Munk. Under the 1909 Act, the copyright owner had the exclusive right to publish and "vend" the copyrighted work. 17 U.S.C. § 1(a) (1909 act) reprinted in Nimmer, supra note 90, App. 6.

Section 27 of the 1909 act provided that:

The copyright is distinct from the property in the material object copyrighted and the sale or conveyance . . . of the material object shall not of itself constitute transfer of copyright . . . ; but nothing in this title shall be deemed to forbid, prevent, or restrict the transfer of any copy of a copyrighted work the possession of which has been lawfully obtained.


In Platt & Munk, the defendant-manufacturer obtained lawful possession of items embodying plaintiffs copyright through a contract for their manufacture. After claims the items were defective the defendant exercised the right of resale of an unpaid seller then available under New York Law. Platt & Munk, 315 F.2d at 849-50. The court noted:

[i]f lawful possession by another sufficed to deprive the copyright proprietor of his right to control the transfer of the copyrighted objects, any bailee of such objects could sell them without infringing the copyright . . . . In view of the necessary role played by manufacturers, shippers and others in producing and distributing copies of the copyrighted works . . . a copyright proprietor could not present his work to the public without the loss of part of his copyright protection. But the author is just as much injured by being deprived of the price of a genuine copy as by having a piratical copy substituted for it. A literal reading of the clause would mean, moreover, that an innocent purchaser of a copy from a conceded pirate would be free to resell it without liability for infringement.

Id. at 851 (citations and internal quotations omitted).

Faced with this problem caused by the ill-chosen word "possession," the court interpreted the second portion of § 27 in light of the first and required that there be a "first sale" or transfer giving the copyright proprietor reward for the copy:

The foregoing makes it clear that the "first sale" which terminates the exclusive right to vend patented or copyrighted objects need not be a truly voluntary one, but can consist of some reasonable and recognized form of compulsory transfer . . . . In such cases the ultimate question embodied in the "first sale" doctrine—whether or not there has been such a disposition of the article that it may fairly be said that the patentee [or copyright proprietor] has received his reward for the use of the article," United States v. Masonite Corp., 316 U.S. 265 at 278.

It is instructive to observe the Masonite Court's position:

There are strict limitations on the power of a patentee to attach conditions to the use of the patented article. As Chief Justice Taney said in Bloomer v. McQuewan [supra note 28] when the patented product "passes to the hands of the purchaser, it is not longer within the limits of the monopoly. It passes outside of it and is no longer under the protection of the act of Congress." And see Adams v. Burke [supra note 28]. In applying this rule, this Court has quiet consistently refused to allow the form into which the parties chose to cast the transaction to govern. The test has been whether or not there has been such a disposition of the article that it may fairly be said that the patentee has received his reward for the use of the article. And see United States v. Univis Lens Co. [supra note 21]. In determining whether or not a particular transaction comes within the rule of
well." Plaintiff also argued that doctrine from patent law to the effect that an implied license is granted to the first purchaser to use and sell the patented item applied to trademarked goods and that the

the Bloomer case, regard must be had for the dominant concern of the patent system. As stated by Mr. Justice Story . . . the promotion of progress of science and the useful arts is the "main object" reward of the inventors is secondary and merely a means to that end. Or in . . . Kendall v. Winsor "Whilst the remuneration for genius and useful ingenuity is a duty incumbent upon the public, the rights and welfare of the community must be fairly dealt with and effectually guarded. Considerations of individual emolument can never be permitted to operate to the injury of these.


Thus Platt & Munk and the authority it relies upon require only that the transaction alleged to have exhausted the right holder's right be one which remunerated them, whatever its form. The notion of fair reward was for determining which non-sale transfers would still exhaust the rights. It would appear implicit in the passages quoted that a non-sale transfer compensating as much as a sale would exhaust the IPRs. There is nowhere a suggestion that some sales the right holder consents to would not exhaust the rights because they were not at as high a price as could have been obtained in a different market.

In Platt & Munk the value inquiry was conducted because of the language of § 27 of the 1909 act. But under the current act, this ambiguity is clarified by the statute. Section 202 splits out the distinction between the sale of copy and the sale of copyright. See 17 U.S.C. § 202 (1988). Section 109(a) makes explicit that ownership authorizes further transfer. Section 109(d) makes it clear that mere possession does not. The enactment of §§ 202, 109(a), and 109(d)—which do not even require a sale, let alone a full value sale, just true ownership—solved the problem which troubled the court in Platt & Munk. The L'Anza court's reliance upon an analysis needed under §§ 1 and 27 of the 1909 Act was misplaced given the enactment of the current § 109. The Nimmers and the Second Circuit—which handed down Platt & Munk—are in agreement:

The current Act, by contrast [to the 1909 Act], contains a stand-alone provision defining copyright ownership as distinct from the material object in which it is embodied . . . . Section 109(a) then defines the instant defense, in contrast to the old Section 27, as an exception to the copyright owner's exclusive public distribution right . . . . In other words, the authorized manufacturer [in Platt & Munk], being "the owner of a particular copy or phonorecord lawfully made under this title" under the statute itself—regardless of whatever may be salted away in the legislative history—"is entitled, without authority of the copyright owner, to sell or otherwise dispose of the possession of that copy or phonorecord."

[While not altogether free from doubt, nonetheless, on balance, it would seem that the literal text of Section 109(a) should be followed, so that its immunity may be claimed by any "owner of a particular copy or phonorecord lawfully made," and not just those who acquired such ownership via a prior transfer from the copyright owner. The Second Circuit’s adoption of that logic [in Bourne v. Walt Disney Co., 68 F.3d 621, 632 (2d Cir. 1995)], some three decades after it handed down Platt & Munk, resolves that doubt for current applications.

Nimmers, supra 90, § 8.112[B][4].

Thus the reward test is likely not the law, and the better of the two positions articulated by the Ninth Circuit is that of Denbicare.

125. Id. at 1151 (the court did not indicate whether situations could occur in which "trademark first sales" would occur but not "copyright first sales").
injunction created an express condition which ran with the goods as a term of the implied license. The court noted that under copyright law, conditions on the first sale do not run with the goods and found no reason for applying the doctrines from patent law rather than those under copyright law.

The setting of Denbicicare provides a good example of the disparate doctrines governing the exhaustion of U.S. intellectual property rights. Under patent law, the exhaustion of rights doctrine is one of judicial creation with differing factual contexts providing detail when and how the international exhaustion of U.S. patent rights occurs. By contrast, under the Copyright Act, there are explicit statutory provisions providing for exhaustion of U.S. copyright and a right to prevent infringing imports. Unfortunately, as the discussion in Part II.C shows this has not settled the matter, and the law is again evolving case-by-case.

Trademark law presents yet a third regime, with Customs regulations allowing parallel imports in particular situations and the further limitation on the exhaustion of U.S. rights for genuine goods which materially differ. Despite these differing regimes, no consistent policy analysis has emerged. One would expect the primary question to be whether, in light of the policies served by free trade and the intellectual property right, should the right be exhausted by the first sale. When such analyses are attempted by U.S. courts, no consistent answer has been reached. By contrast, European Community law has focused on the policies underlying the intellectual property protection as the following Part describes, however, this approach too, has led to much litigation.

III. Exhaustion of Rights Under European Union Law

The European Union ("EU") has a more developed body of law

126. Id.
127. Id. (citing American Int'l Pictures, Inc. v. Foreman, 576 F.2d 661, 664 (5th Cir. 1978)).
regarding parallel importation owing to the decades-long movement towards a single market in the presence of national intellectual property laws. Article 30 of the EEC Treaty is the legal basis for the general rule that national laws having the effect of restricting the free flow of goods are impermissible. An exception to this general rule for intellectual property laws is found in Article 36 which allows such restrictions so long as they do not operate as a disguised restriction on free trans-EU trade. There are specific prohibited practices analogous to U.S. antitrust laws, the relevant ones being found in Article 85, with an exception for those activities which promote technical progress. Generally, the interaction of these laws, and the case law which follows, provides that the exclusive rights of intellectual property rights holders are exhausted when a article is lawfully and consentingly first sold within a member state.

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130. The treaty establishing the European Economic Community, the Treaty of Rome, was opened for signature in 1957. 298 U.N.T.S. 11.

131. Article 30 of Treaty establishing the European Economic Community provides, "Quantitative restrictions on imports and all measures having equivalent effect shall . . . be prohibited between Member States." TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY [EEC TREATY] art. 30.

132. Article 36 provides that Article 30 shall not "preclude prohibitions or restrictions on imports, exports, or goods in transit justified on grounds of . . . the protection of industrial and commercial property. Such prohibitions or restrictions shall not, however, constitute a means of arbitrary discrimination or a disguised restriction on trade between Member states." EEC TREATY art. 36


134. Article 85(1) provides a list of prohibited antitrust practices among them being the controlling of markets, but Article 85(3) makes this section inapplicable to agreements or practices "which contributes to improving the production, or distribution of goods or to promoting technical or economic progress." EEC TREATY art. 85.

135. The doctrine of exhaustion of rights was first articulated in Deutsche Grammophon v. Metro, Case 78/70 1971 E.C.R. 487. See infra notes 139-143 and accompanying text (more extensive discussion of case). There, Deutsche Grammophon sold records to its wholly owned French subsidiary which were parallel imported back into Germany. The European Court of Justice held that Article 36 (see supra note 132) may only be invoked to protect the specific subject matter of the intellectual property right concerned. Since Deutsche Grammophon had voluntarily sold its copyrighted goods, it presumably reaped what the subject matter of copyright was designed to protect.

136. This is the effect of Article 30. The principle of exhaustion of rights may not be invoked by a parallel importer when the first sale is outside an EU Member State. Case 51/75, EMI Records v. CBS United Kingdom, 1976 E.C.R. 811, [1976] 2 CMLR 235 (1976). Here the COLUMBIA trademark shared a common owner in the United States and Europe until 1917, the U.S. mark eventually being acquired by CBS, with EMI holding it in EU states. CBS was enjoined from importing records bearing the COLUMBIA mark because prohibitions in Article 30 on the free movement of goods only pertained to the movement within the EU. Had CBS owned the mark in any one EU nation, imports into this nation could be used a wedge, allowing subsequent trade throughout the EU.
A. Exhaustion of Rights in the EU — Basic Doctrines

The distinction between the exercise and existence of intellectual property rights in the context of the exception in Article 36 is also central to understanding the principle of exhaustion of rights within the EU. The European Court of Justice ("ECJ") has held that EU law does not impair the existence of intellectual property rights, only their exercise.¹³⁷ This distinction becomes relevant in the context of Article 36 which has been interpreted to protect the “specific subject matter” of intellectual property rights from exhaustion.¹³⁸ Thus, the basis of the exhaustion of rights principle for intra-EU trade is that after a consenting first sale, the rights under national intellectual property laws cannot be exercised to protect anything other than the specific subject matter of the IPR: they are exhausted.

In Deutsche Grammophon v. METRO,¹³⁹ the ECJ first recognized the exhaustion of rights principle in holding that rights under copyright¹⁴⁰ were exhausted upon the first sale within the EU. Deut-

¹³⁷. See Cases 56 and 58/64, Etablissements Consten SARL and Grundig-Verkaufs-
GmbH v. Commission, 1966 E.C.R. 299, C.M.L.R 418 (1966). It was necessary that such a distinction be drawn because Article 222 of the EEC Treaty provides that “[t]his Treaty shall in no way prejudice the rules in Member States governing the system of property ownership.” This distinction is also relevant to interpretation of Art 4 bis of the Paris Convention: “(1) Patents applied for in the various countries of the Union by nationals of countries of the Union shall be independent of patents obtained for the same invention in other countries, whether members of the Union or not.” Paris Convention for the Protection of Industrial Property, Mar. 20,1883, as last revised at the Stockholm Revision Conference, July 14, 1967, 21 U.S.T. 1538, 828 U.N.T.S. 305, art. 4 bis. The independence of patents under the Paris Convention is consistent with the exhaustion of rights jurisprudence of the EU if independence is recognized as the independence of the property right of the patent rather than the exercise of the right. See id. art 4 bis ¶(2): “The foregoing provision is to be understood ... in the sense that patents applied for during the period of priority are independent, both as regards the grounds for nullity and forfeiture, and as regards their normal duration.” (emphasis added).

¹³⁸. See, e.g., cases 267-68/95, Merck & Co., Inc. v. Primecrown Ltd., 1 C.M.L.R. 83, ¶ 30 (1997) (patents: “to guarantee that the patentee has the exclusive right to use an invention with a view to manufacturing industrial products and putting them into circulation for the first time, either directly or by the grant of licenses to third parties, as well as the right to oppose infringements”); case 16/74, Centrafarm B.V. v. Winthrop BV, 1974 E.C.R. 1183, ¶ 8, [1974] C.M.L.R. 480:

In relation to trade marks, the specific subject matter of the industrial property is the guarantee that the owner of the trade mark has the exclusive right to use that trade mark, for the purpose of putting products protected by the trade mark into circulation for the first time, and is therefore intended to protect him against competitors wishing to take advantage of the status and reputation of the trade mark by selling products illegally bearing that trade mark.


¹⁴⁰. As the term “copyright” is used here, the civil law distinction between copyright and related rights is not material; both types of rights are analogously exhausted with exceptions discussed in the following sections. Deutsche Grammophon’s claim was premised on the
sche Grammophon ("DG") manufactured sound recordings in Germany which were sold to its Parisian subsidiary, Polydor. Metro acquired the sound recordings and DG sought to enjoin their reimportation into Germany. The Hamburg court hearing the matter submitted to the ECJ the question of whether it was contrary to Articles 5 and 85(1) of the Treaty for a national law to be used to exclude the parallel trade in these circumstances. The court held that "[t]he exercise of the exclusive right referred to in the question might fall under the prohibition set out by Article 85(1) each time it manifests itself as the subject, the means, or the result of an agreement." It continued that the exercise of such a national law must be examined in light of the principles in favor of the free movement of goods:

Amongst the prohibitions or restrictions on the free movement of goods which DG concedes Article 36 refers to industrial and commercial property. On the assumption that those prohibitions may be relevant to a right related to copyright, it is nevertheless clear from that article that, although the Treaty does not affect the existence of rights recognized by the legislation of a Member State with regard to industrial and commercial property, the exercise of such rights may nevertheless fall within the prohibitions laid down by the Treaty. Although it permits prohibitions or restrictions on the free movement of products, which are justified for the purpose of protecting industrial and commercial property, Article 36 only admits derogation from that Freedom to the extent to which they are justified for the purpose of safeguarding rights which constitute the specific subject-matter of such property.

If a right related to copyright is relied upon to prevent the marketing in a Member State of products distributed by the holder of the right or with his consent on the territory of another Member State on the sole ground that such distribution did not take place on the national territory, such a prohibition, which would legitimize the isolation of national markets, would be repugnant to the essential purpose of the Treaty, which is to unite national markets into a protection afforded sound recordings under German law, a right akin to copyright but not copyright in the strict civil law sense. Id.

141. Deutsche Grammophon, 1971 E.C.R. ¶2. Article 5 of the Treaty provides: "They shall abstain from any measure which could jeopardize the attainment of the objectives of this treaty." Article 85 (1) provides:
The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between member states and which have as their object or effect the prevention, restriction or distortion of competition within the common market."

Deutsche Grammophon's distinction between the existence and exercise of national IPR created the framework for subsequent cases—copyright and otherwise. However, it was for Musik-Vertrieb Membran v. GEMA to bring copyright fully under the rubric of Article 36's "industrial and commercial property" language.

Musik-Vertrieb Membran involved sound recordings that were sold in Britain and reimported into Germany. GEMA, the German performing rights society, brought actions on behalf of the copyright owners for the difference in royalties owing in Britain and Germany (1.25%). The defendant alleged that the principle of exhaustion prevented the collection of the additional royalty for importation into Germany. The court agreed and adopted its reasoning used in industrial property rights cases that having chosen to market in countries with differing royalty schemes it exhausted its rights and could not oppose further movement of the goods.

**B. Exhaustion May Occur Upon a First Sale in a Member State Where no IPR was Available**

When the intellectual property protection available for a particular article varies across member states, the issue arises whether sales of an article in a state where no intellectual property protection is available will exhaust the rights all member states so as to allow parallel trade. The answer depends on whether the parallel trade would offend the specific subject matter of the right involved. In Merck v. Stephar, the ECJ held that patent rights in one member state were exhausted with the sale in another member state where no patent protection was available. Merck owned patents in the Netherlands on the composition and process for making the drug Moduretic and marketed the product in Italy where no patent protection was available. Stephar purchased the drug wholesale in Italy

143. *Id.* ¶ 11-12.
146. Or demand the difference in royalty.
149. *Id.* ¶ 2-3. When the drug was first marketed in Italy no patent protection was available by decree. *Id.* ¶ 4. The decree was later held unconstitutional, but by then the invention was no longer novel and hence unpatentable. *Id.*
and sought to resell it in the Netherlands. Merck argued that the purpose of a patent is to allow the patentee to enjoy the rewards of the exclusive right to first market the patented article, and that this was not exhausted by the sale in Italy where there was no exclusive right. The court, however, concluded that the patent right guaranteed the right to first market the product, but does not guarantee that the patentee would obtain a reward in all circumstances. It rejected Merck's argument, and held that, having chosen to market its product in Italy, Merck exhausted its right to block reimportation into the Netherlands:

It is for the proprietor of the patent to decide in light of all the circumstances, under what conditions he will market his product, including the possibility of marketing in a Member State where the law does not provide patent protection for the product in question. If he decides to do so, he must then accept the consequences of his choice as regards the free movement of the product within the Common Market, which . . . must be taken into account by the proprietor of the patent in determining the manner in which his exclusive right will be exercised.

However, when an IP right holder does not consent to the first sale, the right to block reimportation is within the specific subject matter of the IPR and is not exhausted. For example, in *EMI Electrola v. Patricia Im-und Export*, the defendant marketed sound recordings in Denmark which had fallen into the public domain there. The sound recordings were still protected in Germany and EMI tried to prevent their import. The ECJ held that the exhaustion of rights principle was inapplicable because the first sale was not due to an act by, or with the consent of, the IP right holder or a licensee. The fact that any sale with the right holder's consent can exhaust IPRs was made clear in *Centrafarm v. Sterling Drug*. Ster-
ling held parallel patents in several Member States, including Britain and the Netherlands, for the pharmaceutical Negram. With prices for pharmaceuticals running 30% lower in Britain than in the Netherlands, Centrafarm purchased the drug in Britain for import into the Netherlands. While the court held that Sterling’s rights were exhausted upon its sale of the drug in Britain, it added:

Whereas an obstacle to the free movement of goods of this kind may be justified on the ground of protection of industrial property where such protection is invoked against a product coming from a Member State where it is not patentable and has been manufactured by third parties without the consent of the patentee ... a derogation from the principle of the free movement of goods is not, however, justified where the product has been put onto the market in a legal manner, by the patentee himself or with his consent, in the Member State from which it has been imported, in particular in the case of a proprietor of parallel patents.

What constitutes consent for a holder of parallel patents was clarified to some extent in Pharmon v. Hoechst. Hoechst held parallel patents Germany, the U.K., and Holland for the drug frusemide. A British company obtained a compulsory license of the patent pursuant to the British Patents Act of 1949. While the license prohibited export, the licensee sold a substantial amount to Pharmon for marketing in the Netherlands. The ECJ held that the marketing in a Member State under a compulsory license was not a consensual first sale that exhausted the patent rights.

These holdings are represented in text of the Agreement Relating to Community Patents (also known as the second Community patent convention). Article 76(1) provides the general rule that national patent rights would be exhausted by the first sale within an EU state. Article 76(2) provides that the exhaustion principle ap-

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158. Id. at 1154-49.
159. Id. ¶ 11 (emphasis added).
161. Id. ¶ 3.
162. Id. ¶¶ 4, 5.
163. Id. ¶ 8.
164. Id. ¶ 24 ("[W]hen the competent authorities in a member-State ... grant a compulsory license to a third party patentee which allows him to carry out manufacturing and marketing operations which the patentee would normally have the power to prohibit, the patentee cannot be regarded as having consented to the actions of the third party.").
166. Article 76(1) provides:
plies not only where parallel patents are held by the same party in multiple nations, but also to where the patentee in the exporting state has "economic connections" with the proprietor of the patent in the importing state.\textsuperscript{167} The \textit{Pharmon} holding is codified in Article 76(3).\textsuperscript{168} Article 28 provides that Community-wide exhaustion would occur under Community patents.\textsuperscript{169}

Although the second community patent convention has not been ratified, trademark law in the EU has made concrete steps toward formalizing the exhaustion of rights principle. A directive was promulgated in 1988 to guide member nations in harmonizing national trademark law.\textsuperscript{170} The directive provides for exhaustion of trademark rights upon the first intra-EU sale made with the owner's consent,\textsuperscript{171} but national rights will not be exhausted "where there exist legitimate reasons for the proprietor to oppose further commercialization of the goods, especially where the condition of the goods is changed or impaired."\textsuperscript{172} In addition, a separate regulation establishing the Community Trade Mark has been enacted which shares similar provisions with respect to exhaustion of rights.\textsuperscript{173}

\begin{itemize}
\item The rights conferred by a national patent in a Contracting State shall not extend to acts concerning a product covered by that patent which are done within the territory of that Contracting State after that product has been put on the market in any Contracting State by the proprietor of the patent or with his express consent, unless there are grounds which, under Community law, would justify the extension to such acts of the rights conferred by the patent.
\item The rights conferred by a Community patent shall not extend to acts concerning a product covered by that patent which are done within the territories of the Contracting States after that product has been put on the market in one of these States by the proprietor of the patent or with his express consent, unless there are grounds which, under Community law, would justify the extension to such acts of the rights conferred by the patent.
\item The rights conferred by a Community trade mark shall not extend to acts concerning goods which have been put on the market in the Community under that trade mark by the proprietor or with his consent.
\item Exhaustion of the rights conferred by a Community trade mark:
\begin{enumerate}
\item A Community trade mark shall not entitle the proprietor to prohibit its use in relation to goods which have been put on the market in the Community under that trade mark by the proprietor or with his consent.
\end{enumerate}
\end{itemize}
C. Exhaustion of Patent Rights Laws in the EU

The general principles stated above are most readily applicable to patent rights. The ECJ has stated that the specific subject matter of patent rights is to reward the creative effort of the inventor by guaranteeing that the patentee has the exclusive right to "use an invention with a view to manufacturing industrial products and putting them into circulation for the first time, either directly or by the grant of licenses to third parties, as well as the right to oppose infringements."174

_Centrafarm v. Sterling Drug_175 first held that national patent rights were exhausted with respect to products marketed in another member state by the patentee or with its consent.176 The issue before the court was whether the policy in favor of the free movement of goods in Article 30 of the EEC Treaty177 prohibited the use of Dutch patent law to prevent parallel imports of Negram originally marketed in Britain by Sterling's subsidiary.178 The ECJ reiterated the distinction between the existence and exercise of IPR, noting that only the specific subject matter of the IPR was safeguarded by Article 36.179 In marketing the patented object within the EU first through its British subsidiary, Sterling Drug exercised the right which was the specific subject matter of patent protection, and thereby exhausted its patent rights.180 Attempts by the Dutch subsidiary to block the parallel imports was thus in derogation of the free movement of goods.181

Consent to the first marketing of the product plays a prominent role in relation to patent law. _Pharmon v. Hoechst_,182 discussed relation to goods which have been put on the market in the Community under that trade mark by the proprietor or with his consent.

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177. _See supra_ note 131 (text of Article 30).
179. _Id._ ¶ 7-8.
180. _Id._ ¶ 10-15.
181. _Id._
above, adds the rule that sales under a compulsory license do not exhaust patent rights, because the patentee is not freely consenting to the exercise of the specific subject matter of her rights— the exclusive right to first market articles embodying the invention.

Patent rights throughout the EU are exhausted by a first intra-EU sale despite the legal preclusion of patent protection for the marketed item. This principle was first laid down in Merck v. Stephar and recently reaffirmed in Merck v. Primecrown. The cases are similar both factually and legally. The issue in the cases arose from the fact that certain member states did not provide patent protection for certain pharmaceuticals. In both cases, the U.K. patentee sold the pharmaceuticals in markets where no patent protection was available at a significantly lower price than in the U.K. The suits were attempts to stop parallel importation of the goods into the U.K. In Stephar, the advocate general concluded that the court’s jurisprudence on exhaustion applied and suggested the court find the patent rights exhausted by the sales in Member States where no patents were available. The ECJ agreed and held that, having voluntarily marketed its product in a Member State where no patents were available, the patentee exhausted its right to prevent importation of the goods. Fifteen years later in Primecrown, the advocate general urged reversal of the Stephar holding. The ECJ reaffirmed none-

183. See supra notes 160–164 and accompanying text (discussing Pharmon).


188. Or a subsidiary.


190. It is for the proprietor of the patent to decide, in the light of all the circumstances, under what conditions he will market his product, including the possibility of marketing it in a Member State where the law does not provide patent protection for the product in question. If he decides to do so, he must then accept the consequences of his choice.

Id. ¶ 11.

Applying *Stephar*, the ECJ held that the presence of price controls in the exporting state did not render *Stephar* inapplicable. However, if a plaintiff were able to prove that it had a legal obligation to market the product in the exporting state, then its national patent rights in other Member States would not be exhausted by a sale in the exporting state.

**D. Trademarks and Parallel Imports in the EU**

The first sale of trademarked goods within the EU generally exhausts national trademark rights. In addition, rights under the new Community trademark are exhausted upon the first sale within the EU, except when there are "legitimate reasons to... oppose further commercialization of the goods." The doctrinal provisions with respect to trademark law do not differ greatly from those of patent law discussed above: rights under national trademark laws are exhausted by the first sale in the EU unless the right being enforced is the specific subject matter of trademarks. The specific subject matter of trademarks is:

> the guarantee that the owner of the trade mark has the exclusive right to use that trade mark, for the purpose of putting products protected by the trade mark into circulation for the first time, and is therefore intended to protect him against competitors wishing to take advantage of the status and reputation of the trade mark by selling products illegally bearing that trade mark.

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192. *Id.* ¶ 33.
193. *Id.* ¶ 47.
194. *Id.* ¶ 50.
195. *See, e.g.*, case 16/74, Centrafarm B.V. v. Winthrop, 1974 E.C.R. 1183 (where exclusive licenses to the trademark NEGRAM for a pharmaceutical were given in Britain and the Netherlands and goods purchased in Britain were imported into the Netherlands, the court held that the purpose of trademark protection was to allow for the first sale of the product free from competitors trading on the status and reputation of the mark, and that having consented to the sale in Britain, subsequent prohibitions on the free movement of the goods would be inconsistent with the *EEC* Treaty).
196. Council Regulation, 40/94, 1004 O.J. (L 11) art. 13. The article provides:

> Exhaustion of rights conferred by a Community trade mark

1. A Community trade mark shall not entitle the proprietor to prohibit its use in relation to goods which have been put on the market in the Community under that trade mark by the proprietor or with his consent.

2. Paragraph 1 shall not apply where there exist legitimate reasons for the proprietor to oppose further commercialization of the goods, especially where the condition of the goods is changed or impaired after they have been put on the market.

However, two particular issues relating to trademarks have arisen: the repackaging of goods and former corporate affiliations.

1. Repackaging of goods

Pharmaceuticals are frequent sources of parallel trade. The differences in the trademark under which the product is sold or the quantities in which the product is generally prescribed in the destination country require repackaging of the product. A line of cases has developed the conditions under which national trademark rights will be exhausted despite their repackaging by a parallel importer. In order to successfully remarket a repackaged product, a parallel importer must reaffix the proper trademark and show:

1. The repackaging is necessary in order to market the product in a member state and is carried out in a manner which does not affect the condition of the product;

2. The repackaging cannot affect the original condition of the product inside the packaging;

3. The new package clearly states who repackaged the product and the name of the original manufacturer;

4. The presentation of the repackaged product is not liable to damage the reputation of the trademark or its owner;

5. The importer gives notice to the trade mark owner before the repackaged product is put on sale and provide a sample on demand.

198. It should be made clear that this situation is distinct from a parallel importer merely importing branded goods without any modification and frequently involves the removal of old packaging, adding new inserts appropriate for the destination country, manipulating blister packs to get the desired quantity, and adding indication of the repackaging party.


2. Former Corporate Affiliation

A series of cases have addressed the issue of whether former corporate affiliation between the holders of a mark in separate member states bars the use of national laws to prevent importation of legitimate goods bearing the plaintiff’s mark, i.e., whether former corporate affiliation exhausts trademark rights vis à vis the former affiliate. In *Sirena*, the ECJ held that the assignee of a mark in one Member State was barred from using its national trademark rights to prevent importation of goods marketed in another Member State by the assignor. This early holding was extended in *Hag I* which involved the HAG trademark for coffee originally owned by a Hag AG in Germany, Belgium and Luxembourg. Before World War II, Hag AG set up a subsidiary in Belgium, which held the ownership rights to the mark in Belgium and Luxembourg. After the war, the company was expropriated as enemy property and the marks were eventually acquired by Van Zuylen Freres who opposed imports of Hag coffee from the original German company. The ECJ held that national trademark rights could not be used to prohibit goods made in another member state under an identical trademark having the same origin. The roles were reversed in *Hag II*, wherein the German Hag sought to prevent importation of Belgian HAG goods into Germany. The ECJ reversed the holding of *Hag I*. Stressing the lack of consent to the marketing of challenged goods and the source identifying aspect of a trademark, the ECJ held that each of the proprietors of the HAG mark could oppose importation and marketing within their own territories of goods marketed by the other.

*Hag II* was limited by the ECJ to its factual setting involving an involuntarily transferred mark; this left unanswered the question of what types of transfers from a common origin would retain national trademark rights for the parties. This was answered in *Ideal Stan-

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206. *Id.* at 732.

207. *Id.* at 743.


209. *Id.* ¶ 23.

210. *Id.* ¶ 19.
1997] EXHAUSTION OF RIGHTS 481

dard.211 American Standard had licensed its trademark for heating equipment and sanitary fittings to Ideal Standard — its German subsidiary (GIS) — and a similarly named French subsidiary. Through several transactions, the rights in the French mark for heating were held by a company completely unrelated to American Standard. When the French company's German subsidiary tried to import heating products into Germany, where GIS had ceased production, GIS objected. The ECJ held that the assignments did not preclude GIS from opposing the imports.212 Stressing the consistent-quality-indicating function of trademarks, the court reasoned that once a mark has been transferred to an unrelated party, the original owner cannot exercise control of the quality of the goods.213 The role of a trademark to indicate a consistent quality would therefore be thwarted if importation could not be stopped.

E. Exhaustion of Copyright and Neighboring Rights in the EU

Rights in copyrighted214 works are subject to exhaustion upon


213. Id. ¶ 41.

214. The phrase "copyrighted" will be used to refer to both classical copyright and neighboring rights as the distinction is irrelevant for the purposes of the discussion.

In Musik-Vertrieb Membran v. GEMA, cases 55 and 57/80, 1981 E.C.R. 174, [1981] 2 C.M.L.R. 44 (1981), it was argued by the French Government that because copyright protects the moral rights of authors which were not subject to exhaustion, copyrights should be distinguished from patent and trademarks for purposes of exhaustion of rights. Id. ¶ 12. The court rejected this distinction and clearly brought copyrights within exhaustible rights:

"The French Government has argued that . . . [the existing] case-law cannot be applied to copyright, which comprises inter alia the [moral rights of authors]. . . . It is contended that, in thus conferring extended protection, copyright is not comparable to other industrial and commercial property rights such as patents and trade-marks.

It is true that copyright comprises moral rights of the kind indicated by the French Government. However, it also comprises other rights, notably the right to exploit commercially the marketing of the protected work. . . . It is this economic aspect of copyright which is the subject of the question submitted by the national court and, in this regard, in the application of Article 36 of the Treaty there is no reason to make a distinction between copyright and other industrial and commercial property rights.

While the commercial exploitation of copyright is a source of remuneration for the owner it also constitutes a form of control on marketing exercisable by the owner . . . From this point of view commercial exploitation of copyright raises the same issues as that of any other industrial or commercial property
the first sale within the EU. The principle was first articulated in *Deutsche Grammophon v. Metro* as discussed above. Cases after *Deutsche Grammophon* refined which of the rights incident to copyright are subject to exhaustion.

*Musik-Vertrieb Membran v. GEMA* held that royalties owing for sound recordings were exhausted when a parallel importer took them from a Member State with a lower rate to one with a higher rate. The court reasoned that having chosen to market in this way, the copyright holder must live with the consequences of aligning copyright with other industrial and commercial property. Not all of the rights incident to copyright are subject to exhaustion. *Warner Bros. v. Christiansen* held that a lending right for videotapes was not subject to exhaustion. Warner Bros. owned the copyright in a film and assigned the video production rights in Denmark to co-plaintiff Metronome. The defendant purchased a video copy of the film in Britain in contemplation of renting it out in Denmark which would violate an exclusive right of Metronome. The defendant argued that *Membran* should govern, but the ECJ recognized that rental rights reflect the value in the repeated performance of a work and held the right not exhausted.

Further recognizing the ongoing nature of some of the copyrights, *Coditel v. Ciné-Vog Films* held that performance rights in a film were not subject to exhaustion. The case involved the unauthorized rebroadcast of a German television transmission of the film *Le Boucher* in Belgium by Coditel, a Belgium cable television company. The copyright owner apparently granted rights for the film to be broadcast in Germany while simultaneously granting exclusive

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*Id.* ¶ 11-13.

215. *See supra* note 139 and accompanying text (discussing Deutsche Grammophon).


217. *Id.* ¶ 25.


219. *Id.* ¶¶ 4-5.

220. *Id.* ¶ 18.

221. *Id.* ¶¶ 14-17. "[W]here national legislation confers on author a specific right to hire out video-cassettes, that right would be rendered worthless if its owner were not in a position to authorize the operations for doing so." *Id.* ¶ 19.


223. *Id.* ¶ 2-3. Ciné-Vog owned the rights to distribute the film in Belgium (*Id.* ¶ 5) and the exclusive right to exhibit the film publicly in Belgium starting forty months after the first showing of the film in Belgium. *Id.* ¶ 14.
Belgian rights to Ciné-Vog. When the film was broadcast in Germany, Coditel picked up the broadcast and retransmitted it over its cable network—contrary to Ciné-Vog’s rights. The court distinguished performance rights from those of reproduction and held the performance right not exhausted.224 While Coditel involved the provision of services (broadcast), its holding has been extended to the performance rights in copyrighted goods.225

In sum, distribution rights are exhausted with the first sale in the EU,226 but performance rights are not.227 A parallel importer is not liable for the difference in royalty payments a copyright holder charges in different nations.228 A parallel importer, however, can be blocked from lending out gray market copies in countries with lending rights or exercising other continuing rights.229

F. Laws of Member States

The foregoing concerned the laws governing the exhaustion of intellectual property rights under the national laws of member nations of the European Union. These Member States have their own jurisprudence with respect to exhaustion of rights for non-EU trade as well. While it is beyond the scope of this comment to survey the laws of all member nations,230 it should be noted that many European nations have adopted the principle of international exhaustion for some intellectual property rights.231 It is unclear in this context whether the trademark harmonization directive232 which codifies the

224. Id. ¶ 13-14.
228. GEMA, a German copyright protection organization sought the difference in royalties charged in Britain (the source of the gray market sound recordings) and Germany (their destination) the court held the copyrights exhausted because the right holder was free to put his goods on sale wherever they chose; having chosen to market in Britain they reaped their chosen reward with the first sale). Combined cases 55 & 57/80 Musik-Vertrieb Membran v. GEMA 1981 E.C.R. 147.
230. For an extensive survey of the laws relating to parallel imports in Europe, see WARWICK ROTHENBERG, PARALLEL IMPORTS, (1993).
232. See supra notes 170-173 and accompanying text (discussing trademark directive and regulation).
principle of European exhaustion precludes a Member State from adopting international exhaustion. That is, it is unclear whether the European exhaustion principle in the trademark directive provides a minimum level of protection for rights-holders or whether it provides a minimal level of protection for consumers by barring impediments to the free movement of goods. At the time of this writing, it was too early to tell what the ECJ’s views on this issue were, but whatever the resolution, it will play a key role in movement towards harmonization of the exhaustion of rights principle. This is particularly true in that a significant trading nation—Japan—appears to have adopted the principle of international exhaustion.

IV. EXHAUSTION OF RIGHTS UNDER JAPANESE LAW

Compared to the European Union, Japan has relatively little case law on the subject of parallel imports. There have been cases dealing with trademark, copyright, and patent, with a recent patent case likely being the best indicator of where the Japanese courts now stand on the issue.

The Japanese Trademark Act provides that importing goods that bear marks confusingly similar to registered marks constitutes infringement. However, in Parker Pen, the court held that genuine goods imported by the exclusive Hong Kong licensee could be distributed in Japan over the objection of the exclusive Japanese licensee. The court reasoned that the policy of trademark was to identify the source of the goods and guarantee their quality. Since the goods were genuine, indeed identical, to plaintiff’s pens, there was no substantive wrong because the consuming public would not be confused. Subsequent amendments to the Tariff Act made explicit when parallel imports of trademarked goods are permissible:

The permission to make parallel imports of genuine goods extends to those goods which were legitimately trademarked and distributed by a person who is the trademark right holder in Japan or who has a special relationship with the trademark right holder in Japan so that both persons can be regarded as one person. But if the source or quality indicated or guaranteed by the trademark attached to the goods thus distributed differs from the source or quality indicated or guaranteed by the trademark under petition

233. 4 ZENTARO KITAGAWA, DOING BUSINESS IN JAPAN § 3.07[4] (1996)
235. Id.
236. Id.
and the trademark as used by the parallel importer is considered to be separately used under circumstances similar to those of the petitioner's trademark, then in such cases those genuine goods should be excluded from Japan. 237

A 1994 judgment in the Tokyo District Court indicates that in some contexts, Japanese copyrights will not be exhausted by first sales abroad. 238 The plaintiff sold videotapes in Japan and imported from the United States 1000 copies of the movie “101 Dalmatians.” 239 The defendant was in the business of selling pre-recorded video tapes and discs for home use. 240 The defendant distributed a paper to alert the business circles that parallel importation of video cassettes from the United States was illegal. 241 The plaintiff sued alleging that distribution of the paper interfered with its sale of the “101 Dalmatians” videos. 242 The Tokyo District Court reasoned that importation into Japan of video cassettes of a movie not yet released in Japan or still in theaters, would seriously damage the market for the movie as well as sale of authorized video tapes and found for the defendant. 243 Also relevant to the court was the fact that the license grant to the manufacturer in the United States was not thought to be in contemplation of, and with consideration for, distribution in Japan. 244

In the patent context, there are two key Japanese cases. 245 The first, a 1969 case, involved the import of used pin-setting machines from Australia which were covered by Japanese and Australian patents. 246 The court there held that the sale in Australia did exhaust the Australian patent rights, but not those in Japan, and found infringement. 247 A 1995 case reversed this holding. 248 The case, Japauto Products Kabushiki Kaisha v. BBS Kraftfahrzeugtechnik (“aluminum wheels case”), held that the first sale of

237. Id. (citing Finance Ministry directive of 08/25/1972 Kurakan No. 1443).
239. Id.
240. Id.
241. Id.
242. Id.
243. Id.
244. Id.
246. Id. at 568-59.
247. Id.
248. Id.
a patented item outside of Japan also exhausts the patent rights in Japan. The case involved the parallel import of patented aluminum wheels covered by Japanese and German patents. Plaintiff BBS both manufactured its own wheels and licensed another to do so in Germany. The defendants purchased wheels in Germany and imported them into Japan where BBS brought suit under its Japanese patents. The Tokyo High Court, reversing the lower court's finding of infringement, held that the plaintiff was adequately compensated by his sale in Germany and the provision of an additional royalty merely for the goods crossing national borders was unwarranted. The court thus extended the doctrine of exhaustion of rights from those sales taking place in the destination country to all authorized sales.

V. NEED FOR HARMONIZATION

The issue of parallel importation arises because of the ease of transnational commerce. As the transborder flow of goods increases the problem will grow even more pressing. At the same time, there is a movement towards the harmonization of intellectual property laws. It is proper that the confused state of the law of parallel trade be addressed in international fora. However, analysis of the current law of exhaustion of rights reveals deeper divisions in the law of the United States and its major trading partners than may be amenable to simple solutions.

A. Nature of Exhausted Rights

There are three differing principles represented in U.S. law on what exhausts intellectual property rights. The first, and most well established, comes from cases arising under the patent laws and focuses on the transfer of the property interest in the article. For example, in Holiday v. Mattheson, the court stated "[w]hen the owner..."
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sells an article without any reservation respecting its use . . . the purchaser acquires the whole right of the vendor in the thing sold . . . .” The court in *Univis Lens* similarly focuses on transfer of interest in stating that “[a]n incident to the purchase of any article, whether patented or unpatented, is the right to use it and sell it . . . the authorized sale . . . is a relinquishment of the patent monopoly with respect to the article sold.”

A recent copyright case followed a very different principle which maintains that only sales which give the right holder the full value of the sale exhaust the rights. This principle focuses more on the interests of the right holder than those of its transferee and represents an emphasis on the means chosen by Congress — the incentives in the Copyright Act — rather than the goals of copyright — provision of works to the public. That is, only sales which discharge what the court believes to be the statutory purpose of assuring the right holder the “full value” of their IPR. For example, in *L’Anza* the court states that “when title passes does not necessarily indicate a ‘sale’ for the purposes of the ‘first sale’ defense to copyright infringement . . . .” The court also states that “once the copyright owner has received his full value for the copy, the policy goal of protecting the copyright holder gives way to the policies disfavoring limitations on the alienation of property.” So to the *L’Anza* court, exhaustion of rights was not an incident to the sale, but rather the result of balancing competing policies. It is unclear whether this new notion has broad acceptance. The *L’Anza* court was a different panel of the Ninth Circuit than that in *Denbicare* five months earlier which construed the same authority relied upon by the *L’Anza* court but reached the opposite conclusion: “Just as courts will not inquire into the sufficiency of consideration, there is no justification for re-examining the adequacy of the ‘reward’ received by the copyright holder.”

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254. *Id.*
256. *Id.* at 249.
259. *Id.* at 1113 (citing the lower court’s opinion in the same case). See also *supra* notes 101-107 and accompanying text (discussing *L’Anza*).
260. 93 F.3d at 1113.
261. *Denbicare U.S.A., Inc. v. Toys “R” Us, Inc.*, 84 F.3d 1143 (9th Cir. 1996). See also *supra* notes 116-128 and accompanying text (discussing *Denbicare*).
owner in an alleged first sale where the owner has consented to that sale.\textsuperscript{262}

Cases under the trademark laws recognize a third principle in the common control doctrine.\textsuperscript{263} Under this principle, when the source of the goods in the exporting nation is under common control with the authorized seller in the importing nation, parallel trade cannot be stopped under the trademark laws. This is, in effect, exhaustion of the U.S. mark-holder’s rights through first sales by affiliated parties. The Ninth Circuit has explicitly rejected extending this notion to copyright.\textsuperscript{264} Yet, paradoxically, the Ninth Circuit has also held that the same standard applies for determining whether a first sale has occurred under \S\ 109 of the Copyright Act\textsuperscript{265} as under the trademark laws.\textsuperscript{266}

Thus, under U.S. law, there are three different principles determining whether the sale of item embodying IPR will exhaust those rights. By contrast, under EU law, a single principle has traditionally applied. The policy in favor of the free movement of goods provides national IP rights are exhausted by the first authorized intra-EU sale.\textsuperscript{267}

The nature of IP rights in the European Union which are subject

\textsuperscript{262} Id. at 1151. In addition, the \textit{L'anza} court adopted a reward test which conflicts with the position of our major trading partners and frustrates moves towards harmonization. The \textit{L'anza} adopted a “full value” test: distribution rights are only exhausted with respect to lawfully made goods being imported if the copyright owner has received the price charged in the United States. An alternative reward test would be whether the copyright owner received the reward flowing from the exclusive right to first market the product. Under this reward test, having chosen to market its goods as it did, \textit{L'anza} would have to live with the consequences because it exercised its right to distribute copies of its label. This is the approach taken by the European Court of Justice with respect to copyrights in \textit{Musik-Vertrieb Membran} (see also supra note 216 (describing case)) and patents (see supra notes 185, 186, and infra notes 270-271 and accompanying text (describing \textit{Merck} cases holding that sales in countries denying patent protection exhaust patent rights in other countries because considering all market factors patentee chose to exercise the right to first market the product)). Japanese courts appear to take the same approach with respect to patents. \textit{See supra} Part IV. The full value test for patents was implicitly rejected by the Supreme Court for patents in \textit{Adams v. Burke} supra note 28 and accompanying text. \textit{Adams} was essentially a parallel import case, but with the parallel trade taking place within different exclusive territories in the state of Massachusetts. The Court held that when right holder sold the good and received his consideration this exhausted the rights. \textit{See id.}


\textsuperscript{264} Parfums Givency Inc. \textit{v. Drug Emporium}, 38 F.3d 477, 482 (9th Cir. 1994).

\textsuperscript{265} 17 U.S.C. \textsection\ 109 (1988).

\textsuperscript{266} Denbicare U.S.A., Inc. \textit{v. Toys "R" Us, Inc.}, 84 F.3d 1143, 1151 (9th Cir. 1996) (“Since the . . . sale qualified as a first sale for copyright purposes, it is a trademark first sale as well.”).

\textsuperscript{267} \textit{See supra} Part III.
to exhaustion\textsuperscript{268} most closely parallels rights under the U.S. patent law with aspects of the common control principle. The full reward theory has been implicitly rejected by holdings such as \textit{Musik-Vertrieb Membran v. GEMA}\textsuperscript{269} where the ECJ refused to prevent the parallel importation of sound recordings on account of a difference in royalty rates between the importing and exporting country. The ECJ’s reliance on a consenting first sale in the \textit{Stephar} and \textit{Primecrown} cases provides further insight.\textsuperscript{270} In both cases, the ECJ made clear that, having consented to the first sale within a Member State, the right holder exhausts national patent rights, despite the unavailability of patent exclusivity, and accompanying supracompetitive profits in that nation.\textsuperscript{271} This parallels U.S. patent cases such as \textit{Curtiss Aeroplane} where the court stated “[a]s the plaintiff has already been paid for these aeroplanes the full price it asked, it is no longer concerned about the price at which the article is sold, or whether the article is kept in Canada [the exporting country] ... or in the United States [the importing country].”\textsuperscript{272}

The common control principle found in U.S. trademark law\textsuperscript{273} is also represented in aspects of EU law. Most indirectly, but more forcefully than in the United States, the principle exists in the legal principle that a \textit{consenting} first sale exhausts national IP rights. Ordinarily where the plaintiff and the exporting organizations would be under common control, such as parent and subsidiary, or geographically distinct exclusive licensees, the marketing of the product is with the consent of the IP right holder. That is, the sale of the item was with the consent of the right holder and the exhaustion question


\textsuperscript{270} \textit{See supra} notes 184-194 and accompanying text (discussing cases).

\textsuperscript{271} \textit{See supra} notes 184-194 and accompanying text (discussing cases). \textit{See also Pharon, supra} notes 160-164 and accompanying text. \textit{In Pharon}, where the first sale was under a compulsory license national patent rights were not exhausted because of the lack of consent. This lends support to the proposition in the text in two ways: (1) were the ECJ applying a reward theory, the compulsory license would, ipso facto, negate full reward having been received, and (2) had consent to the first sale not been the underlying principle, the ECJ could have reached a contrary holding and better serve the policy in favor of the free movement of goods.


\textsuperscript{273} \textit{See supra} Part I.B.
arises because of a parallel importer. The same situation arises under EU law and is dealt with indirectly through the IP right holder's consent to the marketing either directly or through a licensee.\textsuperscript{274} Thus EU law, theoretically the most compact and consistent across intellectual property doctrines, illustrates by way of contrast the \textit{ad hoc} manner in which analogous principles coexist in the United States.

Japanese law provides yet a third example which sheds light on the differences in exhaustion under both U.S. and EU law. Looking at the recent holdings in Japan and the United States, for example, \textit{L'Anza} and the aluminum wheels case, provides an illuminating contrast. In the aluminum wheels case,\textsuperscript{275} the court held that sales in Germany exhausted Japanese patent rights because the first sale in Germany adequately compensated the patentee and the provision of an additional royalty merely for the goods crossing international borders to be unwarranted.\textsuperscript{276} In \textit{L'Anza}, the court ruled that even a sale within the United States need not exhaust U.S. copyrights when goods were destined for sale at a lower price in another country.\textsuperscript{277} In effect, a U.S. copyright never is exhausted by sales at prices below U.S. prices. Thus, the courts in the aluminum wheels case and \textit{L'Anza} seem to agree that a reward-based test is the appropriate one, but the courts reach different conclusions as to whether the test will be satisfied under ordinary parallel import circumstances.\textsuperscript{278} In contrast to EU doctrine which is premised on the harm to consumers of impairing the free movement of goods, the Japanese courts appear concerned with the unjust enrichment of the patentee rather than harm to consumers from allowing IP rights to facilitate horizontal market division.

Across the three sets of law which this comment examines, there


\textsuperscript{275} See supra note 245 and accompanying text (discussing case).

\textsuperscript{276} Id.

\textsuperscript{277} Id.

\textsuperscript{278} The reasoning of the \textit{L'Anza} court, whatever its merits jurisprudentially, was not well matched to the facts of the case. The copyright in \textit{L'Anza} involved the labels on bottles of hair care products. The court was construing the market price of the hair care product as synonymous with the value received for the copyright. While the value of a copy and the article embodying it are probably identical in the case of, say a videotape, in the label context this seems to be an unrealistic assumption. Just as the full value for the copyright in a bumper sticker should not differ if it were being sold attached to a Mercedes or a Ford, the value of the copyright in the label should not be affected by the market price for the shampoo. Yet this is the basis of the court's holding. See supra notes 101- and accompanying text (discussing \textit{L'Anza}).
are significant differences in how and why an intellectual property right is exhausted by a first sale. Moreover, in some instances, such as within the United States, there are clear differences across intellectual property doctrines and jurisdictions. These must obviously be resolved as an incident to any movement towards international harmonization. While there may be legitimate policy reasons for particular differences across intellectual property doctrines,\textsuperscript{279} there are inconsistent opinions as to the role such differences should play in any ultimate harmonization. For example, cases like \textit{Holiday, Curtiss Aeroplane}, and \textit{Primecrown} base their holdings either on the nature of the transfer of a chattel or policies in favor of free trade, while cases like \textit{L'Anza} and \textit{Ideal-Standard} base their holdings on fulfilling the policy behind the intellectual property right. These, indeed, would appear to be the proper policies to focus upon, but the absence of a clear rationale internationally makes trade a perilous business. It is precisely these discrepancies which must be confronted in order to achieve a principled harmonization and lower trade barriers.

\textbf{B. Territorial Effect of a First Sale}

The use of intellectual property laws as a trade barrier is related to the territory which is covered by the intellectual property right: parallel imports may only be excluded from the territory where the IPR is in effect. The scope of the territoriality of IPR is a central element in the overall idea of exhaustion of rights. Whereas the previous section explored what characteristics must be present for a sale to exhaust IPRs, territoriality answers the two other questions: where a sale must occur in order to exhaust IPR and where those IPRs will

\textsuperscript{279} The evolution of EU cases would suggest that there would not be great differences. For example the ECJ has held the following as the specific subject matters of intellectual property rights: for patents “to guarantee that the patentee has the exclusive right to use an invention with a view to manufacturing industrial products and putting them into circulation for the first time, either directly or by the grant of licenses to third parties, as well as the right to oppose infringements.” Cases 267-68/95, Merck & Co., Inc. v. Primecrown Ltd., 1 C.M.L.R. 83 ¶ 30 (1997). For copyright, it includes the exclusive right of reproduction and first marketing of the work as well as the to oppose infringements. Case 341/87, EMI Electrola GmbH v. Patricia Im- und Export, 1989 E.C.R. 79, [1989] 2 C.M.L.R. 413 (1989); Case 158/86, Warner Bros. v. Christiansen, 1988 E.C.R. 2521. For trademarks:

[T]he specific subject matter of the industrial property is the guarantee that the owner of the trade mark has the exclusive right to use that trade mark, for the purpose of putting products protected by the trade mark into circulation for the first time, and is therefore intended to protect him against competitors wishing to take advantage of the status and reputation of the trade mark by selling products illegally bearing that trade mark.

be exhausted.

Under EU law, the issue of territoriality is not one of nations but one of a region — the area of the EU. The EU has primarily adopted the principle of territoriality and IPRs under the laws of Member States are generally exhausted only by sales that occur within the EU. The clearest rule is that sales outside the EU do not exhaust the national rights throughout EU Member States. The territoriality of Member States' IP laws has been called into some question with respect to countries with which the EU shares a free-trade relationship. Polydor v. Harlequin Record Shops established that a free-trade relationship with the EU did not mean that the principle of exhaustion applied to products originating in such a country. However, some commentators suggest that when language of the free trade agreement parallels that of Articles 30 and 36 of the EC Treaty, the ECJ might interpret such language as exhausting rights. The ECJ has recently held that, under the Trademark Directive, national trademark rights are exhausted by sales outside Member States when: (1) the product has been imported into another Member State by the owner of the mark or another company in the same group as the owner; (2) it was lawfully acquired in the Member State by an independent trader who exported into another Member State; (3) the product has not been altered beyond what is needed to provide information needed under the legislation of the importing state, and (4) the trademark rights in the exporting and importing Member States are held by the same group.

In contrast, under U.S. law there are no clear general rules. With respect to patent rights, Sanofi held that a sale in France exhausted the U.S. patent rights, whereas Griffin held that a sale in Italy did not exhaust the U.S. patentee's rights. While the cases are

280. But see supra note 231 (some nations hold international exhaustion under their laws).
281. See supra Part II.
282. The ECJ held this in EMI v. CBS discussed supra note 136.
285. See supra notes 170-172 and accompanying text (discussing directive).
factually distinct, in that in Griffin parallel patents were held in the exporting and importing state but not in Sanofi, the distinction, as a theoretical matter, is irrelevant to the territorial extent of a U.S. patent. Griffin, a district court case, is in conflict with Curtiss Aeroplane, a circuit court case, which held that foreign and domestic patents are exhausted upon the first sale, even when that sale is outside the United States. The backdrop of all these cases is Boesch v. Graff where the Supreme Court held that U.S. patent rights were territorial. The best principle to synthesize these disparate holdings is to examine whether the U.S. patentee received compensation for the sale alleged to have exhausted its rights. In Sanofi and Curtiss Aeroplane they clearly did, whereas in Boesch the patentee clearly did not. Griffin does not assimilate neatly. In Griffin, it was an exclusive licensee who made the sale. While the U.S. patentee presumably received its bargained-for royalty, the court still held that the U.S. rights were not exhausted under classic principles of territoriality.

Under U.S. copyright law, cases are similarly in conflict. The statutory language giving rise to the conflict, "the owner of a particular copy or phonorecord lawfully made under this title... is entitled without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy or phonorecord," has led courts to inconsistent holdings on the territorial extent of U.S. copyrights. Specifically, it is not clear to the courts where a sale must occur to exhaust U.S. copyright. Early interpretations construed the language to mean that only articles manufactured and sold within the United States were subject to exhaustion, and influential commentators agreed. At least one recent case rejects this and holds that under § 109(a) a sale abroad exhausts U.S. copyright. Others have
reached the opposite conclusion and interpreted § 602(a) as giving the right of § 106(3) (which § 109 limits) extraterritorial scope. Finally, the most recent case from the Ninth Circuit held, in effect, that notions of territoriality are irrelevant in this context, with the relevant concern being whether the first sale was one for full value.

Under U.S. trademark law, on the other hand, in what territory the first sale occurred is not directly relevant to whether the U.S. mark holder has a right to stop parallel imports. If the goods are genuine in that they bear the mark with the authority of the mark holder, and the sale was made by the U.S. mark holder or one under common control, where the sale occurred does not matter; the U.S. trademark rights are exhausted. While older cases such as Katzel reflected judicial adherence to the principle of territoriality, this has largely been superseded by the Supreme Court's holding in K Mart with respect to § 526 of the Tariff Act and circuit court opinions which have limited Katzel to its particular set of equities. Paradoxically, U.S. trademark rights are still clearly territorial in the context of use sufficient to confer protection.

296. See BMG Music v. Perez, 952 F.2d 318 (9th Cir. 1991).
297. L'Anza Research Int'l., Inc. v. Quality King Distrubs., Inc., 98 F.3d 1109, 1116 (9th Cir. 1996).

Generally U.S. copyright law will not be applied extraterritorially against alleged infringers. See Subafilms, Ltd. v. MGM-Panthe Communications Co., 24 F.3d 1088, 1095 (9th Cir. 1994) (citing cases). While, a priori, this might appear to be a useful body of decisions to interpret whether extraterritorial acts exhaust rights under § 109, its applicability is likely limited. The reasons for not applying U.S. law extraterritorially flow from the fact that all nations are sovereign and were the United States to proscribe conduct which a different sovereign either explicitly or implicitly allows, the concept of sovereignty would be rendered meaningless. See generally RESTATEMENT (THIRD) FOREIGN RELATIONS §§ 400-403 (1995). The question of whether extraterritorial sales can exhaust U.S. copyright does not implicate the affront to the sovereignty of other nations that proscribing conduct does. Rather it is simply the question of whether an event that takes place outside the United States can determine whether copyright exists with respect to a work or copy. This notion that has been part of U.S. copyright law for years. For example, even the current U.S. copyright law denies protection to most works which are published abroad before in the United States in a nation that is not in a treaty relationship with the United States. See 1 NIMMER, supra note 90, § 5.05.

299. See NEC Elecs. v. CAL Circuit Abco, Inc., 810 F.2d 1506, 1510 (9th Cir.1987) (limiting application of Katzel to cases with the same equities as Katzel); Olympus Corp. v. United States, 792 F.2d 315, 321-22 (2d Cir. 1986) (limiting Katzel to its "special facts"); Weil Ceramics and Glass, Inc., v. Dash, 878 F.2d 659 (3d Cir. 1989).
300. Person's Co., Ltd. v. Catherine Chrismian, 900 F.2d 1565 (Fed.Cir. 1990) (Japanese prior use insufficient to confer U.S. priority right). The Lanham Act has also been interpreted to have a broad extraterritorial reach. Steele v. Bulova Watch Co., 344 U.S. 280 (1952); Scotch Whisky Ass'n v. Barton Distilling Co., 489 F.2d 809 (7th Cir. 1973); American Rice, Inc. v. Arkansas Rice Growers Co-op Ass'n., 701 F.2d 408 (5th Cir. 1983).
The dearth of Japanese decisional law in the area makes firm conclusions difficult in the area of territoriality. The aluminum wheels case clearly indicates that extraterritorial sales can exhaust Japanese patent rights. Moreover, the Parker Pen case and the Tariff Act suggest a similar principle applies to trademark rights. This aligns Japanese law more closely with U.S. law than EU law, but the clear holding that sales anywhere in the world exhaust parallel Japanese patents is likely not the law in the United States, while it clearly is the law in the EU for intra-EU sales.

The territorial reach of IPR relates to the exhaustion principle in two ways. First, it defines the scope of the rights that will be exhausted if exhaustion occurs. In this aspect, EU law is the broadest, exhausting national IP rights regionally. Under NAFTA, signatories ensure “that measures to enforce intellectual property rights do not themselves become barriers to legitimate trade.” The provisions relating to the border measures for intellectual property are silent with respect to parallel imports. The language quoted above is weaker than the EU’s Article 30 which provides, “[q]uantitative restrictions on imports and all measures having equivalent effect shall . . . be prohibited between Member States.” Nonetheless, an argument can be made that for the same reasons IPRs are regionally exhausted in the EU, regional exhaustion is appropriate under NAFTA. This author is aware of no case that has reached such a conclusion, and when U.S. IPRs are exhausted, they are only ex-

301. See supra note 237 and accompanying text (discussing Tariff Act amendment).
302. The Community Trade Mark and the proposed Community Patent would similarly share in being regionally exhausted, but are regionally and not nationally based. See supra notes 165-173 and accompanying text (discussing Community Trade Mark and proposed Community Patent).
304. Id. § 1701(1).
305. Id. § 1718:

Each Party shall, in conformity with this Article, adopt procedures to enable a right holder, who has valid grounds for suspecting that the importation of counterfeit trademark goods or pirated copyright goods may take place, to lodge an application in writing with its competent authorities, whether administrative or judicial, for the suspension by the customs administration of the release of such goods into free circulation. No Party shall be obligated to apply such procedures to goods in transit. A Party may permit such an application to be made in respect of goods that involve other infringements of intellectual property rights, provided that the requirements of this Article are met. A Party may also provide for corresponding procedures concerning the suspension by the customs administration of the release of infringing goods destined for exportation from its territory.
hausted in territories reached by U.S. IP laws.

The second way territoriality relates to exhaustion is in determining where a sale must occur to exhaust an IP right. Again, here EU law is relatively clear and consistent: only sales within EU member states regionally exhaust IP rights, and this holds true for patents, trademarks, and copyrights.306 There is considerably more disagreement across—and even within—intellectual property rights in the United States.307 While less developed, Japanese law is relatively clear at least with respect to patents and trademarks, that an authorized sale anywhere in the world can exhaust parallel Japanese IP rights.308 Understanding the territorial extent of IPRs is an obvious prerequisite to formulating an intelligent mechanism for harmonization. As the forgoing has shown, there is no clarity, on an international level, as to the extent of IP laws in this context. This not only motivates the need for harmonization further, but also provides a focal point for harmonization to begin.

VI. MOVING TOWARDS HARMONIZATION

As the preceding section illustrates, from a doctrinal and practical perspective, there is a need for harmonization of the exhaustion of rights principle. The legal quagmire has practical consequences.

For example, the holder of a patent to a pharmaceutical may prevent parallel trade from entering the United States from Italy, but the patent holder in the United Kingdom cannot. Another example is that parallel trade of copyrighted phonorecords can occur from Portugal to France, but not from the Philippines to the United States. Also, the holder of a patent to an object made in the United States cannot, based on patent rights, prevent reimportation of the object, but it could stop reimport if it held the copyright to the object, depending on which circuit controls. The same patent holder, holding the rights to the trademark that the object bears, may or may not be able to block reimport based on trademark rights, depending on whether the overseas marketer is under common control of the mark holder.

The current state of the exhaustion of rights principle internationally is uncertain and ambiguous and the practical results of the fractured state of the law probably makes little sense to commercial traders. These same practical problems have motivated other efforts

306. See supra Part III.
307. See supra Part II.
308. See supra Part IV.
at international harmonization. The moves towards the international harmonization of intellectual property laws is clear and growing. Among the most influential of these efforts has been the TRIPs agreement concerning trade-related aspects of intellectual property rights. While it cannot be denied that parallel trade and the exhaustion of rights principle are trade-related aspects of intellectual property rights, the TRIPs agreement failed to confront the issue. Article 6 of TRIPs provides: "For the purposes of dispute settlement under this Agreement, ... nothing shall be used to address the issue of exhaustion of intellectual property rights." This failure to confront a fundamentally trade-related aspect of intellectual property rights was a glaring omission in light of the policy stated in the TRIPs preamble of "[d]esiring to reduce distortions and impediments to international trade, and taking into account the need to promote effective and adequate protection of intellectual property rights." \[311\]

A. Harmonization Models

A coherent international harmonization is necessary to meet the twin goals of adequately protecting intellectual property and reducing impediments to trade. However, this leaves open the question of what form the harmonization should take.

1. National Exhaustion

One possible step towards harmonization would be to adopt the rule internationally that IPRs are only exhausted in the territory of the granting state and only by initial transfers within that state. There are both strengths and weaknesses to this approach. The most obvious deficiency is that a rule based on national borders as the standard of harmonization would be inconsistent with the fundamental principles of international harmonization which is to break down this type of national division for allocating substantive rights.

A second problem with national exhaustion lies is accommodating regional trading areas such as the EU. Certainly, to comport with EU doctrine, there would have to be a provision for regional rather national exhaustion. With the rise of other trading areas such


310. Id. art. 6.

311. Trips Agreement, supra note 309.
as NAFTA and MERCOSUR, national intellectual property rights may be growing less important, and as regional trading areas arise, it is quite likely that they will follow the EU model and need regional exhaustion.

Finally, at least at present, the weight of international opinion appears to be against mere national/regional exhaustion. At the 1996 W.I.P.O. Diplomatic Conference on Certain Copyright and Neighboring Rights Questions, the United States proposed an importation right be added to the Berne Protocol which would have provided for national or regional exhaustion. This proposal was objected to by a coalition led by the delegations of Australia, Canada, and New Zealand and does not appear in the final treaty. Thus, at least under copyright law, there is international opposition to mere national exhaustion.

2. International Exhaustion

On the opposite pole from national exhaustion is harmonization around the principle of international exhaustion. Under this model, authorized sales in any nation would exhaust all parallel IP rights with respect to that item throughout the world. While this option is perhaps the most theoretically appealing in its simplicity, it does not seem to be a feasible option at present. This option, while most beneficial to consumers, would be opposed by IP rights holders. It has a greater impact on their profitability than national exhaustion by

312. See supra note 303 and accompanying text (discussing possible language in NAFTA which would provide a legal basis for regional exhaustion).

313. The proposed language was:

(1) Authors of literary and artistic works shall enjoy the exclusive right of authorizing:
   (i) the making available to the public of the original and copies of their works through sale or other transfer of ownership;
   (ii) the importation of the original and copies of their works, even following any sale or other transfer of ownership of the original or copies by or pursuant to authorization
(2) National legislation of a Contracting Party may provide that the right provided for in paragraph (1)(i) does not apply to distribution of the original or any copy of any work that has been sold or the ownership of which has been otherwise transferred in that Contracting Party’s territory by or pursuant to authorization.


frightening attempts to use exclusive rights to coordinate a transnational system of monopoly pricing which maximizes international profit.

In addition, the proposal put forward by the U.S. delegation at the W.I.P.O. conference indicates that the U.S. delegation opposed international exhaustion. If the proposal was a true reflection of the U.S. position, given the prominent role the United States plays in international intellectual property fora, then international exhaustion faces strong opposition.

3. Selective International Exhaustion by Product Class

A third option is a hybrid of the two options mentioned above. Under this type of exhaustion, certain classes of products would be subject to international exhaustion while others would be subject to only national exhaustion. Such a position has been investigated by the Japanese Ministry of International Trade and Industry.\(^{315}\) One option considered was to authorize parallel trade of products such as compact discs and watches but bar parallel imports of products such as industrial machinery and electrical goods.\(^{316}\) At least on a superficial level this would improve competition in the market for consumer goods. Producer prices would still be buoyed up however.

This system does have the distinct benefits. First, it allows the flexibility to respond to particular situations which may for policy reasons need protection. In the case of patents or copyrights, a particular type of invention or writing may need more of an incentive to create; in the case of a trademark, a particular type of product may be more susceptible to consumer confusion.

4. Rule of Reason Exhaustion Model

Another possible model for exhaustion is to set as the default rule international exhaustion with the possibility of allowing a plaintiff wishing to oppose parallel importation to prove that legitimate reasons exist for their IPR to not have been exhausted by a prior sale, i.e., so that the parallel imports can be stopped. This is essentially the position which has evolved under the ECJ's jurisprudence interpreting Articles 30 and 36 of the EEC Treaty. This notion has found its way into several EU intellectual property harmonization docu-

\(^{315}\) MITI to Study Parallel Imports to See if Regulations are Needed, Pat. Trademark & Copyright Daily (BNA) (Oct. 28, 1991).

\(^{316}\) Id.
The inquiry under this model would be whether the right holder, one authorized by him, or one under common economic control exercised the economic right which the IPR was designed to afford. If they did, then with respect to that article their IPR would be internationally exhausted unless the complaining party proved that the policies underlying free trade and the IPRs at issue would be frustrated by allowing further distribution. Examples where such policies might be frustrated could include: likely decrease in economic welfare of the affected parties, a likelihood of consumer source confusion in the case of trademarks, or, in the case of a patent or copyright, a showing that the presence of parallel trade so decreases the economic incentives to authors and inventors that creation of the type of work involved would likely be decreased substantially.

The strength of such a model of harmonization is its ability to accommodate many interests. On the one hand, it has as a default rule international exhaustion which is both theoretically appealing and most vigorously promotes free trade and movement of goods. On the other hand, it affords intellectual property owners — acting through their governments if necessary — the ability to prevent the exhaustion of their IP rights when circumstances warrant it in light of the policies of intellectual property rights and free trade in goods and services.

The flexibility that confers these benefits is also the most significant deficiency. In order for any harmonization under such a principle to be genuine, it would necessitate consistent and uniform decision making in determining when it is appropriate not to apply the default rule. In addition, the fact that it is not a bright-line rule would tend to foster disputes.

In addition to the jurisprudential and procedural strengths and weaknesses the welfare effects of the different legal regimes ought to

317. See Agreement Relating to Community Patents, Dec. 15, 1989, 1989 O.J. 401, art. 28:

The rights conferred by a Community patent shall not extend to acts concerning a product covered by that patent which are done within the territories of the Contracting States after that product has been put on the market in one of these States by the proprietor of the patent or with his express consent, unless there are grounds which under Community law, would justify the extension to such acts of the rights conferred by the patent.

See also supra note 196 (text of Council Regulation on the Community trade mark relating to exhaustion of rights).

318. See infra Part VI.B (describing the potentially harmful effects on world welfare by allowing parallel trade). It is such a situation which is contemplated as an example where the policies of free trade — increased consumer and producer welfare — would be frustrated.
be considered. The exhaustion of rights doctrine and the parallel trade that it creates have complicated economic effects, not only directly upon the trading parties, but also indirectly due to the potential responses of sellers trying to combat parallel trade in contravention of their marketing plan. These larger effects are easily overlooked by courts adjudicating the dispute between the parties before them. However, as the following Part illustrates, these effects are most instructive in selection an appropriate model for harmonization of the exhaustion of rights doctrine. A primer on the economic concepts used in the following discussion appears as an appendix for those desiring background information.

B. Economics of Parallel Trade

Parallel imports are of concern to sellers of goods because of the effect they have on profitability. The interests of many other parties are affected by a simple parallel goods transaction, though. First, producers in the source country are confronted with supranormal demand for the article.319 As a result, consumers in the source country are confronted with higher prices320 as the market equilibrates to accommodate this excess demand. The trader itself stands to earn a profit by consummating the trade. Finally, consumers in the destination country benefit by the reduced prices.

1. National Welfare and Parallel Trade

The effect of exhaustion of rights law on welfare can be examined by comparing welfare under uniform and discriminatory pricing regimes. The cause of the discriminatory pricing affects the analysis. There is evidence that monopolistic price discrimination is a cause of the conditions supporting parallel trade,321 so this must be considered. Legal regimes which bar parallel trade allow the price discrimination to be maintained and legal acceptance of parallel trade de facto imposes nearly-uniform prices across markets.

Monopolistic price discrimination implies that prices will be

319. They are in effect supplying part of the demand of consumers both in their territory and the destination territory.
320. At least in the short term.
higher in markets with insensitive demand conditions.\footnote{Jean Tirole, The Theory of Industrial Organization 137 (1992).} For example, if demand in the United States for a toy\footnote{See Original Appalachian Artworks, Inc. v. Granada Elecs., Inc., 816 F.2d 68 (2d Cir. 1987) (Cabbage Patch Kids dolls with “adoption” certificates in Spanish which were not accepted by U.S. doll adoption agency materially differed).} is relatively insensitive to changes in price when compared to Spain, monopoly pricing implies that the price charged would be higher in the United States, thus creating the conditions for parallel trade. Ordinarily, U.S. consumers would be adversely affected by this situation because consumers in nations with low elasticity markets are harmed by the prohibition of parallel trade and would prefer the uniform price.\footnote{Id. at 137-38.} Conversely, Spanish consumers would prefer the barring of parallel trade.\footnote{Tirole, supra note 322, at 137-38.} Were the producer to choose a uniform price across all markets it would mean higher prices in their market and, given their greater sensitivity to price changes, this would have more significant welfare-reducing effects.\footnote{Id.}

The foregoing was premised on the producer not choosing to cut off the source market completely rather than suffer the uniform pricing with parallel trade. Elimination of price discrimination may decrease welfare if markets are closed.\footnote{Id. at 138.} When an entire market is foreclosed in this fashion, it is clearly to the great detriment of the consumers in that market. This insight underlies a key result: monopolistic price discrimination reduces welfare if it does not increase total output.\footnote{That is the greater responsiveness of the quantity demanded to price implies that the consumer surplus from the market is more significantly impacted.} Thus, the law of parallel trade creates a dilemma. Allowing international exhaustion of intellectual property runs the risk of causing markets to be foreclosed and barring it will not even increase welfare unless total output increases.

2. World Welfare and Parallel Trade

the preceding sections, laws in a destination country either permitting or preventing parallel trade have economic effects in the (actual or prospective) source countries. When parallel trade is prevented, domestic sellers are being conferred the benefit of supracompetitive profits, while sellers in prospective source countries suffer the cost of the opportunity to supply the parallel trader. Yet, consumers in a prospective source country reap the benefits of lower prices. Conversely, if parallel trade is allowed, uniform pricing may be instituted internationally to prevent parallel trade and this may result in markets not being served. Any attempt at harmonizing parallel trade law internationally ought then to consider the effects on world welfare of different regimes.

a. The Effect of Uniform Pricing on World Welfare

Demand for products such as pharmaceuticals, perfume, and consumer luxuries varies widely across nations. When demand in a source and destination nation differ widely, and parallel imports are allowed, the seller of the traded good faces a decision. If the seller lowers its prices sufficiently to compete in the low demand market, a parallel trader will reimport to the high demand market, undercut the price there and competition will eventually equilibrate the prices across markets. As an alternative to this low uniform price—the price in the low demand country—a seller could choose to not sell in the low demand country at all or only at a uniform price close to what it can charge in high demand market. This will result in the closing of markets.

Uniform pricing thus has the potential to harm world welfare if it results in the closing of a substantial number of markets. A uniform price will close a market when at that price no sales will be made. Such situations arise when the demand conditions are so disparate between rich and poor countries that setting a profit maxi-

332. See Parfums Givenchy v. Drug Emporium, 38 F.3d 477 (9th Cir. 1994).
334. Assume, as is generally the case, that demand is higher in the destination nation.
335. Factoring in transportation costs and other costs created by parallel trade.
336. The statement that no sales will be made should not be taken too literally. The point here is that in some markets, sales for a particular product—say PERUGINA chocolates—may be so low at the uniform price that it will not be worth the cost to set up operations to serve the market at all.
mizing price in the relatively wealthy (higher demand) nation results in no sales in the relatively poor (lower demand) nation. When demand dispersion is high enough across nations, world welfare may be higher if parallel trade is blocked, i.e., no exhaustion of rights, and monopolistic price discrimination allowed in each nation. This is because the welfare-decreasing effects of price discrimination are dwarfed by the total loss of welfare in the closed markets.

b. The Effect of Nonuniform Pricing on World Welfare

Nonuniform pricing — international price discrimination — will harm consumers in high demand countries even if it were to improve overall world welfare. Nonuniform pricing would allow manufacturing concerns in high demand countries to reap a benefit though. The ability to price above a competitive price allows for supranormal profits to be earned, thus increasing the welfare of the owners of those manufacturing in the particular industry. A further effect of nonuniform pricing lies in its transfer of welfare across national borders. When nonuniform pricing is allowed, consumers in relatively wealthy countries feel the brunt of the welfare-decreasing effects of price discrimination because they will ordinarily have a higher willingness to pay; on the other hand, consumers in relatively poor countries benefit. Finally, within a country, preventing the competitive pricing of the parallel trader allows a vendor to raise price. This will cause a transfer of welfare from consumers to producers within that country. Thus, the effects of nonuniform pricing are numerous. The relative magnitudes of particular effects makes reliance on these effects alone an inadequate basis for choosing among different exhaustion models. However, where these effects coincide with sound policy bases and other economic results, such as those in the next Part, they aid in guiding the choice of the appropriate harmonization model.

c. Trading Blocks

The foregoing has shown that the interests of various groups conflict when intellectual property rights are / are not internationally exhausted. Fundamentally, consumers in wealthy countries are harmed

337. See Malueg & Schwartz, supra note 7, at 178-80. See also, supra note 328 and accompanying text (price discrimination can only improve welfare if it increases output).
338. Malueg and Schwarz, supra note 7, at 176-81.
339. Id.
340. See Tirole, supra note 366, at 137, 65-78.
by barring parallel trade, and consumers in poor countries may be harmed if parallel trade is allowed and producers’ response results in the closing of markets. A possible welfare-redeeming solution to this conundrum is the establishment of trading blocks. Assume it were known what countries’ markets would be closed if parallel trade were allowed. Form a first trading block of these countries and a second trading block of all others. If parallel trade were allowed within each of these trading blocks, but not between them, welfare would be improved. Those in the first trading block will be served at the lower prices which would have been optimal for producers had parallel trade been allowed. Consumers in the second trading block will still get many of the competitive benefits of parallel trade because the relatively poorest nation in this block can still function as a source for parallel trade.

Such a scheme, while theoretically promising has many practical limitations. Within a nation, individual product markets may, or may not, be likely to be foreclosed but such markets are clumped together when nations get together to form a trading block. The less focused conglomeration of nations which political arrangements create may still have beneficial effects, though, as economic modeling shows that the international welfare benefits of trading blocks are relatively easy to reap.

C. Harmonization

The economic results are instructive on the proper form of harmonization. The most prominent insights from the economic analyses are the welfare benefits of an international exhaustion regime in the absence of market foreclosure and the significant welfare-depressing consequences were foreclosure to occur on a large scale.

In this light, all of the harmonization principles mentioned have.

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341. Malueg & Schwartz, supra note 7, at 185-89.
342. See id.
343. Id.
344. This nation can be considered as the nation whose demand is “just strong enough” to not been be closed by uniform pricing. Thus the price at which goods would be sold here is “close” to those in markets that would be closed and can provide price pressure in wealthy nations via parallel trade. Merck v. Primecrown can be seen as such a situation. The EC is the trading block, the nations of Spain and Portugal, new entrants to the EC, are on the lowest end of the wealth spectrum in this trading block.
345. Malueg & Schwartz, supra note 7 at 184-89.
346. Id. at 185-87. Malueg & Schwartz also report that trading blocks with “holes” in them — blocks which do not represent all points on the wealth continuum but rather have gaps — can be even more effective. Id. at 188-89.
some redeeming features. Those which favor a broader sweep of exhaustion can legitimately claim improved social welfare through the more efficient working of markets. Those which favor a more narrow sweep can claim a mechanism to assure the potentially dangerous effects of market foreclosure will be prevented. Two of the proposed harmonization principles provide an option of offering both.

Both selective international exhaustion by product class and a rule of reason based international exhaustion provide a baseline level of free international trade. Each also maintains the flexibility to allow parallel trade to be blocked in particular instances if market foreclosure was likely or it was appropriate in light of the policies of IPR and the good traded. The main difference in pursuing one form rather than the other is efficiency in decision making. To adopt selective international exhaustion by product class would place a responsibility on some international trade or IP administrative authority to determine product classifications which are needed to be exempted from the general rule of international exhaustion. This decision would have to be made on a pairwise relationship between trading states because whether there was a likelihood of market foreclosure depends on the particular combination of the product or service and the importing state. That is, it may be appropriate to be concerned about the Mexican market being foreclosed to certain pharmaceuticals, but it would be unlikely that the U.S. market would be foreclosed.

The rule of reason based harmonization model would distribute this decision making to the producing and consuming public. Only upon application to the appropriate tribunal would the question arise whether an exception to the general rule of international exhaustion will be granted. From a resource allocation perspective, this distributed decision making is desirable. The potential problem lies in the ability of decision making tribunal to intelligently reach such a determination. As the previous sections revealed, the determination of whether a particular exemption to the general rule of international exhaustion should be granted would be a fact-intensive market analysis. Of necessity, this analysis would need to consider demand conditions in the potentially foreclosed markets, the cost structure of the relevant industries, and related questions.

These requirements drive the selection of the proper forum for making this determination. The exhaustion of rights problem is one both of international trade and of intellectual property. As such, both the World Trade Organization and the World Intellectual Property Organization ("W.I.P.O.") are logical candidates. If a competent fo-
rum exists for efficiently making the needed determinations, the rule of reason model would be the preferred approach to harmonization.

The W.I.P.O. Arbitration and Mediation Center offers four dispute resolution procedures: mediation, arbitration, expedited arbitration, and mediation followed (in the absence of settlement) by arbitration. In addition, W.I.P.O. is preparing a treaty for the settlement of intellectual property disputes among nations. The W.I.P.O. does have the advantage of being able to draw on a considerable group of experts in national intellectual property laws, and state entities which would, of necessity, be parties to the determination, are proper parties for W.I.P.O. dispute resolution if they express the proper assent. However, unless and until such a treaty establishes a competent forum for making the needed determination, it is unlikely that other resources available from W.I.P.O. will be adequate. First, W.I.P.O.'s dispute resolution services are primarily designed to handle bilateral contractual disputes. Of the services they provide only arbitration has any binding force. While this could prove adequate if the appropriate customs agency of the destination state were a party, it lacks any formal mechanism for national participation in, and enforcement of, the determination process and any workable appellate mechanism. Moreover, and perhaps more fundamentally, because the W.I.P.O. "is responsible for the promotion of the protection of intellectual property throughout the world," it may be ill-situated for the required task for two reasons. First, the difficult inquiry will be one primarily of trade-related and economic issues, not one of substantive intellectual property law. Second, as an institution whose traditional role has been the increasing of protection for intellectual property, W.I.P.O. does not possess among its constituents the consumers of intellectual property in the various states and merchants who trade in gray market goods. Yet these in-


349. See W.I.P.O. Arbitration and Mediation Center supra note 347.

350. Id.

351. See id.


353. See supra Part VI.B. (describing issues of supply and demand in source and destination countries and the possibility of market foreclosure as most relevant inquiries).

terests are, as noted in Part VI.B, significantly impacted by exhaustion of rights law. The inability for these impacted groups to play an equal institutional role in the W.I.P.O. leaves it currently lacking as an appropriate international forum for determining questions of the exhaustion of intellectual property rights.

The World Trade Organization ("WTO") provides an alternative forum. The WTO has established dispute resolution procedures, both with respect to traditional trade subjects such as subsidies, and countervailing measures\textsuperscript{355} and intellectual property matters.\textsuperscript{356} As noted above,\textsuperscript{357} the TRIPs agreement failed to adequately address the exhaustion of rights issue. It is a purpose of the comment to point out that the exhaustion of rights doctrine needs to be harmonized. Once harmonized, the technical and institutional resources of the WTO make it the preferred international forum for making the type of determinations which a rule of reason harmonization of exhaustion of rights law would require. Article 64 of TRIPs\textsuperscript{358} incorporates the Dispute Settlement Understanding ("DSU") of the GATT.\textsuperscript{359} The DSU provides an extensive dispute settlement procedure.\textsuperscript{360} Most importantly, it provides the type of institutional procedures and expertise sufficient to handle the task. The WTO by its very nature, has familiarity with the types of economic and market analyses which may be needed in determining whether an exception is appropriate under a rule of reason harmonization of the exhaustion of rights doctrine.\textsuperscript{361} The DSU also has an established mechanism for dealing with multiple parties to a dispute which would increase the efficiency of the procedure for an intellectual property right holder's perspective,\textsuperscript{362} and a procedure for the appeal of dispute panel decisions.\textsuperscript{363}

One of the drawbacks of the GATT procedure is that there is no concrete deadline for a nation to implement the decision of a dispute


\textsuperscript{356} See supra note 309 Annex 1C.

\textsuperscript{357} See supra note 309 and accompanying text.

\textsuperscript{358} TRIPs Agreement, supra note 309, art. 64.


\textsuperscript{360} See id. arts. 6-23.

\textsuperscript{361} See id. art. 8 (composition of panels for dispute resolution to be from "well qualified" members of either the public or private sector).

\textsuperscript{362} Id. arts. 9-10.

\textsuperscript{363} Id. art. 17.
EM USTION OF RIGHTS

resolution panel. Article XXII:2 of the GATT provides that the appropriate changes be made within a “reasonable period” but this has not been further defined. However, if a government fails to implement a panel or appellate recommendation in order to bring national law in conformity—here the blocking of parallel trade—the government must negotiate with the complainant with respect to acceptable compensation. 364 For intellectual property rights holders this provides a better enforcement mechanism than that present under available W.I.P.O. alternatives. New institutions and structures will undoubtedly need to be created to implement a rule of reason harmonization of the exhaustion of rights doctrine, as well as revision of national laws where necessary. However, the mechanisms available through the GATT dispute resolution procedure make it an able and preferable forum.

The rule of reason exhaustion model is therefore procedurally and substantively the most desirable. It is the conclusion of this comment that international harmonization of the exhaustion of rights principle should be attempted with this model as the starting point. In summary, first, this model reflects the economic insight that the nonexhaustion of intellectual property rights allows appreciable welfare-decreasing effects through international price discrimination. Second, it has the flexibility to prevent the possibly even greater welfare-decreasing harm from the foreclosure of markets by allowing intellectual property owners or potentially-impacted consumers to act to prevent the exhaustion of the intellectual property rights—preventing parallel trade. Third, it is doctrinally the most appealing in that it couples the most theoretically sound harmonization model, international exhaustion, with the ability to have all parties impacted by exhaustion of rights law choices—intellectual property rights holders, consumers in the impacted nations, and traders—participate in the process for determining when non-exhaustion is appropriate. Fourth, it easily accommodates the establishment of the particular exhaustion regimes to reap the welfare benefits from trading blocks. Finally, as noted above, there currently exists an able and well developed international structure in the WTO’s dispute resolution for implementation of the least-appealing aspect of the rule of reason model, determination of when exceptions to the default rule are appropriate.

364. Id. art. 21.
VII. Conclusion

The exhaustion of rights doctrine is one of the most fundamental limitations on intellectual property rights. Yet, as this comment has shown, there is considerable disagreement among the major trading nations as to whether, and when, intellectual property rights will be exhausted. This has spawned abundant litigation and frustrated both intellectual property right holders and parallel traders. As trade in intellectual property grows, the differing views internationally on the exhaustion of rights doctrine will become an even larger burden on the free trade among nations. The failure to appreciably begin the harmonization of the exhaustion of rights doctrine in the WTO and the W.I.P.O. needs to be remedied in a deliberate and thoughtful manner taking into account the economic welfare of all parties potentially affected by the legal choices made. Among the models available for harmonization of the exhaustion of rights doctrine, few have the flexibility to protect the legitimate interests of those impacted by exhaustion of rights law. It is the position of this comment that the model that best protects these interests is one which allows for free trade in goods with the availability of exceptions where warranted in light of the economics of the trading situation and the policies of IPRs.\textsuperscript{365} While procedurally more burdensome than "bright-line" options, it best allows balancing of the competing interests. To implement the procedures necessary it is further suggested that international trade fora, in particular the WTO, be chosen rather than international intellectual property fora, such as the W.I.P.O. While much work still needs to be done to create the details of a working system of harmonized exhaustion of rights law, the problem is by no means insurmountable. Through the cooperation of intellectual property rights owners, trading interests, and consumer groups, a workable solution can be found.

\begin{footnotesize}
\textsuperscript{365} See supra Part VI.A.4 (describing rule of reason harmonization model).
\end{footnotesize}
APPENDIX A

The following provides background information on the economic concepts discussed in Part VI.B of the text.

A. Fundamental Ideas

A key economic concept underlying parallel imports is price discrimination. In this context it refers to the fact that the parallel traded good is priced differently in the source and destination country. Arbitrage refers to the practice of buying a good and reselling it for a profit. The parallel trader is the arbitrageur, buying the article at a lower price in the source market and selling it at a higher one in the destination market. An important issue for the producer of the traded article in determining the price at which to sell it is the elasticity of demand. This refers to how responsive the quantity demanded is to an incremental change in price. The more the quantity demanded changes when price changes an incremental amount, the more elastic demand is termed. Conversely, when even large changes in price do not significantly change the quantity demanded, demand is termed inelastic. Pharmaceuticals are a typical example of a good with inelastic demand: the prescribed amount is typically purchased irrespective of the price.

The common resource or free-rider problem is commonly charged by producers of parallel traded goods. The problem generally refers to a situation where several different parties may use a resource without adequate means of excluding would-be users or assuring recompense for the resource consumed. In this context the charge is made that the seller in the destination country has expended money in promoting the traded product or in providing other serv-

366. I am using the term here in a descriptive sense. See, e.g., Jean Trole, The Theory of Industrial Organization 133 ("Roughly it can be said that the producer price-discriminates when two units of the same physical good are sold at different prices, either to the same consumer or to different consumers."). The term as I use it is not limited to the monopoly practice of market division with monopoly pricing in each market. While this use is properly seen as price discrimination, and indeed may be an explanation for parallel trade, I use the term to describe the market condition of the same good being sold at different prices. Note that this condition may arise for innocuous reasons, e.g., timber felled in Alaska may cost more in Florida because of the cost of transport. Formally, this may not be the same good, however for the purposes of this paper I will ignore this formality because to the parties concerned it is the essentially the same good.

367. Generally arbitrage refers to the ability to turn a riskless profit. The unsettled law of parallel trade makes the riskless part questionable in this context.

368. See supra Parts III.C & D (describing exhaustion of rights law in EU which has frequently involved parallel trade in pharmaceuticals).
ices, such as technical support, and these additional expenditures result in higher costs for the item in the destination country. The parallel trader is claimed to be a free-rider on the developed goodwill or additional services provided when it purchases in a market—presumably one where these additional expenditures are not made—and resells in a market where prices are higher because of these additional investments.369

B. Primer on Welfare Economics

Welfare in the economic sense refers to the benefits which accrue to both producers and consumers in a market. Looking at the group of consumers as a whole, some have a higher willingness to pay for an item than the market price; however they only pay the market price.370 The welfare to consumers from the market is the aggregated differences between what they were willing to pay and the price actually paid.371 For producers, they sell all units at the market price and reap aggregated differences between what it would cost to produce each unit and the revenue they receive—the market price.372 In other words, profit. When a producer, say a monopolist, has market power, they are able to restrict the quantity sold and increase the price. This means that those consumers who were willing to pay the “normal” market price but not the monopoly price will no longer purchase. The welfare attributed to them is lost. The same principle applies to the producer.

However, the distribution of the benefits of a market is a separate consideration from the welfare created by market structure. In addition to decreasing total welfare market power, also has the effect of redistributing a portion of the consumers’ welfare to the producer. This is intuitive in that the producer, in raising price above the competitive price, is taking as profit the difference between some consumers’ willingness to pay and the market price.

The exercise of market power thus typically has the following results in the parallel trade context. If the parallel trade can be stopped, the supplier in the source country can restrict the quantity available in the market and raise the market price. As compared to allowing parallel trade this will have the effect of: (1) increasing the

370. See generally, TÍROLE, supra note 366, at 7-9 (explaining concepts).
371. Id. This is generally known as consumer surplus.
372. Id. This is generally known as producer surplus.
market price in the destination country, (2) decreasing the total welfare created by the market and (3) transferring a share of the total welfare created by the market from consumers to producers. While the last effect may be the most unsettling to consumers in the relevant market, it is the second which is the strongest economic result: ordinarily the exercise of market power will decrease the total welfare generated by the presence of a market.

C. Theories of Parallel Imports

Several different theories have been advanced to explain the international price differentials that give rise to parallel trade.\(^{373}\)

1. Free Riding

Particularly in the trademark context, it is argued that parallel trade is caused by gray marketers free-riding on the marketing and promotional investments of the authorized seller in the destination country.\(^{374}\) This rationale is perhaps most appropriate for goods which are differentiated primarily on the basis of brand name.\(^{375}\) However, the rationale does not perfectly explain the observed pattern of parallel trade. Were parallel traders free-riding on the promotion of retailers, one would expect to see parallel trade in both directions.\(^{376}\) That is, a parallel trader could purchase from a wholesaler in any country then import into another and free ride on the retailer’s promotion in that country.\(^{377}\) However parallel trade is generally observed flowing from relatively poor countries to relatively wealthy ones.\(^{378}\)

\(^{373}\) Many of these may contribute to price differential at one time; they are not mutually exclusive.


\(^{375}\) See Parfums Givenchy, Inc. v. Drug Emporium, Inc., 38 F.3d 477 (9th Cir. 1994) (perfume); Diseños Artísticos E Industriales, S.A. v. Costco Wholesale Corp., 97 F.3d 377 (9th Cir. 1996) (Lladro figurines (copyright claim)); Weil Ceramics and Glass, Inc. v. Dash, 878 F.2d 659 (3d Cir. 1989) (Lladro figurines (trademark claim)).

\(^{376}\) David A. Maleug and Marion Schwartz, Parallel Imports, Demand Dispersion, and International Price Discrimination, 37 J. INL. Econ. 167, 173 (1994). However, the absence of such bilateral parallel trade can also be explained by differential promotional investments across countries. Id.

\(^{377}\) Id.

It should not be forgotten that parallel trade is a shifting of demand from the destination country to the source country. If the same entity is selling the product in both countries then they are still reaping the full benefits of their promotional investments but through sales in a country other than where the promotional efforts may be taking place.

2. Price Discriminating Producer With Market Power

Yet another explanation for the conditions which support parallel trade is a producer with sufficient market power in the destination market to choose the market price at which their goods will be sold in the destination country. A frequent source of such market power are the exclusive rights given under patent and copyright laws. If the goods are highly differentiated, trademark protection may have a similar effect. The ability to maintain separate prices in separate markets is, of course, contingent on the ability to block transnational arbitrage in the good.

A profit maximizing producer with the ability to set price and quantity in a market will set price in response to demand conditions. In each market, the producer can examine the demand schedule and make a profit maximizing price-quantity decision. This optimal pricing implies that more should be charged in markets with lower elasticities of demand. That is, when demand is relatively insensitive to changes in price, higher prices should be charged. Intuitively, this explains some of the pattern of parallel trade. Wealthy countries are likely to be price insensitive relative to poorer countries. This would suggest higher prices in wealthy countries and the ability to parallel import goods from the relatively poorer countries into the richer ones and reap the arbitrage profit. This intuition has been confirmed in some contexts, and there is evidence that monopoly price discrimination contributes to the conditions supporting parallel trade.

379. Malueg & Schwartz, supra note 7, at 172-75.
380. See, e.g., United States v. Univis Lens Co., Inc., 316 U.S. 241 (1942); Eastman Kodak Co. v. Image Technical Servs., Inc, 504 U.S. 451, 479 (1992 ("The Court has held many times that power gained through some natural and legal advantage such as a patent, copyright, or business acumen ... ").
381. Malueg & Schwartz, supra note 7, at 173.
382. Tirole, supra note 366, at 137.
384. See Malueg & Schwartz, supra note 7, at 172-75 (citing sources); see also Tirole, supra note 366, at 137 ("This rule explains why ... the prices of goods in different countries
Unless proscribed, parallel trading will eliminate the ability to set different prices in different markets. The parallel trader will undercut the price of the authorized seller in the destination country and can continue to profitably do so until the cost of acquisition plus transportation to the destination country is reached. Faced with the prospect of having to charge a uniform price in each market — to preempt the parallel trade — the producer may chose not to sell in the market with high elasticity of demand (source) at all. The reason is that a price low enough to sell a practical quantity in the source market may constitute such a reduction in profitability in the destination market — where consumers are relatively insensitive to price change — that it is not worth giving up the profit in the destination market to gain the profit in the source market. This foreclosure has serious effects on welfare which bear on the desirability of allowing parallel trade.

3. Incomplete Pass-through of Currency Fluctuation

Fluctuations in the prices of currencies may give rise to the conditions for parallel trade. When the exchange rate of the destination country appreciates, import prices denominated in the destination currency may not be reduced commensurately. This allows the one to purchase the same good at different (real) prices in different markets and these are the conditions for parallel trade. While the U.S. currency fluctuated significantly during the 1980s, a period of significant parallel trading litigation in the United States, there is a long history of parallel trading among EU nations during the period in which the European Monetary System was in force, a primary goal of which was to stabilize prices.

sometimes do not reflect transportation costs and import taxes ...."

385. See Malueg & Schwartz, supra note 7, at 168-72 (citing sources); see also Tirole, supra note 366 at 139.


387. See supra Part IV.B.


389. See Malueg & Schwartz, supra note 7, at 173.

390. Id. at 173-74.

391. See infra Part III.