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EXHAUSTION AND FIRST SALE IN INTELLECTUAL PROPERTY

Michael V. Sardina*

I. THE LEGAL CONCEPTS

In recent years, legal academia and the public sphere have displayed an increasing interest in arguably two of the most important Intellectual Property law concepts: the First Sale Doctrine¹ and the principles of Exhaustion.² Owners of Intellectual Property rights have a keen interest in the current judicial interpretation and application of these doctrines, predominantly because of the high commercial value attached to the various IP rights that accompany any product sold domestically or internationally.³ Conversely,

* Editor-in-Chief, Santa Clara Law Review, Volume 51; J.D. Candidate, Santa Clara University School of Law, May 2011. I would like to briefly thank Professor Eric Goldman and Cindy Tippett, respectively the Director and former Assistant Director of the High Tech Law Institute at Santa Clara University School of Law; additionally, I would like to thank Lara Muller and the entire editorial board of the Santa Clara Law Review Volume 51.

1. Under U.S. Copyright Law, the First Sale Doctrine is a defense to copyright infringement codified in 17 U.S.C. § 109. Thus, the term “First Sale Doctrine” is generally used to reference the concept of exhaustion of rights in the copyright context.

2. In contrast, under U.S. Patent Law and U.S. Trademark Law schemes, the term “Exhaustion” is used to refer to this same concept. Under Patent and Trademark law, the concept of exhaustion was judicially created and developed through the case law. *See* *Quanta Computer, Inc. v. LG Elec., Inc.*, 553 U.S. 617 (2008) (“For over 150 years this Court has applied the doctrine of patent exhaustion to limit the patent rights that survive the initial authorized sale of a patented item.”); *Sebastian Int’l v. Longs Drug Stores Corp.*, 53 F.3d 1073 (9th Cir. 1995) (“Since 1924, courts have recognized a basic limitation on the right of a trademark owner under the Lanham Act to control the distribution of its own products. . . . [C]ourts have consistently held that . . . the right of a producer to control distribution of its trademarked product does not extend beyond the first sale of the product.”).

3. *See generally Facts About IP*, GLOBAL INTELLECTUAL PROPERTY CENTER, <http://www.theglobalipcenter.com/facts> (last visited Mar. 25, 2011) (“U.S. intellectual property is worth between \$5.0 trillion and \$5.5 trillion—

consumers naturally feel that purchasing a given product should confer ownership and allow for freedom in that product's disposition. Aside from the interests of rights owners and consumers, several other issues have propelled the First Sale and Exhaustion concepts before all levels of the Judiciary. These issues include the escalating globalization of markets and importation of "gray market" goods,⁴ as well as increasing "sales" of software and other digital goods with accompanying contractual licensing agreements.⁵ The consequences of the future judicial interpretations and applications of these concepts will have a massive impact in both the United States and abroad.

The First Sale Doctrine and the principles of Exhaustion are viewed as significant limitations on the monopoly grant that is accorded to owners of Intellectual Property rights.⁶ It is often said that the basic purpose of these limitations is to prevent IP rights owners from obtaining a "second bite at the apple."⁷ When a copyright owner sells a work to an individual consumer, when a patent holder has authorized the sale of a patented device, or once a trademark owner has sold a trademarked good, the right to control the disposition of that work, device, or good is said to be exhausted.⁸ The purchasing consumer is then free to make use of that item in any way he or she might choose: by enjoying the item for its intended use, by reselling the item, or even by destroying the item.⁹ The IP owner has received an adequate and fair level of compensation through the initial sale, and does not deserve to benefit from, or to maintain any control over, a subsequent downstream transaction.¹⁰

Yet, these doctrinal concepts remain muddled in practice and are not clearly defined across the different regimes of

more than the nominal gross domestic product (GDP) of any other country.").

4. *See, e.g.*, *Omega S.A. v. Costco Wholesale Corp.*, 541 F.3d 982 (9th Cir. 2008) (discussing the gray market importation into the United States of Omega watches manufactured abroad).

5. *See, e.g.*, *Vernor v. Autodesk, Inc.*, 621 F.3d 1102 (9th Cir. 2010) (discussing a software program (specifically, AutoCAD) sold with an accompanying software licensing agreement).

6. *See* MELVILLE B. NIMMER & DAVID NIMMER, *NIMMER ON COPYRIGHT* § 8.12(A) (LexisNexis 2011).

7. JANICE M. MUELLER, *PATENT LAW* 427 (Aspen Publishers, 3d ed. 2009).

8. *See id.*

9. *Id.*

10. *See* NIMMER, *supra* note 6, § 8.12(A).

Intellectual Property. Further, the concepts often vary in form and function across international jurisdictions.¹¹ Intellectual Property owners are finding novel ways to argue for, and assert control over, their IP, effectively evading the intentions of the First Sale Doctrine and Exhaustion principles.¹² Thus, as the Circuit Courts of Appeal, and ultimately the Supreme Court of the United States, address emergent issues involving the First Sale Doctrine and the principles of Exhaustion, the decisions that are reached become crucially important to the practical implications of Intellectual Property law.

II. THE “EXHAUSTION AND FIRST SALE IN IP” CONFERENCE

On November 5, 2010, just days before Oral Argument in one of the most anticipated First Sale cases before the Supreme Court, *Costco v. Omega*,¹³ the Santa Clara University School of Law and the High Tech Law Institute hosted a symposium conference entitled “Exhaustion and First Sale in IP.”¹⁴ The timely conference devoted an entire day of discussion to the most pressing issues surrounding the First Sale Doctrine and the principles of Exhaustion, and it featured some of the most renowned economic, academic, and legal scholars as speakers and panel moderators.¹⁵ The Santa Clara Law Review, working in conjunction with the

11. For example, within the patent context, the United States has adopted a doctrine of domestic exhaustion (whereby exhaustion applies only to authorized sales within a domestic market), the European Union has adopted a doctrine of regional exhaustion (whereby exhaustion applies regionally to any sale within a market in the EU), and Japan has recognized a doctrine of international exhaustion (whereby exhaustion applies to any authorized sale anywhere in the world). See MUELLER, *supra* note 7, at 552–53.

12. Copyright owners attempt to contract around the First Sale Doctrine, and eliminate a potential First Sale defense for copyright infringement, by characterizing the “sale” of a digital work as a mere “license.” See 17 U.S.C. § 109 (2008).

13. *Costco Wholesale Corp. v. Omega, S.A.*, 131 S. Ct. 565 (2010). The case was argued before the Supreme Court on November 8, 2011. Disappointing many commentators, thanks in part to Justice Kagan’s recusal from the case, the Court declined to offer any clarification regarding the contours of the First Sale Doctrine. Instead, the Court affirmed the Ninth Circuit in a terse *per curiam* opinion. See *id.* (“The judgment is affirmed by an equally divided Court.”).

14. *Exhaustion and First Sale IP*, HIGH TECH LAW INSTITUTE, <http://law.scu.edu/hightech/first-sale-conference.cfm> (last visited Mar. 25, 2011).

15. See *id.*

High Tech Law Institute, solicited articles concerning a range of topics related to First Sale and Exhaustion from authors with diverse professional backgrounds.¹⁶ These contributions are published within this comprehensive Symposium Issue of the Santa Clara Law Review.

At the conference, discussion was initially focused on the justifications for the First Sale Doctrine and the principles of Exhaustion. Professor Molly Shaffer Van Houweling¹⁷ traced the historical practices of imposing various post-sale restrictions on real property and she analogized these restrictions to comparable restrictions imposed upon intangible works of authorship and invention through Copyright and Patent.¹⁸ She stressed that the First Sale and Exhaustion principles provide some justifiable limitations on these restrictions.¹⁹ In her contribution to this Issue, Professor Van Houweling examines the impact of the real property requirement that restrictions must “touch and concern” the property within the digital context, through an analysis of the Ninth Circuit’s opinion in *MDY Industries v. Blizzard Entertainment*.²⁰

Professor Vincent Chiappetta²¹ introduced the foundational precepts underlying Patent Exhaustion, defining Exhaustion as a patentee’s loss of the ability to assert its IP rights and enforce the specific remedies provided under the Patent Act.²² In his article, Professor Chiappetta analyzes Patent Exhaustion with an emphasis on the nature of the sale of the good (authorized versus unauthorized versus

16. See *Exhaustion and First Sale in IP Conference*, SANTA CLARA LAW REVIEW, <http://lawreview.scu.edu/page.cfm/events/test> (last visited Mar. 25, 2011).

17. Molly Shaffer Van Houweling is a Professor of Law at the University of California, Berkeley Law.

18. Molly Shaffer Van Houweling, Professor of Law, University of California, Berkeley Law, Panel Discussion at the Santa Clara University School of Law High Tech Law Institute Symposium: Exhaustion and First Sale in IP (Nov. 5, 2010).

19. *Id.*

20. Molly Shaffer Van Houweling, *Touching and Concerning Intellectual Property*, 51 SANTA CLARA L. REV. 1063 (2011). See also *MDY Indus., LLC v. Blizzard Entm’t, Inc.*, 629 F.3d 928 (9th Cir. 2010).

21. Vincent Chiappetta is a Professor of Law at the Willamette University College of Law in Salem, Oregon.

22. Vincent Chiappetta, Professor of Law, Willamette University College of Law, Panel Discussion at the Santa Clara University School of Law High Tech Law Institute Symposium: Exhaustion and First Sale in IP (Nov. 5, 2010).

conditional), and the nature of the exhaustion rule (an optional rule versus a default standard).²³ His article then focuses on how the principle of Exhaustion should be tailored to increase economic and market efficiencies in light of the underlying policies of Patent law.²⁴

Following this introduction to Patent Exhaustion, economist Anne Layne-Farrar²⁵ presented her view of the role that Patent Exhaustion plays in real-world licensing practices.²⁶ She identified several key problems, including the informational frictions and asymmetries that may arise when a patent holder is capable of licensing and controlling its IP at multiple levels in the downstream market.²⁷ Her article presents the economic argument that the lack of clarity and guidance in the Supreme Court's decision in *Quanta v. LG Electronics*²⁸ allows for the possibility of contractual flexibility to avoid the impact of exhaustion. This is actually beneficial to patent owners and licensees operating within multi-level licensing schemes, and yet it does not ultimately undermine the policies behind exhaustion; parties should generally be free to contract around any default First Sale rule.²⁹

Discussion at the conference then shifted to transborder and comparative law issues arising within the interaction of the Intellectual Property laws and trade policies of various countries. Professor John Rothchild³⁰ discussed the situation where either the manufacture, or the first sale, of a particular good occurs outside of the United States.³¹ He reemphasized

23. Vincent Chiappetta, *Patent Exhaustion: What's It Good For?*, 51 SANTA CLARA L. REV. 1087 (2011).

24. *See generally id.*

25. Dr. Anne Layne-Farrar is a Vice President with Compass LexEcon, and holds a Ph.D. in economics from the University of Chicago.

26. Dr. Anne Layne-Farrar, Vice President, Compass LexEcon, Panel Discussion at the Santa Clara University School of Law High Tech Law Institute Symposium: Exhaustion and First Sale in IP (Nov. 5, 2010).

27. *Id.*

28. *See Quanta Computer, Inc. v. LG Elec., Inc.*, 553 U.S. 617 (2008).

29. Anne Layne-Farrar, *An Economic Defense of Flexibility in IPR Licensing: Contracting Around "First Sale" in Multilevel Production Settings*, 51 SANTA CLARA L. REV. 1149 (2011).

30. John A. Rothchild is the Associate Dean and an Associate Professor at the Wayne State University Law School.

31. John A. Rothchild, Associate Dean and Associate Professor, Wayne State University Law School, Panel Discussion at the Santa Clara University School of Law High Tech Law Institute Symposium: Exhaustion and First Sale

the importance of the single-reward principle, whereby a patentee receives one and only one reward for an authorized sale of a patented device, and where a copyright holder receives a single reward for a sale of the work.³² Professor Rothchild's article provides a comprehensive legal synopsis that highlights the distinction between copyright and patent cases involving a foreign component, while taking into consideration the presumption against the extraterritorial application of U.S. laws.³³

Professor Irene Calboli³⁴ delivered a comparative analysis of trademark exhaustion principles operating in the European Union, as opposed to those operating within the North American Free Trade Association.³⁵ Her presentation discussed the three typical versions of exhaustion—national, international, and regional—and indicated that although the principles of trademark exhaustion were developed to facilitate global trade, any exhaustion concept must accord national and territorial laws.³⁶ Her article provides a scholarly overview of the trademark exhaustion framework in North America and in Europe, and it identifies the practical implications that can be drawn from this comparative analysis.³⁷

Professor Daniel Chow³⁸ illustrated the present state of trademark exhaustion and parallel importation in China.³⁹

in IP (Nov. 5, 2010).

32. *Id.*

33. John A. Rothchild, *Exhausting Extraterritoriality*, 51 SANTA CLARA L. REV. 1187 (2011).

34. Dr. Irene Calboli is an Associate Professor of Law and Director of the Intellectual Property and Technology Program at Marquette University Law School. In Spring 2011, she served as a Visiting Professor of Law at DePaul University College of Law.

35. Dr. Irene Calboli, Associate Professor of Law, Director of Intellectual Property and Technology Program, Marquette University Law School, Panel Discussion at the Santa Clara University School of Law High Tech Law Institute Symposium: Exhaustion and First Sale in IP (Nov. 5, 2010).

36. *Id.*

37. Irene Calboli, *Market Integration and the (Limits of) the First Sale Rule in North America and European Trademark Law*, 51 SANTA CLARA L. REV. 1241 (2011).

38. Daniel Chow is the Joseph S. Platt-Porter Wright Morris & Arthur Professor of Law at The Ohio State University Moritz College of Law.

39. Daniel Chow, Joseph S. Platt-Porter Wright Morris & Arthur Professor of Law, The Ohio State University Moritz College of Law, Panel Discussion at the Santa Clara University School of Law High Tech Law Institute Symposium: Exhaustion and First Sale in IP (Nov. 5, 2010).

He suggested that although Chinese law does not explicitly reference parallel imports, it does suggest that parallel importation into China might be theoretically possible.⁴⁰ Yet, given the political and practical realities existing within the country, bureaucratic dysfunction and various certification laws applicable to imported products will likely prevent any such possibility.⁴¹ Professor Chow supports this argument in his article by first outlining the most relevant provisions of Chinese trademark law, and then by providing an in-depth analysis of the pertinent line of cases on point.⁴²

The conference concluded with a panel devoted entirely to the topic of the First Sale Doctrine and its interaction with the myriad of emergent issues in Copyright law. Despite some consumer and public support for a strong and viable First Sale Doctrine, Professor Raymond Nimmer⁴³ argued that the Doctrine has been crippled by contractual licensing: the question is not whether a copyright holder can circumvent any application of the First Sale Doctrine, but simply how best to accomplish this.⁴⁴ Professor Nimmer discussed the recent decision in *Vernor v. Autodesk*,⁴⁵ and he highlighted the important distinction between a licensee and true ownership.⁴⁶ Professor Nimmer's article elucidates the current state of the law, bringing clarity to the relationship between the copyright law doctrine of First Sale and the general law and practice of contract.⁴⁷

III. THE SANTA CLARA LAW REVIEW'S CONTRIBUTION TO THE BODY OF LEGAL LITERATURE

Collectively, the goal of the articles presented in this comprehensive Symposium Issue on the First Sale Doctrine

40. *Id.*

41. *Id.*

42. Daniel Chow, *Exhaustion of Trademarks and Parallel Imports in China*, 51 SANTA CLARA L. REV. 1283 (2011).

43. Raymond T. Nimmer is the Dean and Leonard Childs Professor of Law at the University of Houston Law Center.

44. Raymond T. Nimmer, Dean and Leonard Childs Professor of Law, University of Houston Law Center, Panel Discussion at the Santa Clara University School of Law High Tech Law Institute Symposium: Exhaustion and First Sale in IP (Nov. 5, 2010).

45. See *Vernor v. Autodesk, Inc.*, 621 F.3d 1102 (9th Cir. 2010).

46. Nimmer, *supra* note 44.

47. Raymond T. Nimmer, *Contract First Sale and the Over-riding Role of Contract*, 51 SANTA CLARA L. REV. 1311 (2011).

and the principles of Exhaustion in Intellectual Property is to provide clarity and exposition to the legal topic. The following pages present a diverse range of analyses and arguments supported by many distinct and sometimes contrarian viewpoints. This Issue aims to capture the spirit of the “Exhaustion and First Sale in IP” conference, and highlight the continuing importance of these Intellectual Property concepts. Further, these articles strive to raise and address the most important issues, cases, and opinions regarding the First Sale and Exhaustion concepts. Through publication of this Issue, the Santa Clara Law Review seeks to contribute to the collective debate and the body of legal academic literature in this pressing area of Intellectual Property law.