



KLEMCHUK LP
PROTECTING INNOVATION

HOW *COSTCO* AND ITS PROGENY AFFECT THE FIRST SALE DOCTRINE – BASED ON WHERE GOODS ARE MADE AND SOLD

KLEMCHUK LP

P 214-367-6000 E info@klemchuk.com 8150 N Central Expressway | 10th Floor
F 214-367-6001 W klemchuk.com Dallas, Texas 75206

“Gray Market” Goods – What Are They?

- Black Market
 - Goods that are illegal and/or distributed through illegal channels
- Gray Market
 - Genuine but unauthorized
 - Goods that are legal, but are distributed through unauthorized channels
 - Also referred to as a “Parallel Import”
 - Imported into U.S. without authority of IP owner



“Gray Market” Goods – What Are They?

- Possible when the price of an item is significantly higher in one country than another
 - Why would IP owner set different prices?
 - Advertising expenses
 - Specifications
 - Profit margin
- Makes arbitrage possible if price difference is enough
 - Purchase in non-U.S. market
 - Import into U.S.
 - Sell for less than authorized dealers in U.S.
 - Still make a profit



“Gray Market” Goods – Are They Bad?

- Favorable Effects of Gray Market
 - Increased price competition, thus lower consumer prices
- Unfavorable Effects of Gray Market
 - Decreased profit margins for IP owners
 - Reduced investment in development of IP
 - Tarnished reputation and/or goodwill of existing IP



“Gray Market” Goods – What Does the Copyright Act Say?

- Exclusive Right to Distribute – 17 U.S.C. § 106(3)
 - “the owner of copyright under this title has the exclusive rights to do and to authorize any of the following:
...
(3) to distribute copies or phonorecords of the copyrighted work to the public by sale or other transfer of ownership, or by rental, lease, or lending”
- Infringing Importation – 17 U.S.C. § 602(a)(1)
 - “Importation into the United States, without the authority of the owner of copyright under this title, of copies or phonorecords of a work that have been acquired outside the United States is an infringement of the exclusive right to distribute copies or phonorecords under section 106, actionable under section 501.”



“Gray Market” Goods – What Does the Copyright Act Say?

- Statutory right to exclude others from distributing copies is robust, but not absolute
- First Sale Doctrine – 17 U.S.C. § 109(a)
 - “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 the copyright owner, to sell or otherwise dispose of the possession of that copy or phonorecord. ...”



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“Gray Market” Goods – Does Place of Manufacture Matter?

- First Sale Doctrine – 17 U.S.C. § 109(a)
 - “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 the copyright owner, to sell or otherwise dispose of the possession of that copy or phonorecord. ...”
- Does the phrase “lawfully made under this title” limit application of the First Sale Doctrine to only items made in the U.S.?
- Or is it broad enough to apply to items made inside and outside the U.S.?



“Gray Market” Goods – Round-Trip vs. One-Way Importation

- **Round-Trip Importation** – Copyrighted goods are:
 - Manufactured *inside* the U.S.
 - Sold to a party outside the U.S.
 - Imported back into the U.S.
- **One-Way Importation** – Copyrighted goods are:
 - Manufactured *outside* the U.S.
 - Sold to a party outside the U.S.
 - Imported back into the U.S.



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“Gray Market” Goods – Round-Trip Importation

Quality King Distribs., Inc. v. L’Anza Research Int’l, Inc
523 U.S. 135 (1998).

- **Facts:**
 - Copyrighted labels for hair care products
 - Manufactured in U.S. (California)
 - Sold to authorized UK distributor (significantly lower price)
 - Sold to unauthorized Malta distributor
 - Imported to unauthorized U.S. distributor
 - Sold to unauthorized U.S. retailers at discounted price



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“Gray Market” Goods – Round-Trip Importation

Quality King Distribs., Inc. v. L’Anza Research Int’l, Inc
523 U.S. 135 (1998).

- **Question Presented to the Supreme Court:**
 - Is section 602(a) of the Copyright Act (giving the copyright owner the right to prohibit unauthorized importation of copies) limited by the First Sale Doctrine?
- **Answer:**
 - YES, the First Sale Doctrine applies to round-trip importation



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“Gray Market” Goods – Round-Trip Importation

Quality King Distribs., Inc. v. L’Anza Research Int’l, Inc
523 U.S. 135 (1998).

- **Justice John Paul Stevens (writing for unanimous Court):**
 - “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.”



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“Gray Market” Goods – One-Way Importation

Costco Wholesale Corp. v. Omega S.A., 562 U.S. ___ (2010), *aff’g* 541 F.3d 982 (9th Cir. 2008).

- **Facts:**

- Copyrighted design on back surface of watches
- Manufactured in Switzerland
- Sold to authorized non-U.S. distributor
- Sold to unauthorized non-U.S. third parties
- Sold to unauthorized non-U.S. wholesaler
- Sold to Costco (unauthorized)
- Costco imported into U.S. and sold at 1/3rd discount



“Gray Market” Goods – One-Way Importation

Costco Wholesale Corp. v. Omega S.A., 562 U.S. ___ (2010), *aff'g* 541 F.3d 982 (9th Cir. 2008).

- **Question Presented to the Supreme Court:**
 - Does the First Sale Doctrine apply to one-way importation for goods manufactured outside U.S.?
- **Answer:**
 - NO, the First Sale Doctrine is not applicable
 - BUT, a 4-4 split decision – “The judgment is affirmed by an equally divided Court”
 - Debate continues – continuing divide among circuit courts



“Gray Market” Goods – One-Way Importation

Costco Wholesale Corp. v. Omega S.A., 562 U.S. ____ (2010), *aff’g* 541 F.3d 982 (9th Cir. 2008).

- **District Court:**
 - Summary judgment applying First Sale Doctrine
- **Ninth Circuit:**
 - Reversed – First Sale Doctrine does *not* apply
 - Copies made outside the U.S. not necessarily lawful copies
 - Recognizing First Sale Doctrine for goods made outside U.S. constitutes an improper extraterritorial application of U.S. copyright law



“Gray Market” Goods – One-Way Importation

Costco Wholesale Corp. v. Omega S.A., 562 U.S. ___ (2010), *aff’g* 541 F.3d 982 (9th Cir. 2008).

- **End Result:**
 - Application of the First Sale Doctrine does not depend on location of first sale
 - Application of the First Sale Doctrine does depend on location of manufacture
 - At least indirectly encourages copyright owners to manufacture their goods outside the U.S.



“Gray Market” Goods – One-Way Importation

John Wiley & Sons, Inc. v. Kirtsaeng, 654 F.3d 210 (2d Cir. 2011).

- **Facts:**
 - Copyrighted books
 - Manufactured in Asia (different supplemental content, type and quality of materials, and designation of authorized countries)
 - Sold to non-U.S. friends and family of defendant
 - Shipped to defendant
 - Sold on websites such as eBay.com



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“Gray Market” Goods – One-Way Importation

John Wiley & Sons, Inc. v. Kirtsaeng, 654 F.3d 210 (2d Cir. 2011).

- **District Court:**
 - Rejected Defendant’s proposed jury instructions including First Sale Doctrine as a defense
- **Second Circuit:**
 - Affirmed – First Sale Doctrine does *not* apply
 - Focused on language “lawfully made under this title” in Section 109(a)



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“Gray Market” Goods – One-Way Importation

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- **Second Circuit:**
 - “Lawfully made under this title” – multiple interpretations:
 - “manufactured in the U.S.”
 - “any work made that is subject to protection under this title”
 - “lawfully made under this title had this title been applicable”



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- **Second Circuit:**
 - “Confronted with an utterly ambiguous text, we think it best to adopt an interpretation of Section 109(a) that best comports with both Section 602(a)(1) and the Supreme Court’s opinion in *Quality King*.”
 - The Supreme Court’s *dicta* suggested that copyrighted material manufactured abroad cannot be subject to the First Sale Doctrine contained in Section 109(a).



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“Gray Market” Goods – One-Way Importation

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- **Second Circuit – Dissenting Opinion:**
 - The language of the First Sale Doctrine “does not refer to a place of manufacture: It focuses on whether a particular copy was manufactured lawfully under Title 17 of the [Copyright Act].”
 - According to the Copyright Act, a “U.S. copyright owner may make her own copies or authorize another to do so ... Thus, regardless of place of manufacture, a copy authorized by the U.S. rightsholder is lawful under U.S. copyright law.”



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“Gray Market” Goods – One-Way Importation

Pearson Education, Inc. v. Yadav, 2011 U.S. App. LEXIS 19239 (2d Cir. Sept. 19, 2011).

- **Second Circuit:**
 - Similar to facts of *Wiley*
 - Again affirmed that the First Sale Doctrine is not applicable, thus unauthorized importation of textbooks in the U.S. was prohibited
 - Unless and until the Supreme Court or the Second Circuit *en banc* reverses the Second Circuit’s decision in *Wiley*, no choice



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Potential Effects of *Costco* and its Progeny

- Supreme Court's 4-4 Affirmance of *Costco*
 - Manufacturing copyrighted goods outside the U.S. likely provides copyright owner with better control over the U.S. market
 - Determine when the first sale in U.S. should occur and at what price



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Potential Effects of *Costco* and its Progeny

- Criticism of *Costco*
 - Loss for consumers and U.S. economy
 - Contrary to public policy of First Sale Doctrine
 - Greater protection to copyrighted works manufactured outside the U.S.
 - Incentive to transfer manufacturing outside U.S.
 - Eliminates price competition by foreclosing (or attempting to foreclose) gray market
 - Puts at risk existing substantial secondary market



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Potential Effects of *Costco* and its Progeny

- Support for *Costco*
 - Third parties should not be allowed to circumvent exclusive right to distribute
 - Control timing of entry into different markets and price at which entry occurs
 - Capitalize on local promotional opportunities
 - Combat piracy
 - Vary content by market
 - Foster local distribution networks
 - Divide rights across markets



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Potential Effects of *Costco* and its Progeny

- Post-*Costco* Strategies for Copyright Owners
 - Place copyrighted work on product
 - Label
 - Artistic design
- Register copyright with Copyright Office
- Record copyright with Customs and Border Patrol
- Manufacture outside the U.S.
 - NOTE – Subject to change if Supreme Court accepts another opportunity to review and does not result in a split 4-4 decision



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“Gray Market” Goods – Issues Other Than Copyright

- *Lanham Act*
 - *K Mart Corp. v. Cartier, Inc.*, 485 U.S. 176 (1988)
 - *Lanham Act* prohibits importation of goods manufactured in a foreign country by a foreign manufacturer, even if the foreign party has a license from a U.S. firm
 - Prohibited parallel importation based on fact that goods were not all coming from same origin



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“Gray Market” Goods – Issues Other Than Copyright

- Trademark and U.S. Customs Service
 - *Lever Bros. Co. v. United States*, 981 F.2d 1330 (D.C. Cir. 1993).
 - U.S. Customs typically recognizes “affiliate exception” whereby foreign goods bearing U.S. trademarks are not excluded if trademark owner and importer are parent and subsidiary
 - However, exception *not* applied because goods were physically and materially different – confuse consumers
 - So trademark owner can effectively prevent genuine goods that are materially and physically different



“Gray Market” Goods – Issues Other Than Copyright

- Trademark and U.S. Customs Service
 - 19 CFR § 133.23 – Restrictions on Importation of Gray Market Articles
 - “Restricted gray market articles” include goods bearing a genuine trademark applied by an independent licensee, by a foreign owner, or to physically and materially different articles (*Lever-rule*)
 - Labeling in close proximity – “This product is not a product authorized by the United States trademark owner for importation and is physically and materially different from the authorized product.”



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