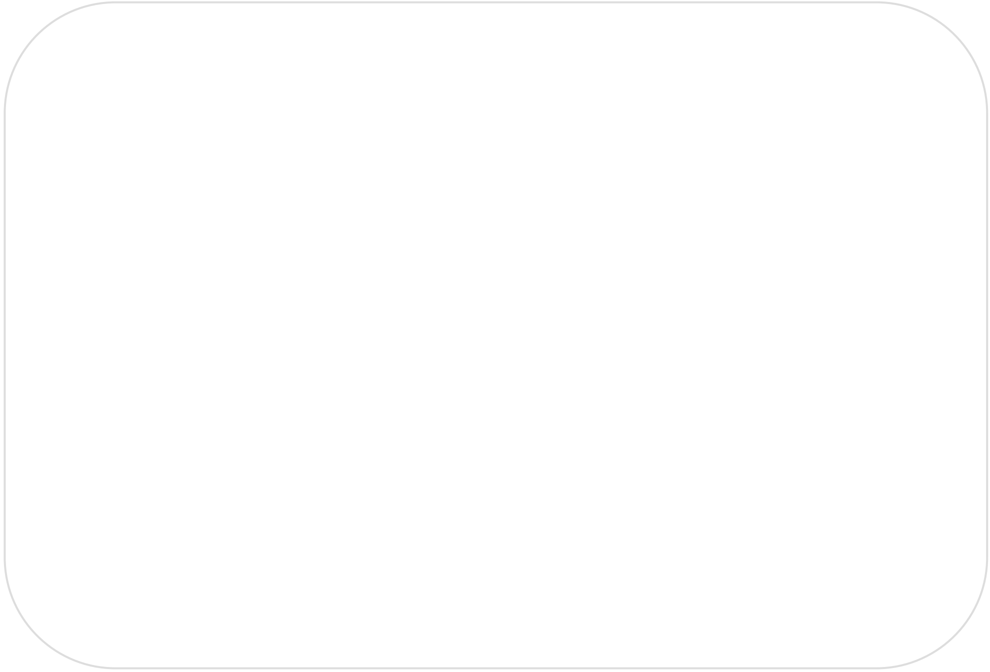

Institute of Innovation Research
Hitotsubashi University

Tokyo, Japan
http://www.iir.hit-u.ac.jp

Exhaustion of IP Rights: Reflections from Economic Theory

by

Peter Ganea Ph.D.

Max Planck Institute for Intellectual Property, Competition and Tax Law
Marstallplatz 1, 80539 Munich/Germany
Tel. +49-89-24246-454
p.ganea@ip.mpg.de

February, 2006

The doctrine of exhaustion denies IPR owners the right to control subsequent sales of patented, copyrighted or trademarked products after they have been placed on the market with the consent of the right owner. Exhaustion rules therefore inevitably interfere with the right owner's exclusive market position, as they reduce his leeway for price differentiation and expose him to intensified price competition. The study analyzes to which extent such interference can be justified in the light of the different economic natures of patents and design rights, copyrights and trademark rights. The author of this article has been a visiting scholar at the Institute of Innovation Research (IIR) at Hitotsubashi University from March to June 2005. Special thanks go to Prof. Sadao Nagaoka (IIR) for his kind supervision and for his helpful comments on this article. All errors and omissions, however, remain on the author.

Exhaustion of IP Rights: Reflections from Economic Theory

© Peter Ganea

I. General Remarks

This article deals with the exhaustion of patents, copyrights and trademark rights, one of the most heatedly debated IP-related topics. The core question is whether a patent, copyright or trademark right entitles its owner to prevent the further circulation of goods incorporating his IP after they were put into circulation with his consent. Does a patent entitle its owner to prohibit the import of patented goods from a country in which they were legally sold by a licensee and legally purchased by the importer? Can a foreign film producer prevent the import of legally sold video cassettes or DVDs of a cinematographic work in a country in which the same film is still shown in the movie theatres? Can the owner of a famous trademark prevent legal purchasers of goods bearing his trademark from selling them independently of established distribution channels?

The terms "Patent exhaustion", "trademark exhaustion" etc. mean that the right to control further market distribution has ceased to exist upon first legal sale, not that the IP as a whole has exhausted. The owner of the copyright in a video game, for example, may still proceed against the unauthorized commercial display and performance of his games in a gaming arcade, as the right to perform the work in the public subsists even after the legal sale of the video game copies.[1] Subject to exhaustion is only the right to control subsequent circulation of a legally sold item.

[1] Red Baron-Franklin Park, Inc. v. Taito Corp., 883 F.2d 275 (4th Cir. 1989).

The exhaustion problem is of special relevancy when it comes to international trade in goods which incorporate IP rights. Different national average incomes prompt right owners to differentiate the price for one and the same good, and such price differentiation invites thirds to purchase such goods where they are sold at a cheap price and to resell them where consumers are charged a high price, thereby arbitraging away international price differences.[2] Should trade in such goods, which is widely known as "parallel imports", be permitted or not? The actual international conventions on patent, trademark and copyright protection, e.g. the TRIPS Agreement under the WTO, leave the answer to this question to their member states, and an international consent is not yet in sight. The international exhaustion problem remains one of the most vividly discussed IP issues between the developed and the underdeveloped world. Whereas the former fear a flood of cheap commodities to the detriment of national industry and employment, the latter argue that a prohibition of parallel imports would form a de-facto trade barrier that prevents developing countries from tapping their comparative advantage of cheap labor.[3]

However, also on the domestic market, the permissibility of re-circulating goods that have been put into circulation with the consent of the right owner is under discussion. One example is the independent sale of so-called Original Equipment Manufacturer (OEM-) software, i.e. software bundled with hardware and sold at a much cheaper price than the price charged for the isolated program versions.[4]

---

[2] More about monopolistic price differentiation below. 2. b).

[3] *Verma*, Exhaustion of Intellectual Property Rights and Free Trade - Article 6 of the TRIPS Agreement, 29 IIC 534 (1998).

[4] According to a decision of the German Federal Court, such OEM software copies are first circulated when they are sold to the authorized distributors, so that the distribution right in them does not extend to subsequent sale to retailers or end users. The latter would be free to distribute the copies without adhering to the sales conditions prescribed by the copyright owner (decision of 6 July 2000, Zeitschrift fuer Urheber- und Medienrecht 2000, 1079).

The sometimes emotional exchange of arguments obstructs the analysis of the core problem, namely whether and to what extent intellectual property exhaustion impairs the essence of patent, copyright and trademark rights. This study aims at developing a general framework that integrates the interests of both right owners in an adequate reward for their creative efforts and the public in the availability of high-value commodities at cheap prices.

II. Patent Exhaustion

1. Legal Concepts…

The explanations in this subchapter will outline the present legal theories with respect to patent exhaustion, which were partly developed by scholars, partly by the judiciary, in short. We may roughly distinguish between two legal schools:[5]

One regards exhaustion as a natural limitation to the patent law. It is mainly grounded on the so-called "reward theory", according to which the patent owner has obtained an equitable award upon first sale. There would be no reason to allow him to reap further benefits by a control right over the subsequent circulation. In other words, by granting the patent owner the opportunity to put the patented product exclusively on the market, the objective of patent protection has been met. Further acts of circulating the patented product would no more affect the specific subject-matter of the patent right. Another justification for the exhaustion of patent rights often referred to in this context

[5] Explained in detail by *C. Heath*, Legal Concepts of Exhaustion and Parallel Imports, in: *C. Heath*,

is the "theory of safeguarding market circulation", according to which a right to control subsequent acts of market circulation would raise insecurity as to which extent the market participants may dispose of their legally purchased property and thereby jeopardize the smooth market circulation. Patent exhaustion as a limitation to the patent right is accepted by the majority of important legislations, including the U.S. and Continental Europe.

However, the majority of legislations restrict exhaustion to the national level. With regard to international exhaustion, the majority of national and regional legislations adhere to the principle that a legal sale abroad shall have no effect on the right to market the patented product domestically, so that the patent right can be exercised against the inflow of products produced and marketed e.g. under a license abroad. From a legal perspective, a patent constitutes a territorial right, meaning that its grant, invalidation etc. in one country has no effect on the treatment and fate of a parallel patent for the same invention in another country. Therefore, also the legal exploitation of the patented technology on one domestic market shall not limit the scope of its exercise on the other domestic market. In prescribing Community-wide "regional" exhaustion, the EU has somehow softened this principle in order to realize a barrier-free internal market, even though patent harmonization within the EU is still on the way.

The other school of thought, the so-called "implied license doctrine", is of British origin and applied in many Common-Law countries. It basically leaves the extent to which a product can be re-circulated upon first legal sale to the decision of the right owner respectively to the agreement concluded with his licensee. Just as the owner of a material commodity, the patent owner may decide whether to dispose of his immaterial

---

Parallel Imports in Asia, Kluwer Law International 2004, 13 et seq.

property once and for all or whether to entrust its exploitation under certain restrictions. Accordingly, the right owner may for example oblige his licensee in another country to mark the patented product with a sign that sale is restricted to that country and may not be traded to another country. Such a mark would not only be effective against the immediate licensee but also ban third purchasers from reselling the marked products outside the limits indicated by that mark. Sale of unmarked goods instead would imply that the right owner has consented in unrestricted resale ("implied license").

The implied license doctrine enjoys increasing popularity in Japan and China, both countries without a Common Law tradition. In its famous "BBS" decision of 1 July 1997 on parallel imports,[6] the Japanese Supreme Court, for example, stated that "...a domestic patentee who markets patented products abroad and wishes to exclude their sale and use in our country by subsequent purchasers, has to make clear his intention of such a restriction when dealing with the transferee, and has to clarify such restriction on the patented goods for the benefit of subsequent purchasers." In absence of such a clarifying mark on the product, priority must be given to international trade.

China's Supreme People's Court has not yet had the opportunity to make a corresponding judgment, but in anticipation of future cases, it has inserted a precautionary rule in Item 94 of its draft set of detailed interpretation rules on the application of law to patent infringement cases, which, however, is still under discussion. With regard to the international exhaustion, it states that the patent right shall be deemed exhausted upon first sale unless the licensing contract contains a clause that restricts the sales territory.

[6] 29 IIC 331 (1998)

2. ... and Economic Theory

a) The economic importance of patents

Freshmen in economics learn that perfect price competition is the competition form that generates the highest possible welfare. Their reference model is the “model of perfect competition”. It shows that welfare, i.e. the aggregation of the so-called consumers' surplus, i.e. the advantage for those consumers who would have paid a higher price than the given market price, and the producers' surplus, i.e. the advantage of those producers who would be able to sell the product at a lower price than the given market price, is on an optimum level if the market is perfectly competitive.

Perfect market competition means that the market price is the result of innumerous market transactions, i.e. that it is taken for given by all market participants and not manipulated by a single player. A single supplier on the market would be able to actively set a price according to the consumers' readiness to pay, thereby eating up a part of the consumers' surplus and offering a reduced supply at higher prices.[7]

However, perfect competition is only possible under a number of very restrictive preconditions. It requires, *inter alia*, an atomistic market structure, i.e. a huge number of players so that no single player can manipulate the market price. Moreover, the goods traded on the market must be completely homogenous. A good that attracts consumers by unique qualitative features would result in an exclusive position of its supplier and allow him a certain pricing leeway. According to the perfect competition model, however, all situations in which single producers can actively set prices instead of

[7] With regard to monopolistic price formation, see *Varian*, Intermediate Microeconomics (5th ed.

taking a market price for given are sub-optimal. A part of the consumers' surplus will be eaten up without compensating such loss by a corresponding increase in the producer's surplus. Therefore, the total aggregate of consumers' and producers' surplus decreases.[8]

In our real world, however, situations of perfect competition are quite rare. Especially the assumption of complete homogeneity of goods does not match today's reality. It may have been realistic in times in which mainly agricultural products and natural resources were objects of market transactions, but it does not fit to our present markets in which sophisticated and qualitatively diverse goods are traded. The sole answer that the model can give to this deviation from what it considers "perfect" is that the innovative step incorporated in a unique commodity be immediately imitated by the competitors. The weak point of the model of perfect competition becomes obvious – it can only demonstrate the welfare effect of pure price competition but it remains silent on welfare enhancement by long-term competition in terms of quality and innovation.

Patent protection eliminates this weak point. Economically, it can be explained as the acceptance of one market failure, namely a monopolistic pricing leeway that results from the exclusive right to market a certain commodity,[9] in order to eliminate another market failure, namely free riding on innovative efforts, which will sooner or later diminish any incentive on the supply side to be competitive in terms of quality and innovation. The inefficiency of such free-riding can also be demonstrated by the model of perfect competition: accordingly, the gratis supply of other market participants with results of innovative or creative effort amounts to a so-called positive externality. An

---

1999) W.W. Norton & Co. New York, London, 416 et seq.

[8] *Varian*, (above note 7), 422 et seq.

[9] Some commentators deny patents the character of monopoly rights – see e.g. *Pretnar*, The Economic Impact of Patents in a Knowledge-Based Market Economy, 34 IIC 887 (2003). According to economic theory, however, any pricing-leeway forms a deviation from perfect competition and logically amounts to a monopolistic situation. In other words, the fact that patent owner is in the

internalization of the externality in form of a right to be rewarded would enable the supplier to enhance his supply to an extent that meets the real demand for it. What the model of perfect competition cannot explain, however, are the long-term consequences of such an unrewarded effort, namely that sooner or later, any incentive to be competitive in terms of innovation and creativity will disappear.

It should be noted, however, that the grant of a patent does not mean permission to unrestricted monopolistic pricing. Apart from rare cases in which no substitute can be found on the respective market, the patent owner is normally disciplined by the availability of alternative, yet qualitatively differing goods of the same category, so that he cannot fully escape price competition.

b) Price differentiation by the patent owner – an "unfair" discrimination?

As exclusive supplier, the monopolist can dictate prices according to the demand's willingness to pay. If the willingness to pay is varying among different consumer groups, he will try to differentiate prices and charge each consumer group a price that corresponds to its willingness to pay. Price differentiation enables him to skim a higher proportion of the consumer surplus than in case of uniform price setting. In the ideal case, each consumer will be charged the price that he is ready to pay, but normally, such "perfect price discrimination" is impossible, as the individual consumer will not reveal his real willingness to pay. Therefore, price differentiation is normally restricted to differentiation according to consumer groups (so-called third-degree price differentiation).[10]

The demand's willingness to pay depends on the so-called price elasticity of demand,

---

position to differentiate prices evidences that the patent right amounts to a monopoly.

that is, the extent to which the demand reacts to a change in the price of a given commodity. A high elasticity indicates that the demand can easily switch to another commodity in case of a price increase. It can also mean that the further purchase of that commodity would use up to too much of the income of the household, so that it has no other choice but to refrain from further purchase. The monopolist will charge a relatively low price from such consumer groups. Low price elasticity instead indicates that the consumers do not have a choice to switch to or that their average income is high enough to cope with the price increase. The monopolist may therefore charge a higher price.[11]

Without doubt, such price differentiation discriminates against those who are willing to pay a relatively high price. However, in comparison with a uniform monopoly price, it can enhance welfare, when it enables the supply of those consumers who would not have been able to afford the commodity at that uniform price. Why should therefore patent owners, as exclusive right owners endowed with a certain pricing leeway by law, only be allowed to set a uniform price but not to differentiate prices? The supporters of far-reaching exhaustion rules state that by fostering arbitrage, the monopolistic pricing leeway of patent owners will be reduced, with the result of a better supply at cheaper prices. This view might be justified with regard to "undesired" monopolists who overcharge consumers in an abusive manner, but do patent owners really abuse their market power when they exploit a pricing leeway which results from the grant of an exclusive right? Do they really have to be "disciplined"?

Far-reaching exhaustion rules expose the patent owner to price competition on the market for which the patent is granted. Such intensified price competition through the

---

[10] See *Varian* (above note 7), 434 et seq.

sale of products bearing his own technology will have a negative impact on the profit that he can gain when putting the patented product into circulation.

Therefore, it can hardly be assumed that the patent owner has had the opportunity to obtain an "adequate reward" upon first circulation, in that the objective of patent protection has been met and subsequent sale would no more affect the specific subject-matter of patent protection.

c) International exhaustion and trade theory

The most relevant form of price differentiation with respect to patented products is international price differentiation. Here, the patent owner differentiates prices according to different average national income levels. Should he be deprived of this opportunity to exploit his monopoly by international exhaustion? As already mentioned in the introductory remarks, the supporters of an international exhaustion refer to the welfare effect of unrestricted international trade in terms of a better international supply at lower costs.

Economically, the welfare effect of international trade can be demonstrated by the so-called model of comparative advantages. It observes two countries, each of them producing the same two commodities. One of these countries enjoys an absolute productivity advantage, meaning that it is able to produce both commodities at higher productivity than the other country. Even in such case, one product can be produced at relatively low costs in the one country, and in the other country it is just the other way round. The model of comparative advantages now evidences that in spite of the fact that one country enjoys an absolute productivity advantage, trade between both countries

[11] Ibid.

makes sense, as it enables each country to concentrate on the commodity it can produce at relatively low costs. In other words, international division of labour results in a better supply at lower prices on each national market.

However, also the model of comparative advantages cannot be unrestrictedly applied to our real world. It explains a situation in which the immediate reason for international price differences is cost differences. It starts from the assumption that the prices on each national market result from perfect competition and remains silent on other factors of influence like the existence of monopolies, different institutional preconditions and the like on price formation. In other words, it basically starts from the same restrictive assumptions as the model of perfect competition. Therefore, it cannot simply be applied to a situation in which not only different factor endowments but also the exclusive right to market a certain product is decisive for international price differences. [12]

d) The necessity of safeguarding market circulation

It cannot be ignored that controlling the re-circulation of patented products causes costs, which consist in the insecurity of legal purchasers as to which extent they may freely dispose of their property without offending against the law. Here, it must be kept in mind that patent protection does not end in itself but that its objective is to enhance welfare. A patent system that exposes market participants to a high degree of uncertainty may reduce entrepreneurial activity, raise hedge losses and reduce welfare. This argument is basically consisted with the above-mentioned "theory of safeguarding

[12] The quite simple model of comparative advantages, which was developed by *Ricardo* in 1817, has undergone subsequent modifications and refinements, so by the Factor-Proportions Model of *Heckscher* and *Ohlin* that includes different national endowments with the factors labor and capital in its observations, or by the *Stolper-Samuelson*-Theorem that allows conclusions with regard to changes in factor prices (labor and capital) due to the changes in output entailed by the transition from autarky to trade. All these modifications, however, give us no further hint on possible effects

market circulation", pursuant to which exhaustion rules are necessary to secure the smooth circulation of goods.

In sum, from an economic perspective, the theory of safeguarding market circulation turns out to be the only tenable justification for exhaustion rules. Rules based on this theory should emanate from a consideration whether the beneficial effect of reduced uncertainty outweighs the possible incentive incompatibilities arising from a reduced pricing leeway. We may assume that within a national or largely integrated regional market, the costs of keeping up prevention mechanisms against parallel trade against an in other respects free flow of commodities are considerably high. In other words, the more "abnormal" trade barriers especially established to prevent parallel trade appear within an in any other respects integrated and uniform market environment, the more convincing is the call for an exhaustion rule. On the other hand, the more national markets are isolated from each other, the less costly can prevention measures against parallel trade be assumed, not at least because national boundaries are "natural" trade barriers that partition single unified market areas from each other. Here, the social benefit arising from undistorted price differentiation, namely incentives to be competitive in terms of innovation and quality, is likely to outweigh the remaining insecurity costs resulting from trade barriers against parallel imports.

e) Some thoughts on the "implied license" doctrine

As already mentioned, English law has developed the so-called "implied license" theory pursuant to which the patent owner is deemed to have given his consent into unrestricted resale of his product unless he has clearly declared that distribution outside

---

that the existence of IP rights may have on the welfare that free trade is assumed to generate.

established channels is not permitted. English law requires such declaration of will to be in form of a mark on the product (not only in the license contract etc.) so as to inform potential re-distributors about the sales restriction. However, why should the owner of the patent have an interest in not indicating a mark that resale is prohibited? One reason can be the so-called double marginalization problem: an exclusive local distributor may sell his products at a price that contravenes the sales policy of the right owner, in that it significantly reduces the output the right owner. In such case, the original right owner can be interested in disciplining his distributors by allowing limited intra-brand competition.[13] At a first glance, to privatize the exhaustion problem by leaving it to the decentralized decision autonomy of the market players appears quite appealing, because it widens the scope of contractible subject-matter and reduces regulatory interference into the market.

However, a closer look reveals some significant weaknesses of this solution. One is of rather practical nature. Third potential resellers are not involved in the contract between the right owner and can therefore hardly be expected to know whether the right owner has allowed resale or not. The only feasible way to inform them in a manner that does not cause unreasonable search costs to them is to attach a declaration of will directly on the product, indicating the territorial extent to which re-circulation of the product is allowed. However, even such a declaration of will may be expressed in a hazy and misleading manner, as common standards for such marking are widely absent. Second, the attachment of such a mark and its content may result from a contractual agreement between the right owner and his local licensee, distributor etc. and therefore

[13] *Gallini/Hollis*, A Contractual Approach to the Grey Market, 19 Int'l Rev. L. & Econ. 1(10 et seq.),with special regard to intra-brand competition between products bearing the same trademark. Their findings, however, are *mutatis mutandis* applicable to the patent exhaustion problem. The question of trademark exhaustion is treated in Chapter IV.

from a bilateral bargaining monopoly in which only two parties decide about the terms and conditions of allocating a patent right. The result of their bilateral bargaining, however, reduces the room for manoeuvre of third parties who had no opportunity to bring in their own views. In the light of these uncertainties and insufficiencies, a clear (though reasonably justified) exhaustion rule to which all market participants have to adhere in the same manner appears to be preferable over privatizing the exhaustion problem by leaving its solution to individual decision-making.[14]

3. Intermediate results

So far, the observations have brought the following to light:

a) The "reward theory" according to which the patent owner has had the opportunity to obtain an "adequate reward" upon first sale does not convince, as it disregards that due to arbitrage, the "adequate reward" will sooner or later be reduced by intensified price competition through sale of products bearing his own technology.

b) The same applies to the "free trade argument" raised in context with parallel imports, as it imposes a model developed under the assumption of perfect price competition on a situation in which competitors are deliberately exempted from price competition.

c) To a certain extent, exhaustion rules are justified in the light of the "theory of safeguarding market circulation". It considers that an unrestricted right to control

[14] See also *Yusuf/Moncayo von Hase*, Intellectual Property Protection and International Trade – Exhaustion of Rights Revisited, 16 No.1 World Competition Law and Economics Review (1992), 115.

further acts of distributing legally sold products creates obstacles to the free movement of commodities and therefore increases hedge losses and costs of uncertainty. These costs can be deemed unduly high in case of an in other respects largely integrated market. Here, exhaustion rules make sense. The “theory of safeguarding market circulation”, however, is less compelling as justification for the international exhaustion.

d) Finally, the “implied license” doctrine, on the first glance an alluring alternative to legal exhaustion rules, turns out to be inefficient, as it may enhance costs of uncertainty.

III. Copyright Exhaustion

1. The Economic Function of Copyright and its Treatment in Legal Reality

Traditionally, subject to exhaustion under copyright is the “distribution right”, i.e. the right to put material copies of the work like CDs, books, tapes etc. into circulation. That the distribution right has exhausted, however, does not mean that the legal purchaser may exploit his work exemplar in any thinkable manner. Only the distribution right has exhausted upon first sale, but not e.g. the right to communicate the content of a legally purchased CD to the public by making it available on the internet or playing it in a discotheque. On the international stage, a comprehensive distribution right in all categories of works such as in performances and phonograms was first introduced into

the World Copyright Treaty and the World Performances and Phonograms Treaty of 1996. Both treaties, however, leave the exhaustion issue to national regulation by the member states.

The economic function of copyright is not much different from that of patents. Also a copyright entitles its owner to exclusively market an item that incorporates his work, which can be a book, a CD but also an artistically designed perfume flacon. Therefore, the above explanations with regard to patent exhaustion can be similarly applied to the exhaustion of the copyright distribution right. In other words, neither the "reward theory" nor the "free trade argument" can justify copyright exhaustion rules, as they expose the owner of a legal monopoly to pure price competition through sale of products incorporating his own work, which will sooner or later reduce the "adequate reward" obtained upon first circulation, and also the implied license doctrine turns out to be economically inefficient, as it imposes the result of bilateral bargaining on third market participants. Just as in case of patents, there remains only one tenable argument in favour of copyright exhaustion, namely the mentioned "theory of safeguarding the free market circulation".

Even in countries like Germany, where copyright is rather perceived as a non-disposable right of the individual author than as a market instrument, it is commonly accepted that copyright must be subject to certain limitations in order to safeguard social welfare. In a decision of 4 May 2000 regarding the unauthorized poster reproduction of copyrighted perfume flacons for promoting their re-circulation outside the channels established by the copyright owner, the German Federal Court even subjected the reproduction right to the exhaustion doctrine set forth in Sec. 17 of the

German Copyright Act,[15] stating that copyright as a whole (and therefore not only the distribution right) must take second place to the interest in the marketability of the copyrighted goods.[16]

How is copyright exhaustion treated in legal practice of other countries? As already mentioned, the international rules leave the exhaustion issue to national legislation. The European Union makes use of this freedom to protect the Internal Market against cheap imports from abroad. A number of copyright-related EU Directives[17] contain slightly differently worded provisions which, however, are commonly interpreted as allowing exhaustion *only* within the Internal Market, i.e. as prohibiting parallel imports of CDs, books etc. from third countries. The clearest provision is contained in Art. 4(2) of the Information Society Directive of 2001, pursuant to which "the distribution right shall not be exhausted within the Community in respect of the original or copies of the work, except where the first sale or other transfer of ownership in the Community of that object is made by the right holder or with his consent." In the light of the above argument that spatial price differentiation increases welfare by enabling the supply of low-income consumer groups, even EU-wide exhaustion appears questionable, given the huge differences in national incomes, especially after the EU accession of a number of Eastern European countries in the course of the 2004 enlargement. However, the EU pursues the higher-ranking political goal of establishing a unified European market without any trade barriers, in which a control right over subsequent parallel trade upon first sale within the Community would hardly be acceptable. The motive behind

[15] Pursuant to Sec. 17 of the Copyright Act, the distribution right exhausts upon first sale within the European Community – on Community-wide exhaustion, see (2).
[16] 32 IIC 717 (2001) The Federal Court, however, explicitly denied a direct exhaustion of the reproduction right. It only banned the copyright owner from exercising it in order to circumvent the legal exhaustion of the distribution right.
[17] On computer programs (1991), on the rental right (1992), on database protection (1996) and on

prohibiting its members to allow parallel imports from third countries, which is apparently a political one, namely to protect the European film, music and software industry against cheap imports from abroad, should not be discussed as it is of little relevance for our theoretical observations. In the light of the mentioned objective to establish a unified market, however, it is certainly justified not to leave it to each member state to formulate its own exhaustion policy with regard to third countries, but to prescribe a common regime. Otherwise, CDs, DVDs, books etc parallel imported into member states which opted for international exhaustion would be banned from subsequent importation into those members which prohibit parallel imports, which would result in a new trade barrier within the EU.[18] In sum, the treatment of copyright exhaustion in the EU comes quite close to the results of our economic observations, namely that exhaustion rules make sense within a largely integrated market area but not on the international stage. However, this treatment is not based on considerations regarding the economic importance of copyright but rather on the motive to erect a "fortress Europe", with far-reaching circulation freedom within its boundaries and protectionism against price competition from outside.

Among the IP codes of the U.S., the Copyright Act is the only one that provides for an explicit exhaustion rule. Sec. 109 (a) contains a provision which is generally known as "first sale doctrine". It is based on a Supreme Court decision of 1908[19] which regarded the right to put work copies into circulation ("to vend") as a necessary supplement to the right to make copies and not as a right that could be independently exercised against recirculation upon first legal sale. Case law with regard to

---

copyright in the information society (2001)

[18] *Von Lewinski,* International Exhaustion of the Distribution Right Under EC Copyright Law, E.I.P.R. 2005 27(7), 233.

[19] Bobbs-Merrill Co. v. Straus, 210 U.S. 339.

international exhaustion is ambiguous, however. The majority of decisions since the 1980ies regard parallel imports of copyrighted products as infringing the importation right in Sec. 602 of the Copyright Act,[20] and it remains doubtful whether the Supreme Court's "Quality King" decision of 9 March 1998[21], which allowed parallel imports of copyrighted goods, really entailed a change to this view. It dealt with the special case of a product originally produced in the U.S. and exported to the U.K. where the defendant purchased it at a cheap price and re-imported it to the U.S. The Supreme Court based its reasoning on the wording of Sec. 109 (a) pursuant to which the first sale doctrine would apply to products "lawfully made under this title", which it obviously interpreted as "made in the U.S." Products lawfully made abroad (e.g. under a license) would therefore not fall under the first sale doctrine, and the importation right in Sec. 602 would remain applicable. In sum, U.S. case law gives no further hint on how to view at the first sale doctrine in the light of economic theory but is rather based on the interpretation of legal provisions.

If we take a final look at the Japanese Copyright Act, we find a quite clear provision on copyright exhaustion. Sec. 26-2 provides for a "right in ownership transfer", meaning a right to distribute the work original or copies that exhausts upon first circulation. It was introduced in 1999 in response to the WCT which requires a distribution right but leaves the exhaustion issue to the members. Excluded from exhaustion are cinematographic works. Their owners enjoy a more comprehensive "distribution right" (Sec. 26), which was already introduced in 1970 and originally intended as a non-exhaustive right. Due to the special pattern of traditional film

[20] E.g. Columbia Broadcasting Systems v. Scorpio Music Distributors 569 F.Supp 47 (E.D. Pa. 1983) aff'd mem., 738 F.2d. 424 (3d Cir. 1984)

[21] 118 S.Ct. 1125 (1998)

exploitation in form of renting or otherwise circulating only a few copies among movie theatres, film producers should be indirectly protected against unauthorized showing by a control right over the circulation of their film rolls. However, in the meantime, also producers of audiovisual subject-matter like films stored on video cassettes which are exploited in the same manner as books and CDs, namely through mass sale of items for individual use, claim to be film producers and to enjoy the non-exhaustive "distribution right" in Sec. 26.[22] In order to rectify this unbalanced situation, the Supreme Court in a decision of 25 April 2002 interpreted the "distribution right" as exhaustive with regard to computer games and permitted the second-hand-sale of legally purchased games, even though it still regarded video games as falling under "cinematographic works".[23] In this context, the court also stated that a non-exhaustible right would jeopardize the free movement of goods and allow the right owner to obtain an unnecessary double reward. In sum, the Japanese trend towards a liberal regime over trade in copyrighted goods is evident. However, the reasoning of the Supreme Court is not only based on the cognition that the market must be kept free of obstacles, but also on the view that copyright owners do not deserve a "double reward", an argument that has proved untenable in the observations regarding patent exhaustion.

2. On the Feasibility of the So-called Online Exhaustion

Whereas the online submission of films, music, software and texts against payment has

[22] See e.g. the "Beauty and the Beast" decision of the Tokyo District Court of 1 July 1995, 27 IIC 570 (1996).
[23] 35 IIC 467 (2004), comment by *Ganea*.

become a common form of copyright transactions, the application of the exhaustion doctrine is still restricted to the right to put work materializations like CDs or books into circulation. To a number of commentators, it appears quite odd that the exhaustion doctrine allows the resale of CDs or books bought at the sales counter whereas an individual who has ordered the same content via the internet and downloaded on a material carrier is banned from the sale of copies of his download, just because the content was not "distributed" to him but transmitted.[24]

A substantial difference between traditional store and online sale becomes only evident if we distance ourselves from the subjective view of the work purchaser and recall that the only tenable justification for exhaustion rules we have found is the need to safeguard the free circulation of commodities. In case of store sale, it is commonly accepted that only third parties like independent retailers or end users may freely dispose of purchased work copies, but not e.g. the directly authorized licensor or distributor. He is bound to the conditions regarding territory of sale etc. imposed by the right owner. The distribution right in work copies circulated in offence against such contractual rules is not regarded as exhausted, as the copies are not put into circulation with the right owner's consent. However, in case of internet sale, the immediate transaction partner to the copyright owner is no more a commercial distributor but the end user himself. Why should the right owner in this case be banned from imposing limitations on subsequent use, e.g. in form of a click-wrap agreement?

Unlike traditional store sale in form of transferring ownership in an item bearing protected contents, sale via internet rather resembles a permission to use than "sale" in the traditional sense, even if the purchaser is allowed to make a copy of the program on

[24] E.g. *Knies*, Erschoepfung Online? (Exhaustion Online?), GRUR Int. 2002, 314; *Eric Tjong Tjin*

his hard disk, and unlike the subject-matter of store sale, the subject-matter of online transactions is not "commodities" incorporating protected contents but the protected contents as such. In other words, in case of online transmission, no goods are "put into circulation" with the consent of the right owner and a "movement of goods" that could be jeopardized by a control right over subsequent acts of circulating protected contents does not occur.

It should not remain unmentioned that a click-wrap permission to use is far from a real contractual agreement that expresses the will of both parties, as the right owner rather imposes his use conditions on the purchaser. Abidance to them is secured by technological protection measures. They render such uses impossible which were originally permitted by limitation rules but they cannot be circumvented without offending against copyright. On the other hand, copyright limitations (such as the exhaustion rule) emerged at a time when the prevailing exploitation patterns did not allow to control the private use of legally purchased work carriers. The legislature accepted the inevitable, permitted such non-controllable private uses and partly introduced collective compensation systems of "rough justice" character, so for example levies imposed on equipment with audio or audio-visual recording function, regardless of whether the single purchaser really used it for recording protected contents.

The internet reduces such inefficient rough justice, in enabling the supply side to meet individual demands better than ever before by way of price and product differentiation. A few years ago, a consumer had to buy a whole CD if he wanted to hear a certain title, together with a dozen or more other unwanted pieces. The internet enables him to download only the preferred content at a correspondingly cheap price. In

---

Tai, Exhaustion and Online Delivery of Digital Works, E.I.P.R. Iss.5 (2003), 207.

the near future, the already technically possible “pay-per-view” or “pay-per-listening” -forms of copyright transaction will open an even broader variety of online copyright transactions. In other words, that form of copyright transactions which results in a durable copy of contents identical to the CD, DVD or book available at the sales counter is only one amongst many others, and the end user has the choice between many forms of permitted use, at different prices and under different conditions. In exchange, he must accept the various restrictions on use in click-wrap licenses etc. which are in most cases accompanied by technical protection measures to secure that he individually allowed scope of use will not be exceeded.[25]

It should not be ignored that the supporters of the above mentioned (untenable) reward theory would arrive at another conclusion, as it makes indeed no difference whether a work copy is sold at the sales counter or the protected content is submitted via the internet: in both cases the copyright owner has equally obtained the “adequate reward”. However, even the supporters of the reward theory admit that amongst all possible transaction forms, online exhaustion rules can only be applied to cases which are analogous to purchase at the sales counter.[26]

Exhaustion rules that apply only to a part of the possible online transactions, however, are likely to cause further confusion among online purchasers who are already exposed to a high degree of legal insecurity on the virtual market. What forms of resale should be allowed by the exhaustion rule and what not? May the purchaser of a virtual album

[25] It should not be ignored that parts of the Continental European copyright community have a rather skeptical attitude towards the increased opportunities of right owners and work consumers to enter into direct transaction relationship, as the mentioned “right owners” are in most cases not the immediate authors but the commercial work exploiters. The above-mentioned “rough justice” of collective copyright management at least secured the authors stable revenue according to fixed distribution standards, whereas the decreasing need for collective administration due to the internet would expose authors to the unilateral bargaining power of the culture industry.

[26] *Eric Tjong Tjin Tai* (above note 24).

resell single music pieces or, in analogy to sale in the CD shop, only the whole album? Which manner of resale should be allowed, sale of tangible CD-R copies, sale through re-transmission etc.? In sum, online exhaustion would raise insecurity and therefore run counter the basic intention behind exhaustion rules, which is to safeguard smooth market transactions. Copyright exhaustion should therefore remain limited to the non-virtual world, even if it may sooner or later become obsolete, as protected contents are increasingly traded via the internet.

3. Intermediate Results

a) Just as patent protection, copyright protection should only be limited by exhaustion rules if otherwise the smooth circulation of commodities would be seriously hampered.
b) Exhaustion rules originally target at eliminating obstacles to the market circulation of *commodities*. Therefore, they cannot be offhand applied to online transactions, where no commodities are sold, but contents submitted. The broad variety of possible online transactions renders those transactions which are equivalent to sale at the counter hardly distinguishable from other transaction forms. In order to avoid unnecessary confusion as to which extent an online purchaser may dispose of the downloaded content, the application of exhaustion rules should be limited to the non-virtual world in which clearly identifiable work copies ("commodities") are traded.

IV. Trademark Exhaustion

1. Origin Function and Exhaustion

In economic terms, the exclusive right to mark the own product, i.e. the right to prohibit others from using the same sign on their products, helps to eliminate the market failure of information deficiencies. A mark contains plenty of information about the quality and features of the marked product. In other words, it enables consumers to locate the commodity which fits to their preferences.

In absence of such a signaling mark, the search costs of obtaining adequate information would be too high. As a result, the consumers would refrain from buying a pig in a poke but rather rely on the only available information, which is the price. Due to the unavailability of quality information, they would opt for the cheapest product which is likely to be the one fabricated at lowest production costs and therefore to be of worst quality. Those suppliers who engage in costly quality competition would not be able to sell their products and sooner or later disappear from the market. The result would be a market on which only goods of uniformly bad quality are traded, with dissatisfied consumers and suppliers without any incentive to be good in terms of quality maintenance and improvement. This so-called "adverse selection" is a market failure and leads to a sub-optimal situation because it prevents the supply side from meeting the consumer's preferences.[27]

A trademark signalizes to the consumers that the marked product stems from a certain centre of will[28] which stands for certain quality promises. If the trademark

[27] *Varian* (above note 7), 642 et eq.; the economic importance of trademarks is highlighted by *Landes/Posner*: Trademark Law: An Economic Perspective, 30 Journal of Law & Economics 265 (1987)

[28] This expression (German: "Willenszentrum") has been used by *Koppensteiner*,

owner does not neglect quality control, the consumers will establish certain quality expectations in the marked product and be ready to purchase it at a correspondingly high price. Especially well-known trademarks open their owners a certain pricing leeway, because they enjoy an exclusive market position. In this regard, the objective of trademark protection is not much different from that of patent and copyright protection, namely to secure dynamic quality competition by exempting the right owner from pure price competition based on information asymmetry. Just like patent and copyright owners, trademark owners have a huge interest in exploiting the pricing leeway arising from their entrepreneurial effort by differentiating prices. And just like in case of patents and copyright, the resale of marked products purchased at a location where they were put into circulation at a cheap price is an act of free riding.

However, free riding on what? In one important aspect, trademark protection is substantially different from patent or copyright protection, as it does not grant its owner the exclusive right to put a certain product on the market, but only the exclusive right to attach a mark which indicates that the marked product stems from a center of will that guarantees for its quality. Where a marked product enjoys an exclusive position on the market, it is the result of the trademark owners' exploitation of his right in the intended manner, but not of a right to supply the market with a certain product. Competitors are free to put identical but differently marked products into market circulation, unless the marked good is simultaneously protected by a patent or copyright. In other words, in contrast to a patent or copyright which rewards an already achieved result of outstanding innovative or creative efforts, the trademark right only lays the foundation for such a reward. It leaves it to the right owner to establish a monopolistic position

---

Markenrechtsentwicklung und Parallelimport (Development of Trademark Law and Parallel

which allows him to charge monopoly prices in exchange for the result of outstanding entrepreneurial efforts.

The basic function of the trademark which is to indicate the origin of a certain commodity leaves not much room for a renunciation from the exhaustion principle. Once a marked product is legally put into circulation, the function of the mark to indicate the origin can be regarded as fulfilled, and it will not be impaired by subsequent acts of circulation.[29] In other words, even if circumventing the distribution channels established by the trademark owner can be regarded as a form of free riding, such free riding does not affect the subject matter protected by the trademark right. The interest of the trademark owner in undistorted price differentiation can therefore not be protected by a trademark regime that is solely based on the origin function.

2. Is an Extension of the Scope of Trademark Functions Desirable?

It should be noted that normally not only the function of origin indication, but also a number of other functions are attached to trademarks, like for example the "quality function" i.e. the function of guaranteeing to the consumer that his quality expectations will be met, or the "advertisement function" i.e. the function of implementing information about the product's features and qualities into the consumer's consciousness. Trademark owners often supply different markets with products of different quality under the same trademark and sell them at different prices. Arbitrage in form of

---

Imports), ÖBL 1994, 195.

[29] *Heath*, Legal Concepts of Exhaustion and Parallel Imports, in *Heath* (ed.), Parallel Imports in Asia, Kluwer Law International, The Hague et al. 2004, 13 (17 et seq.)

purchasing the (in most cases cheaper) products of low quality and offering them on a market which is supplied with high-quality products at a correspondingly high price may severely impair the goodwill associated with that trademark. Should therefore the quality function of a trademark, the goodwill it incorporates be protected against parallel imports? U.S. case law, for example, prohibits parallel imports of goods that are "materially different" from the domestically traded goods, mainly in order to protect consumers against disappointed quality expectations.[30]

Other important trademark legislations show or – until recently showed - much more reserved towards a protection of functions other than the origin function. Japanese case law, for example, looks back on a long tradition of acknowledging international exhaustion, with reference to the origin function as the only protected function of trademarks.[31] Also the Supreme Court's recent "Fred Perry" decision of 27 February 2003,[32] which held that imports of textiles produced under an unauthorized sublicense abroad could not be regarded as parallel imports of genuine goods, does not mean a renouncement from this view. Such import would still harm the *source function* of the trademark, as the breach of contract by the direct license partner deprived the right owner of the opportunity to control and maintain quality, so that the imported goods can no more be regarded as put into circulation with his consent.

In the EU, the Trademark Directive of 1989 has abandoned the so-far prevailing principle of international trademark exhaustion. Art. 7 stipulates that "the trade mark shall not entitle the proprietor to prohibit its use in relation to goods which have been

---

[30] E.g. Lever Bros. Co. v. U.S., 981 F.2d 1330 (D.C. Cir. 1993)

[31] Starting with the Osaka District Court's "Parker" decision of 27 February 1970, 2 IIC 325 (1971); that the quality function is not directly protected by the trademark right was explicitly stated by the Tokyo District Court in its "Lacoste" decision of 7 December 1984, 1141 Hanrei Jihô 143.

[32] Summarized in 35 IIC 217 (2004).

put on the market in the Community under that trade mark by the proprietor or with his consent." The ambiguously formulated provision is widely interpreted as allowing only parallel trade within the Community and as prohibiting parallel imports of marked goods from third countries to the territory of the EU.[33] However, neither the provision itself nor the recitals to the directive contain any further substantial hint that this partial renouncement from the exhaustion principle is based on any considerations with regard to an enlarged scope of trademark functions. Its sole objective seems to be the protection of the European trademark industry against the inflow of genuine goods which are cheaply manufactured and circulated abroad. Even though a study of 2000 has brought to light that international exhaustion would presumably not entail noteworthy damage to the European industry, the EU still adheres to the regional exhaustion, with reference to the fact that an explicit international exhaustion rule would not be introducible, and that leaving the exhaustion issue to the national legislation of each member would cause distortions on the Internal Market.[34]

One EU member which would probably not consent in the (re-)introduction of worldwide trademark exhaustion is Germany. Prior to the enactment of the Trademark Act of 1994, German case law was quite clear in limiting the catalogue of protected functions to the origin function. This is best reflected by the Federal Court's decision in its "Cinzano" decision of 2 February 1973,[35] that "if the mark owner himself is not

---

[33] E.g. the "Silhouette" decision of the European Court of Justice of 16 July 1998, 29 IIC 920 (1998); even before this clarification, the German Federal Court in its "Dyed Jeans" decision of 14 December 1995 (28 IIC 131 (1997) interpreted the rule in Art.7 as allowing only regional exhaustion within the EU – the decision is criticized by *Albert/Heath* in 28 IIC 24 (1997).

[34] Communique from Commissioner *Bolkestein* available through www://europa.eu.int/comm/internal-market/en/indprop/tm/comexhaust.htm

[35] 4 IIC 432 (1973)

obliged to maintain a constant quality, third parties can even less be expected to do so".

However, the overhaul of 1994 prompted a number of commentators to assume that also the quality function would now be directly protected and that this would necessitate a reorientation in the exhaustion question. [36] They refer, *inter alia*, to the complete transferability of the trademark under the new provisions. It would therefore have lost a lot of its dependence on a certain business operator, which is regarded as a hint that the trademark is no more solely an instrument of indicating the product's origin. A further hint is that trademark owners are now explicitly entitled to prescribe quality standards to their licensees, and circulation of products which do not meet these standards is no more regarded as a matter of contract breach but as trademark infringement. Here, not only the licensee who shows responsible for the inferior quality comes into question as infringer but also thirds who re-circulate the products of low quality. The same applies to products that the license partner circulated outside the scope agreed upon in the license contract - also here, third circulators may be held liable for trademark infringement.

It remains doubtful, however, whether all these changes really reflect an enlargement of the protected trademark functions. Even if circulation of goods of inferior quality or circulation beyond the licensed scope now constitutes infringement, such goods cannot possibly be regarded as put into circulation *with the consent of the right owner* any more. In other words, their availability on the market cannot be traced back to the same "center of will" that has in the past performed well in terms of quality maintenance and improvement, and therefore infringes the origin function of the mark. Even without

[36] E.g. *Lehmann/Schoenfeld*, Die neue europäische und deutsche Marke: Positive Handlungsrechte im Dienste der Informationsökonomie (The New European and German Trademark: Positive Transaction Rights at Service of the Information Economy) GRUR Int. 1994, 481.

clarifying rules at hand, the above-mentioned "Fred Perry" decision of the Japanese Supreme Court has arrived at a similar solution.

In contrast to U.S. case law, the German rules remain silent on inferior goods put on a foreign market *with the consent* of the trademark owner. How to deal with parallel imports of such goods into markets where superior goods are sold under the same mark? In my opinion, there is no reason to protect the quality promise inherent in a trademark. To fabricate and to market products of different quality under the same trademark is at least no economic activity that deserves special protection. Such protection may instead have effects that run counter to the original intention of trademark law, which is to intensify quality competition by abolishing information insufficiencies, especially if we take into account that our global economy is not only characterized by the free movement of goods but also by the free movement of consumers who want to see their quality expectations met wherever they purchase the product of their preferred brand. And even in cases where not goods of "inferior" but only of "different" quality, i.e. adapted to national preferences, sizes, customs, etc. are traded, it should be left to the initiative of the trademark owner to mark the products correspondingly in order to protect consumers against disappointed quality expectations.[37]

3. Intermediate Results

a) The traditional function of trademark, which is to indicate that the marked product stems from a certain center of will, leave not much room for a control right over the

[37] With regard to Japan, see *Tamura*, Shôhyôhô gaisetsu (Commentary on Trademark Law), 2nd ed.

subsequent circulation of the marked goods. In contrast to patent and copyright protection, trademark protection does not entitle the right owner to put a certain commodity exclusively into circulation but only to prohibit competitors from using the same mark. His monopoly position on the market is a mere consequence of using the trademark in the intended manner but not directly protected by the trademark right. In other words, the trademark right as such does not exempt him from price competition but only provides him with the opportunity to obtain a certain monopoly status, in enabling him to establish confidence among consumers that their quality expectations will be met.

b) An enlargement of the scope of trademark functions to the quality function or the advertisement function, i.e. a direct protection of the quality promise incorporated in a trademark, is at least unnecessary, if not undesirable. It should be left to entrepreneurial decision of the trademark owner to keep to his own quality promises. There is no need for legal rules that allow him to lean back and to rely on protection against price competition by parallel imports of inferior goods circulated by him under the same mark.

V. Final Results

The increasing demand for a more liberal regime over exhaustion reflects concern about too strong IP rights. However, far-reaching exhaustion rules as a means to correct possible overprotection would lack economic accuracy, not at least because they would

---

Kôbundô Publishing House, Tokyo 2004, 477 et seq.

be similarly applied to both subject-matter that is indeed over-protected as well as to adequately protected subject-matter. A more accurate approach to this problem would be to reconsider the scope of protected subject-matter, whether absolute rights in mere information collections, business methods, shampoo bottle labels etc. are really necessary. However, if we consider that at least patent and copyright protection were originally designed to exempt right owners from price competition in order to secure a reward for *outstanding* innovative and creative efforts, we have to admit that exhaustion rules of any kind run counter this original legislative intention, in that they re-expose right owners to price competition from which the grant of IP rights originally intended to exempt them. Therefore, exhaustion rules should be enacted with great care and for the sole purpose of avoiding unduly high hedge costs and insecurity, in order to safeguard the overall objective behind the grant of IP rights, which is to enhance welfare.