

Applicability of the Copyright Law's First Sale Doctrine to Imported Goods Manufactured Abroad: *Costco Wholesale Corp. v. Omega S.A.*

Brian T. Yeh
Legislative Attorney

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Summary

Section 106(3) of the Copyright Act grants a copyright holder the exclusive right to distribute copies of a copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending. In addition, § 602(a) of the Copyright Act generally prohibits the importation into the United States, without the authority of the copyright holder, of copies of a work that have been acquired outside the United States; such importation is considered an infringement of the exclusive right to distribute copies of the work under § 106. However, the Copyright Act's "first-sale" doctrine, codified at § 109(a), provides a limitation to the copyright holder's distribution rights—it entitles the owner of a particular copy of a copyrighted work that has been "lawfully made under" title 17 of the U.S. Code (where the Copyright Act is codified) to sell or otherwise dispose of the possession of that copy, without the prior permission of the copyright holder. In other words, once a copyright holder agrees to sell particular copies of his work to others (constituting the "first sale" of such copies), the copyright holder may not thereafter further control subsequent transfers of ownership of those copies.

On November 8, 2010, the U.S. Supreme Court will hear oral arguments in *Costco Wholesale Corp. v. Omega S.A.*, in which it will have an opportunity to examine the scope of the first sale doctrine with respect to so-called "gray-market" goods—products that have been manufactured and purchased abroad and thereafter imported into the United States for resale at often discounted prices to U.S. customers. The case involves the sale by Costco in its California warehouse stores of authentic Omega watches made in Switzerland. Costco had purchased these watches (which bear a copyrighted design on their underside) from third parties that had purchased the watches from authorized Omega distributors located abroad. While Omega had permitted the initial foreign sale of its watches, it did not authorize their importation into the United States or Costco's domestic sale of the watches. Omega sued Costco for infringing its distribution and importation rights under §§ 106(3) and 602(a) of the Copyright Act; Costco defended itself by arguing that the first sale doctrine, § 109(a), precludes Omega's infringement claims. In September 2008, the U.S. Court of Appeals for the Ninth Circuit reversed the district court's grant of summary judgment to Costco, holding that the first sale doctrine does *not* apply to imported goods that had been manufactured and first sold abroad. The appellate court reached this determination by asserting that copies of copyrighted works made and sold outside the United States are not considered "lawfully made" within the meaning of § 109(a); thus, these copies are not subject to the first sale doctrine, and Costco is precluded from raising such defense to Omega's infringement claims.

Some observers have been critical of the Ninth Circuit's interpretation of the first sale doctrine, concerned about its potential implications. Specifically, some have asserted that the appellate court's decision creates incentives for outsourcing, as manufacturers would desire to move production abroad of goods containing copyrighted aspects (thus avoiding the first sale doctrine's effect and providing the manufacturer with greater control over distribution of the goods). In addition, they believe the appellate court's decision, if upheld by the Supreme Court, negatively impacts domestic retailers and importers of goods made abroad because these entities would have to undertake the difficult task of tracing the origins of any copyrighted component of imported goods (or risk being sued for copyright infringement). Finally, they worry that U.S. consumers would be harmed by being denied the opportunity to purchase gray-market goods at discounted prices. However, others argue that notwithstanding these possible implications of the Ninth Circuit's ruling, Congress had granted copyright holders the right to control importation of copies in such a way as to segment domestic and foreign markets, and it is up to Congress to amend the Copyright Act to change that policy choice.

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Introduction

Exclusive Rights of Copyright Holder

Section 106(3) of the Copyright Act grants a copyright holder the exclusive right to distribute copies of a copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending. In addition to the general distribution right, Section 602(a) of the Copyright Act provides a copyright holder with the right to prohibit the importation into the United States of copies of a work that have been acquired outside the United States; such importation, if done without the authority of the copyright holder, is considered an infringement of the exclusive right to distribute copies of the work under § 106.[1]

Limitations on Rights of Copyright Holder

However, the Copyright Act's "first-sale" doctrine, codified at § 109(a), provides a limitation to the copyright holder's distribution right: "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 the possession of that copy." For example, someone who purchases a new book in a bookstore (thus constituting the "first sale" of that particular copy) becomes the owner of that physical item. He or she may thereafter distribute the book (for example, give it away to a friend or sell it to a used book store) without obtaining prior consent of the book's copyright owner.[2] Owners of copies of a copyrighted work that have been "lawfully made under" title 17 of the U.S. Code (where the Copyright Act is codified) are thus immunized from copyright infringement liability when they transfer ownership of those copies to other individuals.[3] As the U.S. Supreme Court has previously explained, "The whole point of the first sale doctrine is that once the copyright owner places a copyrighted item in the stream of commerce by selling it, he has exhausted his exclusive statutory right to control its distribution."[4]

Compelling public policy reasons support the Copyright Act's first sale doctrine. As the U.S. Supreme Court has noted, "The primary objective of copyright is not to reward the labor of authors, but 'to promote the Progress of Science and useful Arts.'"[5] In accordance with this constitutional mandate, the Copyright Act balances the rights of copyright holders in their

[1] 17 U.S.C. § 501(a) ("Anyone who violates any of the exclusive rights of the copyright owner … , or who imports copies … into the United States in violation of section 602, is an infringer of the copyright…"). The Copyright Act provides several additional rights to the copyright holder, a description of which is beyond the scope of this report. For more information about the Copyright Act, *see* CRS Report RS22801, *General Overview of U.S. Copyright Law*, by Brian T. Yeh.

[2] As another example, public libraries and video rental businesses such as Netflix and Blockbuster rely on the first sale doctrine to avoid being liable for infringement of the copyright holders' distribution rights.

[3] The first sale doctrine is triggered by the first authorized disposition by which title passes. Melville B. Nimmer & David Nimmer, 2 NIMMER ON COPYRIGHT § 8.12[B][1][a] (Matthew Bender 2010). If the copyright owner leases a copy of the work, the doctrine does not apply. *Id.* The first sale doctrine also does not apply to owners of infringing or pirated copies of copyrighted works, as these copies would not be considered "lawfully made under" title 17. Quality King Distributors, Inc. v. L'anza Research Int'l, Inc., 523 U.S. 135, 147 n.17 (1998).

[4] *Id.* at 152.

[5] Feist Publ'ns, Inc. v. Rural Tel. Serv. Co., 499 U.S. 340, 349 (1991) (*quoting* U.S. CONST. art. I, § 8, cl. 8.)

intellectual property with the public's interest in having robust ownership rights in the tangible material in which copyrighted works are fixed. By terminating the distribution right of copyright holders after the initial sale of a particular copy, owners of those copies benefit from having unrestrained alienability of personal property.

Gray-Market Goods

At issue in *Costco Wholesale Corp. v. Omega S.A.*, a case currently pending before the U.S. Supreme Court,[6] is the scope of the first sale doctrine with respect to so-called "gray-market" goods—products that have been manufactured and purchased abroad and thereafter imported into the United States for resale to U.S. customers, usually at discounted prices. Also known as "parallel imports," gray-market goods are legitimate, genuine products possessing a brand name protected by a trademark and/or containing designs or other subject matter protected by copyright.[7] These goods are usually manufactured abroad and then purchased and imported into the United States by third parties, "thereby bypassing the authorized U.S. distribution channels."[8] U.S. retailers can sell gray-market products at cheaper prices compared to the higher domestic prices established by the manufacturer. The question facing the Supreme Court in *Costco* is whether a manufacturer's right to prohibit unauthorized importation of copyrighted works is exhausted by the initial foreign sale of copies of copyrighted works that were made outside the United States.

Quality King Distributors, Inc. v. L'anza Research International, Inc.

In 1998, the U.S. Supreme Court was confronted with a question reminiscent of that posed in *Costco*, although there is a factual difference between the cases that may be legally significant to the Court's disposition of *Costco*. In *Quality King Distributors, Inc. v. L'anza Research International, Inc.,* a California company (L'anza) manufactured and sold shampoo and other hair care products; the products were manufactured in the United States, but were sold by L'anza both domestically and internationally. L'anza had copyrighted the labels that it affixed to its products. The prices that L'anza charged its domestic distributors were significantly higher than the prices charged to foreign distributors. L'anza's United Kingdom distributor had sold several tons of L'anza's products (affixed with the copyrighted labels) to a distributor in Malta; Quality King Distributors bought the products from the Malta distributor and imported the products for resale in the United States through retailers who were not within L'anza's authorized chain of distribution.[9] L'anza sued Quality King for infringement of its distribution and importation rights under the Copyright Act. The district court rejected Quality King's defense based on the first sale doctrine; the Ninth Circuit Court of Appeals affirmed that judgment, noting that § 602's ban on importation would be "meaningless" if § 109 "were found to supersede the prohibition on importation in this case."[10]

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[6] Costco Wholesale Corp., v. Omega, S.A., No. 08-1423 (U.S., *cert. granted* April 19, 2010).

[7] Omega S.A. v. Costco Wholesale Corp., 541 F.3d 982, 984 n.1 (9th Cir. 2008).

[8] *Id.* (quoting Parfums Givenchy, Inc. v. Drug Emporium, Inc., 38 F.3d 477, 481 n.6 (9th Cir. 1994)).

[9] *Quality King Distributors,* 523 U.S. at 139.

[10] L'Anza Research Int'l, Inc. v. Quality King Distributors, Inc., 98 F.3d 1109, 1114 (9th Cir. 1996).

The Supreme Court in *Quality King* reversed the Ninth Circuit and held that the first sale doctrine endorsed in § 109 applies to copies of copyrighted works that are imported into the United States.[11] In reaching this conclusion, the Court first observed that the copyright holder's distribution right granted by § 106(3) is expressly limited by other provisions of the Copyright Act, including the first sale doctrine codified at § 109(a). Section 602(a) provides that unauthorized importation is an infringement of the copyright holder's exclusive right to distribution under § 106. Therefore, the Court reasoned that the rights granted by § 602 must also be limited by the first sale doctrine. According to the Court, because § 106(3) "does not encompass resales by lawful owners, the literal text of § 602(a) is simply inapplicable to both domestic and foreign owners of L'anza's products who decide to import them and resell them in the United States."[12] The Court held that the owner of goods lawfully made under the Copyright Act "is entitled to the protection of the first sale doctrine in an action in a United States court even if the first sale occurred abroad."[13]

In a concurring opinion, Justice Ginsburg identified the issue left unresolved by the *Quality King* opinion—one that appears likely to be answered by the *Costco* decision:

> This case involves a "round trip" journey, travel of the copies in question from the United States to places abroad, then back again. I join the Court's opinion recognizing that we do not today resolve cases in which the allegedly infringing imports were manufactured abroad.

In making this clarification, Justice Ginsburg cited without comment two treatises on copyright law:

> *See* W. Patry, Copyright Law and Practice 166-170 (1997 Supp.) (commenting that provisions of Title 17 do not apply extraterritorially unless expressly so stated, hence the words "lawfully made under this title" in the "first sale" provision, 17 U.S.C. § 109(a), must mean "lawfully made in the United States"); *see generally* P. Goldstein, Copyright § 16.0, pp. 16:1-16:2 (2d ed. 1998) ("Copyright protection is territorial. The rights granted by the United States Copyright Act extend no farther than the nation's borders.").

Costco Wholesale Corp. v. Omega S.A.

The facts of *Costco v. Omega* are relatively straight forward. The Swiss corporation Omega manufactures wrist watches in Switzerland and sells them through authorized distributors and retailers around the world. Omega engraves on the underside of its watches a small logo—an original artwork that it refers to as the "Omega Globe Design," that Omega had registered as a copyrighted work with the U.S. Copyright Office. Costco obtained authentic Omega watches from the "gray market"—from third parties that had purchased the watches from authorized Omega distributors overseas. Costco then sold the watches to U.S. customers within its California warehouse stores. While Omega had authorized the initial foreign sale of its watches, it did not authorize their importation into the United States or Costco's domestic sale of the watches.[14]

[11] *Quality King Distributors,* 523 U.S. at 145.

[12] *Id.*

[13] *Id.* n.14.

[14] *Omega S.A.*, 541 F.3d at 983-84.

Omega sued Costco for infringing its distribution and importation rights under §§ 106(3) and 602(a) of the Copyright Act; Costco defended itself by arguing that the first sale doctrine, § 109(a), precludes Omega's infringement claims. Without explanation, the U.S. District Court for the Central District of California granted summary judgment to Costco on the basis of the first sale doctrine.[15]

Ninth Circuit's Opinion

In September 2008, the U.S. Court of Appeals for the Ninth Circuit reversed the district court, holding that the first sale doctrine does *not* apply to imported goods that were manufactured and first sold abroad.[16] The appellate court reached this determination by asserting that copies of copyrighted works made and first sold outside the United States are not considered "lawfully made" within the meaning of § 109(a); thus, these copies are not subject to the first sale doctrine, and Costco is precluded from raising such defense to Omega's infringement claims.[17]

In support of its position, Costco had argued that the Supreme Court's *Quality King* decision had "effectively overruled" three Ninth Circuit opinions in the 1990s[18] that were issued before *Quality King*. Those earlier appellate court opinions had developed a "general rule that § 109(a) can provide a defense against §§ 106(3) and 602(a) claims only insofar as the claims involve domestically made copies of U.S.-copyrighted works."[19] The Ninth Circuit in *Costco* determined, however, that *Quality King* did not directly overrule or otherwise invalidate this general rule that § 109(a) is limited to copies legally made in the United States.[20] Instead, the Ninth Circuit distinguished *Quality King* by limiting that decision to its specific facts—that of a good made in the United States that had been sold abroad and then re-imported without the consent of the copyright holder.

The appellate court explained that the basis for its "general rule" was its concern that applying § 109(a) to copies made abroad "would violate the presumption against the extraterritorial application of U.S. law."[21] The court further opined that "[t]o characterize the making of copies overseas as 'lawful[ ] … under [Title 17]' would be to ascribe legality under the Copyright Act to conduct that occurs entirely outside the United States, notwithstanding the absence of a clear expression of congressional intent in favor of extraterritoriality."[22] Finally, the court stated,

> In short, copies covered by the phrase "lawfully made under [Title 17]" in § 109(a) are not simply those which are lawfully made by the owner of a U.S. copyright. Something more is required. To us, that "something" is the making of the copies *within the United States*, where the Copyright Act applies.[23]

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[15] *Id.* at 983.

[16] *Id.* at 985.

[17] *Id.* at 986.

[18] BMG Music v. Perez, 952 F.2d 318 (9th Cir. 1991), Parfums Givenchy, Inc. v. Drug Emporium, Inc., 38 F.3d 477 (9th Cir. 1994), and Denbicare U.S.A. Inc. v. Toys "R" Us, Inc., 84 F.3d 1143 (9th Cir. 1996).

[19] *Omega S.A.*, 541 F.3d at 985.

[20] *Id.* at 987.

[21] *Id.* (citations omitted).

[22] *Id.* at 988 (citations omitted).

[23] *Id.* (emphasis in original).

The Ninth Circuit also cited Justice Ginsburg's concurrence in *Quality King* that appeared to approve its interpretation of § 109(a), and noted that the *Quality King* "majority opinion did not dispute this interpretation."[24]

The appellate court acknowledged that if its interpretation of § 109(a) were taken to its logical extreme, a copyright holder "could seemingly exercise distribution rights after even the tenth sale in the United States of a watch lawfully made in Switzerland."[25] However, the court explained that its earlier precedents would address this situation—those opinions had held that parties can raise the first sale defense in cases involving foreign-made copies if the copyright holder had authorized a lawful domestic sale.[26] Because Omega had not authorized any of the domestic sales in this case, the appellate court found it unnecessary to decide whether this exception to its "general rule" had survived *Quality King*.[27]

On April 19, 2010, the Supreme Court granted certiorari in *Costco*[28] to consider the following issue:

> Under the Copyright Act's first-sale doctrine, 17 U.S.C. § l09(a), the owner of any particular copy "lawfully made under this title" may resell that good without the authority of the copyright holder. In Quality King Distribs., Inc. v. L'Anza Research Int'l, Inc., 523 U.S. 135, 138 (1998), this Court posed the question presented as "whether the 'first sale' doctrine endorsed in § 109(a) is applicable to imported copies." In the decision below, the Ninth Circuit held that Quality King (which answered that question affirmatively) is limited to its facts, which involved goods manufactured in the United States, sold abroad, and then re-imported. The question presented here is: Whether the Ninth Circuit correctly held that the first-sale doctrine does not apply to imported goods manufactured abroad.[29]

In its brief submitted to the Court, the petitioner Costco argued that the Ninth Circuit's distinction between goods made in the United States and those made abroad "has no basis in the Copyright Act's first sale-doctrine"; furthermore, Costco warned that the Ninth Circuit's ruling, if upheld by the Court "would have severe consequences, which Congress could not have intended, for the U.S. economy."[30] Costco elaborated its concerns about the implications of the Ninth Circuit's interpretation of § 109(a) that makes the first sale doctrine categorically inapplicable to goods manufactured abroad:

> Manufacturers that sell globally will prefer to manufacture their goods abroad because of the increased control they will gain over subsequent sales and use of their products. Conversely, retailers and consumers will be hesitant to buy or sell such products for fear of unintended liability for infringement. Moreover, by exempting goods manufactured abroad from the first-sale doctrine, the Ninth Circuit's decision gives rise to a number of other absurd

[24] *Id.* at 989. Although the opinion of the Court in *Quality King* did not dispute Justice Ginsburg's interpretation, it also did not directly acknowledge it either, nor did any member of the Court join her concurring opinion.

[25] *Id.*

[26] *Id.,* citing Parfums Givenchy, Inc. v. Drug Emporium, Inc., 38 F.3d 477 (9th Cir. 1994), and Denbicare U.S.A. Inc. v. Toys "R" Us, Inc., 84 F.3d 1143 (9th Cir. 1996).

[27] *Id.* at 990.

[28] Costco Wholesale Corp. v. Omega, S.A., 130 S. Ct. 2089, 2010 U.S. LEXIS 3424 (2010).

[29] U.S. Supreme Court, Question Presented in No. 08-1423, Costco Wholesale Corp. v. Omega, S.A., *at* http://www.supremecourt.gov/qp/08-01423qp.pdf.

[30] Brief for Petitioners at 12, Costco Wholesale Corp. v. Omega, S.A, No. 08-1423.

> outcomes unintended by Congress, including copyright infringement liability for libraries that lend foreign books or movies.[31]

The respondent Omega urges the Court to uphold the Ninth Circuit opinion and find that "a third party infringes a copyright owner's exclusive rights by importing or distributing in the United States a copy that the copyright owner made and sold overseas exclusively for distribution outside the United States."[32] Omega argues that the act of making copies of a copyrighted work abroad, for foreign sale and distribution, is not governed by the Copyright Act—thus, such actions do not implicate any exclusive rights granted under § 106, and these copies cannot be lawfully or unlawfully made "under this title."[33] Omega notes that because § 602(a)(1) applies to genuine copies of copyrighted works made abroad, Congress deliberately allowed for the segmentation of domestic and foreign markets—that is, "Congress *intended* to provide U.S. copyright owners the right separately to authorize foreign and domestic distribution of legitimate copies."[34]

In then-Solicitor General Kagan's brief for the United States as amicus curiae that was filed regarding the petition for a writ of certiorari in the *Costco* case, the United States government argued that the Ninth Circuit's decision is consistent with *Quality King* and the "consensus view of the leading commentators on copyright law."[35] While acknowledging Costco's "legitimate concerns"[36] about the Ninth Circuit's "reasoning [that] could result in adverse policy consequences, particularly if carried to its logical extreme,"[37] the United States stated that it was unaware of any evidence that the most serious potential consequences have actually materialized. These "potential adverse policy effects that [Costco] identifies are a direct and inherent consequence of Congress's decision in 1976 to expand Section 602's ban on unauthorized importation beyond piratical copies," the government observed.[38] This policy choice of Congress allows the differential treatment of goods made domestically and abroad. However, the government suggested that "Congress of course remains free to amend the Copyright Act in order to adjust the balance between protection of copyright holders' prerogatives and advancement of other policy objectives."[39]

Conclusion

The Supreme Court will hear oral arguments in *Costco v. Omega* on November 8, 2010. Because Elena Kagan in her previous role as Solicitor General had written a brief recommending that the Court not grant the petition for writ of certiorari in the case, the new Justice Kagan has recused herself in the upcoming *Costco* case.[40] Her recusal means that only eight justices will consider the

[31] *Id.*

[32] Brief for Respondents at 2, Costco Wholesale Corp. v. Omega, S.A, No. 08-1423.

[33] *Id.* at 8.

[34] *Id.* at 12 (emphasis in original).

[35] Brief for the United States as Amicus Curiae at 5-6, On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit, Costco Wholesale Corp. v. Omega, S.A, No. 08-1423.

[36] *Id.* at 18.

[37] *Id.* at 5.

[38] *Id.* at 18.

[39] *Id.* at 19.

[40] Tony Mauro, *Kagan Recuses in Ten More Cases*, NATIONAL LAW JOURNAL, Sept. 13, 2010.

case; thus, it raises the possibility of a 4-4 tie vote, in which event the Ninth Circuit's decision would stand.

The Court's opinion in *Costco* may have considerable impact on the domestic retail industry. A decision that upholds the appellate court's opinion could impact the secondary markets of copyrighted goods, such as eBay, Amazon.com, and even traditional brick-and-mortar secondhand stores. If the Court reverses the Ninth Circuit, its decision could affect the ability of companies to sell copyrighted works at different price points in the U.S. and foreign markets (a practice known as "geographical price discrimination."). It remains to be seen whether the factual differences between *Quality King* and *Costco* are legally significant: as described earlier, the former case involved products that had been manufactured in the United States before being first sold abroad and then re-imported into the United States without the consent of the copyright holder, whereas the latter case involves a product that was made abroad, first sold abroad, and thereafter imported and sold within the United States without the permission of the copyright holder. As Justice Ginsburg's concurrence in *Quality King* explained, the *Quality King* Court did not address whether the first sale doctrine applies to imported goods that had been manufactured abroad. This question promises to be resolved by the Court's *Costco* opinion. The answer may well turn on whether a majority of the members of the Court agree or disagree with the statements made in the copyright treatises cited by Justice Ginsburg's *Quality King* concurrence: the first sale provision does *not* have extraterritorial application; that is, the words "lawfully made under this title" appearing in § 109(a) must be construed to mean "lawfully made in the United States."

Author Contact Information

Brian T. Yeh
Legislative Attorney
byeh@crs.loc.gov, 7-5182