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The Cloak of Copyright: How Costco v. Omega Enabled Price Discrimination

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THE CLOAK OF COPYRIGHT: HOW *COSTCO v. OMEGA* ENABLED PRICE DISCRIMINATION

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Abstract

In December of 2010, *Costco v. Omega* came down from the Supreme Court. The Switzerland-based watchmaker Omega sold Seamaster Collection watches, which were affixed with its copyrighted logo, in the United States as well as in foreign markets. Omega priced watches in the United States market higher than elsewhere. Costco obtained Omega's watches from a third party that had purchased the watches abroad, then sold them at its membership warehouses for cheaper prices than authorized Omega dealers in the United States. Consequently, Omega sued Costco for copyright infringement. Costco pursued a defense based on the first sale doctrine in response. While from a legal perspective the case was a copyright dispute, this categorization does not make sense from an economic view. Rather, the application of economic models reveals that the core issue in *Costco* centers about price discrimination, not copyright. This thesis uses a law and economics framework to analyze the facts of and the decision in *Costco* to determine whether the outcome was welfare maximizing and to assess the implications that the case will have on copyright law in the future.

ACKNOWLEDGEMENTS

This thesis would not have been possible without the mentorship of Professor Eric Helland. Through his Law and Economics course and from working on this paper, he helped me realize the broader reach of economics and how it could merge with my love for legal analysis. He made it possible for me to take a risk and write this type of thesis, as well as providing a way for me to incorporate what I've learned through PPE. I am grateful for his encouragement and advice. I would also like to thank my parents for their continuous support over the years, and their dedication to advancing my education. My parents have backed every decision I have made, and helped me pursue my interest in the law in countless ways. I appreciate all they have done.

Thank you.

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"The primary objective of copyright is not to reward the labor of authors, but 'to promote the Progress of Science and useful Arts.' To this end, copyright assures authors the right to their original expression, but encourages others to build freely upon the ideas and information conveyed by a work. This result is neither unfair nor unfortunate. It is the means by which copyright advances the progress of science and art."

- Justice Sandra Day O'Connor

INTRODUCTION

WHEN LUXURY BECOMES CHEAP | COSTCO AND OMEGA'S ROCK AROUND THE CLOCK

A tiny symbol, etched lightly onto the metal surface on the backside of a watch. Just several centimeters in diameter, the logo is not apparent without looking closely. Yet this seemingly innocuous figure is more than just a status symbol for a luxury watch. The logo is copyrighted. And this one, small, copyrighted, logo has the potential to threaten the livelihood of wholesale dealers, online commerce, aftermarkets, and even libraries. It could make renting foreign movies illegal and put restrictions on giving gifts, not to mention causing prices to rise for imported goods.

These are some of the fears that have arisen in the wake of the United State Supreme Court's 2010 decision—or indecision—in *Costco v. Omega*, 562 U.S.__(2010). The case involved the wholesale, members-only warehouse chain Costco, and the Swiss luxury watchmaker Omega. Omega manufactured its watches in Europe, and each watch was emblazoned with a small, copyrighted logo on the back. In the United States, Omega price discriminated and sold the watches at a higher price than in its other international markets. A third party purchased Omega watches abroad, imported them into the United States, and consequently sold the watches to Costco. Costco in turn sold the watches to consumers at rates that were lower than the prices Omega had designated for the United States market. Furthermore, Costco was not an authorized dealer for the particular watches.

Omega brought suit against Costco, alleging that because the watches had a copyrighted logo on them, Costco was liable for copyright infringement. The question before the court was whether the first sale doctrine, which maintains that certain rights are exhausted after the initial sale of a copyrighted good, applied to imported goods manufactured abroad. With Justice Kagan recusing herself because of prior involvement in the case, the court failed to reach a majority opinion and was deadlocked in a 4-4 decision, meaning that the appellate court decision favoring Omega—and that the first sale doctrine only applied to goods manufactured domestically—remained.

The Supreme Court's lack of consensus regarding the scope of the first sale doctrine incited a series of hypotheses for potential ways the ruling would be construed in the future to provide an even broader application of the first sale doctrine. In its amicus brief for the petitioner, the Retail Industry Leaders Association called the first sale doctrine the "Magna Carta of property rights and open commerce in copies of copyrighted works."[1] The first sale doctrine is critical to businesses. It enables the free flow of commerce and the ability to sell genuine products without the threat of a copyright infringement lawsuit. In turn, the first sale doctrine

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[1] "Brief Amici Curiae of Retail Industry Leaders Association, et. al., in Support of the Petitioner," *Costco Wholesale Corporation v. Omega S.A,* 562 U.S. __ (2010), American Bar Association, <http://www.americanbar.org/content/dam/aba/publishing/preview/publiced_preview_briefs_pdfs_09_10_08_1423_PetitionerAmCu7RetailCos.authcheckdam.pdf > (accessed 24 March 2011), p. 9.

gives rise to aftermarkets and makes it possible to rent, lease, resell, lend, and gift goods, whether through an organized movie rental store or a neighbor's garage sale.

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Facially, *Costco* is a case about copyright infringement. But from an economic perspective, the scenario does not fit the traditional copyright model. Instead, Omega's arguments better align with theories of price discrimination. While Omega sued Costco on the grounds of copyright infringement, the watchmaker was masking its desire to price discriminate—a strategy that raises prices in the United States and likely reduces domestic welfare—in the intricacies of copyright law.

The foundations for analyzing the *Costco* decision rest in the law. The first chapter looks at the *Costco* facts closely and the current laws that govern the case, including the Copyright Act of 1976 and the United States Code that references the first sale doctrine. Next comes a review of the trajectory of court cases that have shaped the first sale doctrine, beginning with *Bobbs-Merrill Company v. Straus,* 210 US 339 (1908), a case dealing with Macy's selling copies of a copyrighted book that it purchased from a wholesaler, at prices that were lower than those set by the publisher. The case that follows is *BMG Music v. Perez*, 952 F. 2d 318 (1991), where Edmundo Perez purchased BMG Music's copyrighted recordings that had been manufactured abroad, then sold them in the United States. The next pivotal court decision was in *Quality King Distributors, Inc. v. L'anza Research International, Inc.,* 523 U.S. 135 (1998). In *Quality King*, L'anza sold hair products with copyrighted logos affixed to the bottles. The goods were exported, and Quality King purchased the goods abroad then reimported them back into the United States and sold the hair products in California.

While the courts have explored many aspects of the first sale doctrine and copyright law, a clear policy regarding goods bearing copyrighted logos, especially those produced abroad, is lacking. This ambiguity provides an entry point to assess the law through economic models, which are introduced in the second chapter. The chapter reviews economic models related to intellectual property and the facts of the case, such as patents, copyrights, and price discrimination. The similarities to *Costco* as well as the limitations are assessed for each model. Ultimately, this section reveals that traditional models of intellectual property and specifically copyright are not relevant, suggesting that the case is not truly about copyright like Omega argued. Instead, the models will show that *Costco* is more about special protections and privileges that have been formulated for copyright holders with the first sale doctrine, including the ability to price discriminate.

Finally, the economic theories are applied to the case itself to determine whether or not it was decided correctly using a law and economics framework. In particular, Chapter 3 examines if the ruling maximizes domestic welfare. The analysis will show that not only was the decision unbeneficial in the particular interaction between Costco and Omega, but also that a broad sweeping rule that the first sale doctrine should not apply to goods manufactured abroad is problematic. In light of the flaws with the decision, this section also looks at the potential for other rules that the courts could invoke in similar cases in the future. The first rule comes from price discrimination theory, suggesting that the viability of a first sale defense should be decided on a case-by-case basis and depend upon the changes on output that result from a copyright holder's ability to price discriminate. The second builds upon Justice Sotomayor's questioning during oral argument and considers if producers, distributors, and retailers could enter into contracts to limit sales, with the first sale doctrine acting as a penalty default rule and any remedies coming from those defined under contract law.

While this case did not have any precedential value due to the deadlock decision, it presents questions that the courts are likely to encounter again. For example, the Google Books lawsuit shows how developments in technology will make issues of the first sale doctrine not only more prevalent, but also increasingly complicated. In the class action copyright infringement suit, which was initiated in 2005, Google was accused of not obtaining the copyrights over certain works it digitized and published online. In particular, there were a series of "orphan works," or books with no identifiable copyright owner. Even though Google had reached a settlement in the lawsuit, a New York federal district court judge, Judge Denny Chin, rejected the settlement in March 2011. Afterwards, there was growing speculation that the problems of the intersection between technology and copyright would come before Congress and that the time was ripe was even broader copyright reform.

With the scope of the first-sale doctrine expanding with technological innovation, it will be important to assess not only the impacts of prior decisions, but also what the effects could be for crafting laws in the future. As globalization continues, enabling goods to be manufactured and sold around the world, combined with society becoming increasingly digital, law may not keep pace with technology. Looking at the law with an economic lens may provide better methods for jurisprudence in the interim.

CHAPTER 1

THE LAW | HOW COPYRIGHT EXPANDED

The arguments in the *Costco* case deal predominantly with the United States Copyright Act of 1976 and the specific doctrine of first sale. United States Code pertaining to copyright has evolved because of technological advancements, but the intent has always remained to provide protections to creators over expressive works. Throughout the past century, the courts have considered many cases on grounds similar to *Costco*. While the first pivotal case involved a dispute over sales of a book, more recent cases have expanded copyright law to include logos on non-copyrighted goods, like in *Costco*.

LEGAL PROVISIONS

HISTORY OF THE COPYRIGHT ACT

Title 17 of United States Code lays out the fundamental structure for copyright law. It is derived from a series of copyright acts that starts with the Copyright Act of 1790, the first set of federal restrictions on copyright that was based on the Statute of Anne in English law.[2] The Copyright Act of 1909 superseded the Copyright Act of 1790, which was subsequently revised sixty-eight years later by the Copyright Act of 1976 (herein, "the Copyright Act). The impetus for the 1976 changes was developments in technology such as radio, television, computers, and tape recording, for which the prior law did not have any regulations.

Despite these updates to the Copyright Act, the revisions still posed several challenges for court decisions. One of the problems in interpreting the Copyright Act in cases like *Costco* comes from the tension between two sections of the Copyright Act, 17 U.S.C. § 602(a) and 17 U.S.C. § 109(a).[3] 17 U.S.C. § 602(a) prohibits the importation, without the copyright owner's permission, of copies acquired outside the United States. Congress initially established § 602(a) to provide guidelines for the importation of pirated items, or goods made without permission of the owner of a copyright, as well as the unauthorized importation of goods that were manufactured legally. The original intent of this section was that either action would be considered infringement, barring three exceptions: goods imported for governmental use, goods used solely for private use and not distribution, and goods imported with fewer than five copies.[4] The conflicting section, 17 U.S.C. § 109(a), prevents a copyright owner who has sold copies from interfering with the later sale of those copies if they were "lawfully made under this title."[5] This is the first sale doctrine.

Essentially, the confusion is that a copyright holder can prohibit products from being imported into the United States at any time, but he or she is simultaneously prevented from

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[2] "General Guide to the Copyright Act of 1976," United States Copyright Office, September 1977, <http://www.copyright.gov/reports/guide-to-copyright.pdf> (accessed 22 March 2011).
[3] See Appendix A and Appendix B for the full text of 17 U.S.C. § 602 and 17 U.S.C. § 109.
[4] "General Guide to the Copyright Act of 1976," United States Copyright Office, September 1977, <http://www.copyright.gov/reports/guide-to-copyright.pdf> (accessed 22 March 2011).
[5] *BMG Music v. Perez*, 952 F. 2d 318 (C.A. 9, 1991), <http://scholar.google.com/scholar_case?case=13705363198185453600&hl=en&as_sdt=2&as_vis=1&oi=scholarr> (accessed 16 March 2011).

controlling the goods after the first sale—how then could the copyright holder bar importation unless he or she was able to have a say in later sales? Previous rulings, like *CBS v. Scorpio Music Distributors,* 738 F.2d 424 (3d Cir. 1984), have tried to clarify the contradiction and have understood the phrase "lawfully made under this title," to grant first sale protection only to copies where the product was originally made and sold legally in the United States.[6,7] This means that if a good is produced *abroad*, it can be imported into the United States and the foreign manufacturer can retain a degree of control once the product enters the United States, even after the first sale.

FIRST SALE DOCTRINE

The first sale doctrine was established in the case of *Bobbs-Merrill Company v. Straus,* 210 US 339 (1908) and later codified in 17 U.S.C. § 109(a) through the Copyright Act.[8] Under the doctrine, a person that purchases a copyrighted work from the copyright holder obtains the right to sell, display, or dispose of the good.[9] Basically, after that initial sale, the property rights are transferred to the buyer who can then use the product however he or she wishes notwithstanding the distribution interests of the copyright holder. There is an exception that the new owner cannot make copies of the item; that action is still considered infringement. The right

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[6] In *CBS v. Scorpio Music Distributors,* CBS owned copyrights to six sound recordings. CBS authorized a Philippines-based music corporation, Vicor Music Corporation, to produce and sell several of the copyrighted recordings. These particular recordings were only to be sold in the Philippines. In June 1981, Vicor sold copies of the CBS recordings to Rainbow Music, Inc., also based in the Philippines. Rainbow Music sold the records to the Nevada state corporation, International Traders, Inc., which in turn sold them to Scorpio, a company in the state of Pennsylvania. Several months later, in November 1981, CBS terminated the manufacturing agreement with Vicor. As part of the termination agreement, Vicor had sixty days to sell off its inventory. All of the transactions leading to Scorpio's possession of the recordings occurred during this period. CBS sued Scorpio, alleging that it imported copyrighted works without CBS's consent and therefore violated the Copyright Act. The court ultimately granted CBS's motion for summary judgment, finding that "lawfully made under this title" in § 109(a) meant that the first sale doctrine applied only to goods that had been legally manufactured and sold in the United States and did not apply to the purchase of imports. *CBS v. Scorpio Music Distributors*, 738 F.2d 424 (3d Cir. 1984).

[7] *BMG Music v. Perez*, 952 F. 2d 318 (C.A. 9, 1991), <http://scholar.google.com/scholar_case?case=13705363198185453600&hl=en&as_sdt=2&as_vis=1&oi=scholarr> (accessed 16 March 2011).

[8] See "Controlling Cases" section for the complete facts of *Bobbs-Merrill.*

[9] "Copyright Infringement - First Sale Doctrine," *Criminal Resource Manual*, United States Department of Justice, <http://www.justice.gov/usao/eousa/foia_reading_room/usam/title9/crm01854.htm> (accessed 23 March 2011).

to distribute the purchased good extends only to the particular copy bought and does not allow for duplication.[10] The purpose of the first sale doctrine is to allow free transactions, be it through selling, renting, leasing, or gifting. It enables people that have purchased a good to have a property right over it and thereby the ability to use it how they wish. Copyright holders cannot interfere with personal transactions.

Controlling Cases

Bobbs-Merrill Company v. Straus, 210 US 339 (1908)

The first case in the trajectory leading to *Costco* was *Bobbs-Merrill Company v. Straus*, a Supreme Court case from 1908 that established the framework for the first sale doctrine. The defendants, Isidor Straus and Nathan Straus, ran the famous New York department store, R.H. Macy & Company ("Macy's"). Bobbs-Merrill Company owned the copyright to a book, *The Castaway*, which was sold at Macy's. Every copy of the book contained the following text: "The price of this book at retail is one dollar net. No dealer is licensed to sell it at a less price, and a sale at a less price will be treated as an infringement of the copyright."[11] Macy's, however, was selling the book for less than the one-dollar per copy price required under the statement; each book was sold for only eighty-nine cents. Bobbs-Merrill brought suit against Macy's in the Circuit Court of the United States for the Southern District of New York, which consequently went to the Circuit Court of Appeals and finally the United States Supreme Court.

Bobbs-Merrill had sold copies of its books to wholesale dealers. Some of these wholesalers sold the book directly to retailers, and others sold them to different wholesalers. In

[10] "Copyright Infringement - First Sale Doctrine," *Criminal Resource Manual*, United States Department of Justice, <http://www.justice.gov/usao/eousa/foia_reading_room/usam/title9/crm01854.htm> (accessed 23 March 2011).
[11] *Bobbs-Merrill Co. v. Straus,* 210 US 339 (1908), <http://scholar.google.com/scholar_case?case=2444759653364042939&hl=en&as_sdt=2&as_vis=1&oi=scholarr> (accessed 22 March 2011).

the wholesale dealer chain, the books were sold at a discount from the net retail price despite the warning stamped inside the books. Wholesalers could do this though because the written terms specified *retailers*. Furthermore, as the opinion stated, "the wholesale dealers were under no agreement or obligation to enforce the observance of the terms of the notice by retail dealers or to restrict their sales to retail dealers who would agree to observe the terms stated in the notice."[12] Thus, wholesalers were technically exempt from having to sell the books at the one-dollar price per unit.

The court determined that the fact pattern in *Bobbs-Merrill* was not analogous to any prior case, and that the issue dealt with the extent of protection that was provided under the existing copyright laws, particularly §§ 4952, 4965, and 4970 of the Revised Statutes of the United States. In these sections, one phrase was especially crucial—"the sole right of vending the same."[13] The Supreme Court reframed the issue: Does the sole right to vend secure for the owner of the copyright the right, after a sale of the book to a purchaser, to restrict future sales of the book at retail, and to the right to sell it at a certain price per copy, because of a notice in the book that a sale at a different price will be treated as an infringement?[14]

The court held that the answer to this question was no, and that the statutes did not give copyright owners the ability to control the price that books could be sold at by future purchasers with whom they did they did have a specific contract. Bobbs-Merrill had already sold the books at the price and quantity that it felt appropriate, so it suffered no harm from any later sales being

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[12] *Bobbs-Merrill Co. v. Straus,* 210 US 339 (1908), <http://scholar.google.com/scholar_case?case=2444759653 364042939&hl=en&as_sdt=2&as_vis=1&oi=scholarr> (accessed 22 March 2011).
[13] Ibid.
[14] Ibid.

at a lesser cost since the revenues would not go to them.[15] Any further restrictions to prices on the product would extend beyond the rights afforded under the copyright statutes.

***BMG Music v. Perez*, 952 F. 2d 318 (1991)**

BMG Music created and sold phonorecords in the United States, which are defined by the Copyright Act as "material objects in which sounds, other than those accompanying a motion picture or other audiovisual work, are fixed by any method now known or later developed, and from which the sounds can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device."[16] BMG Music also owned copyrights over various sound recordings in the phonorecords.[17]

Edmundo Perez solely owned two of his own businesses, La Feria del Disco and La Feria del Disco No. 1. In this capacity, Perez purchased BMG Music phonorecords with copyrighted sound recordings that had been manufactured abroad, and then sold them in the United States. BMG Music sued Perez, maintaining that Perez's sales violated the Copyright Act. The district court issued an injunction against Perez, but Perez continued to sell the copyrighted goods without BMG Music's permission. Perez was found to be in contempt, and the judge ruled that he had willfully infringed on the copyright and was required to pay BMG Music both statutory damages and attorney's fees.[18] Perez brought the case to the Ninth Circuit Court of Appeals.

Perez argued that his actions were protected under the first sale doctrine. The district court relied on the decision in *CBS v. Scorpio Music Distributors,* 738 F.2d 424 (3d Cir. 1984), which found that to take advantage of the first sale doctrine, the goods in question had to have

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[15] *Bobbs-Merrill Co. v. Straus,* 210 US 339 (1908), <http://scholar.google.com/scholar_case?case=2444759653 364042939&hl=en&as_sdt=2&as_vis=1&oi=scholarr> (accessed 22 March 2011).
[16] 17 U.S.C. § 101, United States Copyright Office, <http://www.copyright.gov/title17/92chap1.html> (accessed 16 March 2011).
[17] *BMG Music v. Perez*, 952 F. 2d 318 (C.A. 9, 1991) <http://scholar.google.com/scholar_case?case=1370536 3198185453600&hl=en&as_sdt=2&as_vis=1&oi=scholarr> (accessed 16 March 2011).
[18] Ibid.

been originally manufactured in the United States because of the "lawfully made under this title" clause in the Copyright Act. Because the phonorecords were produced abroad, the first sale doctrine did not apply. The district court also rejected Perez's argument that his infringement was de minimis, or minimal, and that § 602(a) was confined to only wholesale importation; since Perez had imported multiple copies to resell, he was still in violation.[19] Ultimately, the *Scorpio* precedent was upheld.

***QUALITY KING DISTRIBUTORS, INC. V. L'ANZA RESEARCH INTERNATIONAL, INC.*, 523 U.S. 135 (1998)**

All of the previous cases discussed had addressed the applicability of §§ 602(a) and 109(a) for products where the good itself was copyrighted. *Quality King* raised a new issue for the courts: What is the interaction of these rules when the copyright is for a logo instead of a good? The respondent L'anza Research International, Inc. (L'anza), based in California, made and sold a variety of hair care products, including shampoos and conditioners. On all of its products, there was a copyrighted label. L'anza sold its products to domestic distributors in the United States, who were able to resell the products to authorized retailers.[20] L'anza also sold its products in foreign markets. It found, however, that in markets in the United States, consumers were willing to pay more for high quality products when they were sold along with lesser quality items, especially in conjunction with extensive advertising.[21] As a result, L'anza engaged in minimal advertising in foreign markets, meaning the prices the company could charge foreign distributors were 35% to 40% lower than those for distributors in the United States.[22]

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[19] *BMG Music v. Perez*, 952 F. 2d 318 (C.A. 9, 1991) <http://scholar.google.com/scholar_case?case=1370536 3198185453600&hl=en&as_sdt=2&as_vis=1&oi=scholarr> (accessed 16 March 2011).
[20] *Quality King Distributors, Inc. v. L'anza Research Int'l, Inc.*, 523 US 135 (1998), <http://scholar.google.com/ scholar_case?case=11630239533508029010&hl=en&as_sdt=100000002&as_vis=1> (accessed 16 March 2011).
[21] Ibid.
[22] Ibid.

In 1992 and 1993, L'anza sent a shipment of its products, which had been manufactured in the United States and bore the copyrighted labels, to a foreign distributor. The petitioner Quality King Distributors, Inc. (Quality King) purchased these goods abroad and then sold them at discounted prices to unauthorized retailers in the United States. These retailers then sold the products in California without L'anza's permission.

L'anza sued, asserting that Quality King's actions violated L'anza's "exclusive rights under 17 U.S.C. §§ 106, 501, and 602 to reproduce and distribute the copyrighted material in the United States."[23] In district court, L'anza filed a motion for summary judgment, while Quality King presented a defense using the first sale doctrine. The court rejected the defense, and granted the summary judgment in favor of L'anza.[24] Quality King appealed, and lost. The Supreme Court then granted cert to the case, which was argued on December 8, 1997.

The question before the Court was whether § 602(a) of the Copyright Act, which gives the copyright owner the right to prohibit the unauthorized importation of copies, was limited by the first sale doctrine. In a unanimous decision, the Supreme Court found that the Copyright Act was in fact limited by the first sale doctrine, ruling in favor of Quality King on March 9, 1998. The Court's rationale was that, since Quality King was a lawful owner of the products after purchasing them, the company could resell them under the first sale doctrine. Justice Stevens wrote the majority opinion, stating that, "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."[25]

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[23] *Quality King Distributors, Inc. v. L'anza Research Int'l, Inc.*, 523 US 135 (1998), <http://scholar.google.com/scholar_case?case=11630239533508029010&hl=en&as_sdt=100000002&as_vis=1> (accessed 16 March 2011).
[24] Ibid.
[25] Ibid.

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Even after these various cases helped shape the meaning of Copyright Act, the courts still had not addressed several critical issues. Following *Bobbs-Merrill*, it was clear that the first sale doctrine existed. The *BMG* precedent had also been stable, meaning that "lawfully made under this title" required domestically-produced goods if the buyer wished to invoke the first sale doctrine. And in *Quality King*, the Supreme Court determined that once goods had been exported from the United States, reimportation was permissible because the exporter would have anticipated relinquishing rights under the first sale doctrine. But there was still ambiguity over the different requirements of §§ 602(a) and 109(a). The Supreme Court had yet to make a clear decision on how the Copyright Act applied to imports, and if the first sale doctrine could act as a defense for goods that were originally manufactured abroad. This hole in this interpretation of the Copyright Act set the stage for the Supreme Court to hear *Costco.*

THE COSTCO V. OMEGA DECISION

On December 13, 2010, the United States Supreme Court released its decision in *Costco Wholesale Corporation v. Omega S.A,* 562 U.S. __ (2010)*,* which was granted cert from the Ninth Circuit Court of Appeals in California. The petitioner Costco Wholesale Corporation, or Costco, is a company that operates warehouses where people that pay for membership can purchase a selection of branded and private-label products at low prices.[26] Costco buys most of its goods directly from manufacturers and ships straight to the member warehouses. Omega S. A. is based in Switzerland, and produces upscale watches that it sells worldwide. On the back of every watch it manufactures, Omega engraves a tiny symbol called the Omega Globe Design,

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[26]"Costco Wholesale Corporation," Google Finance, <http://www.google.com/finance?client=ob&q=NASDAQ: COST> (accessed 15 March 2011).

which is registered under the United States Copyright Act.[27] Omega contended that its rationale for affixing the copyrighted design to all of its watches was so that it could use Title 17 of the Copyright Act to control the importation and sale of its watches in the United States, which had been purchased through authorized foreign distributors.[28]

In the case at hand, Omega sold watches with its copyrighted logo to an authorized distributor abroad. A third party bought the watches and sold them to ENE Limited, a company based in New York, which in turn sold the watches to Costco.[29] Costco made these watches available for customers to purchase in its warehouses. Omega, however, had not directly given Costco permission to sell these particular watches—the Omega Seamaster Collection—at its United States warehouses; it had only authorized the initial foreign sale, which was intended to sell the watches in South America, and had not authorized importation or any subsequent sales to the United States.[30] Costco had essentially purchased the goods on the "gray market"—under *Parfums Givenchy, Inc. v. Drug Emporium, Inc.* 38 F.3d 477, 481 n.6 (9th Cir. 1994), "'gray-market goods' or 'parallel imports' are genuine products possessing a brand name protected by a trademark or copyright...They are typically manufactured abroad, and purchased and imported into the United States by third parties, thereby bypassing the authorized U.S. distribution channels."[31]

Moreover, the watches that were designated to be sold in certain foreign markets were less expensive than those meant for the United States, so by purchasing the watches through the

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[27]"Brief for the Petitioner," *Costco Wholesale Corporation v. Omega S.A,* 562 U.S. __ (2010), American Bar Association, <http://www.americanbar.org/content/dam/aba/publishing/preview/publiced_preview_briefs_pdfs_09_10_08_1423_Petitioner.authcheckdam.pdf > (accessed 15 March 2011).
[28]Ibid.
[29]"*Costco Wholesale Corp. v. Omega S.A.*," Legal Information Institute at Cornell University School of Law, <http://topics.law.cornell.edu/supct/cert/08-1423> (accessed 15 March 2011).
[30]"Opinion," *Omega S.A. v. Costco Wholesale Corporation,* 541 F.3d 982 (C.A. 9, Sept. 3, 2008), <http://www.ca9.uscourts.gov/datastore/opinions/2008/09/03/0755368.pdf> (accessed 15 March 2011).
[31]Ibid.

chain involving several different distributors, Costco was able to effectively buy identical watches at a lower cost than other distributors in the United States.[32] Consequently, Costco's gray-market purchase meant it could sell the watches to consumers at an amount below Omega's manufacturer's suggested retail price (MSRP). Costco was selling the Seamaster watches in California for $1,299 US, while the MSRP for United States sellers was $1,995 US.[33]

Omega sued Costco, alleging that Costco's initial purchase of the watches and then its sales to end consumers constituted copyright infringement under the Copyright Act since the Act gives authors of copyrighted works the exclusive right to reproduce, distribute, display, license, and prepare their work.[34] Omega moved for summary judgment in district court, but Costco filed a cross-motion citing the first sale doctrine, also under the Copyright Act, which states that certain ownership and control rights are exhausted after the initial sale of a copyrighted good. In particular, after a manufacturer sells a good, it loses the ability to set prices for the item by asserting a copyright claim. The district court found in favor of Costco on both motions and also awarded Costco $373,003.80 in attorney's fees; Omega appealed to the United States Ninth Circuit Court of Appeals, located in California.[35]

The appellate court ultimately reversed the summary judgment ruling as well as the district court's award of legal fees. The Ninth Circuit Court analyzed whether the Supreme Court's ruling in *Quality King Distributors, Inc. v. L'anza Research International, Inc.,* 523 U.S.

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[32]*Costco Wholesale Corp. v. Omega S.A.*," Legal Information Institute at Cornell University School of Law, <http://topics.law.cornell.edu/supct/cert/08-1423> (accessed 15 March 2011).
[33]Daniel Fisher, "*Costco v. Omega* is About Much More Than Cheap Watches," *Forbes*, 5 November 2010, <http://blogs.forbes.com/danielfisher/2010/11/05/costco-v-omega-is-about-much-more-than-cheap-watches/> (accessed 15 March 2011).
[34]17 U.S.C. § 106, Legal Information Institute at Cornell University School of Law, <http://www.law.cornell.edu/uscode/17/usc_sec_17_00000106----000-.html> (accessed 15 March 2011).
[35]"Opinion," *Omega S.A. v. Costco Wholesale Corporation,* 541 F.3d 982 (C.A. 9, Sept. 3, 2008), <http://www.ca9.uscourts.gov/datastore/opinions/2008/09/03/0755368.pdf> (accessed 15 March 2011).

135 (1998) required the interpretation of the first sale doctrine that Costco advanced.[36] It decided that *Quality King* was not irreconcilable with the precedent in *BMG Music v. Perez,* 952 F.2d 318 (1991), which confined the scope of the first sale doctrine to copies of goods that were legally made in the United States.[37] Furthermore, it found that the phrase, "lawfully made under this title," which is under § 109(a) of the Copyright Act, also applied only to goods that had been manufactured in the United States; any other interpretation would impermissibly extend the application of the Copyright Act extraterritorially.[38]

This framework distinguished *Costco* from *Quality King* since in the latter, the goods had originally been produced in the United States, were exported overseas, then came back in the country, while Omega's watched were manufactured abroad initially. In its opinion, the Ninth Circuit Court stated, "Because there is no genuine dispute that Omega made the copies of the Omega Globe Design in Switzerland, and that Costco sold them in the United States without Omega's authority, the first sale doctrine is unavailable as a defense to Omega's claims."[39] Since the watches were made in Switzerland and not the United States, under the binding *BMG Music* ruling the first sale doctrine did not apply.

Costco appealed, and on April 19, 2010, the United States Supreme Court granted cert to the case. The case was argued on November 8, 2010, and the court ruled just over a month later, on December 13, 2010. The question before the court was whether the first sale doctrine applies to imported goods manufactured abroad.[40] Justice Kagan, who had filed a brief in an earlier phase of the case while she was still Solicitor General and before she was appointed to the

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[36]See "Controlling Cases" section for the complete facts of *Quality King.*
[37]See "Controlling Cases" section for the complete facts of *BMG Music.*
[38]"Opinion," *Omega S.A. v. Costco Wholesale Corporation,* 541 F.3d 982 (C.A. 9, Sept. 3, 2008), <http://www.ca9.uscourts.gov/datastore/opinions/2008/09/03/0755368.pdf> (accessed 15 March 2011).
[39]Ibid.
[40]"Brief for the Petitioner," *Costco Wholesale Corporation v. Omega S.A,* 562 U.S. __ (2010), American Bar Association, <http://www.americanbar.org/content/dam/aba/publishing/preview/publiced_preview_briefs_pdfs _09_10_08_1423_Petitioner.authcheckdam.pdf > (accessed 15 March 2011).

Supreme Court, recused herself from voting.[41] With the recusal, the Court failed to reach a majority opinion and was deadlocked in a 4-4 decision, meaning that the appellate court decision favoring Omega remained. The per curiam opinion that was released simply stated, “The judgment is affirmed by an equally divided Court.”[42] There was no further analysis, no rationale for the ruling, and no reference to how individual justices voted. The evenly split ruling also meant that the case provided no precedential value. *Costco* could have provided a way for the Supreme Court to clarify important aspects of the Copyright Act, but instead the curious ruling left even more questions unanswered.

[41]Justice Kagan’s brief, filed on behalf of the government in 2009, argued that the petition for a writ of certiorari should be denied. The brief stated that the lower court’s opinion was consistent with *Quality King* and supported the existing case theory that § 602 should trump § 109. It also indicated that the location of manufacture was important to consider. The complete text of the brief is available from the United States Department of Justice at http://www.justice.gov/osg/briefs/2009/2pet/6invit/2008-1423.pet.ami.inv.pdf.
[42]“Opinion,” *Costco Wholesale Corporation v. Omega S.A,* 562 U.S. __ (2010), <http://www.supremecourt.gov/ opinions/10pdf/08-1423.pdf> (accessed 16 March 2011).

CHAPTER 2

THE ECONOMICS | IF THE MODEL DOESN'T FIT…

Because of the failure to reach a majority opinion, the courts have been largely silent on the extent of applying the Copyright Act to goods which are not themselves copyrighted, and in particular to goods that have been manufactured internationally. Economics can play a role in navigating these complex legal issues. Looking at economic models can help craft a framework to determine the scope of the first sale doctrine.

ECONOMIC MODELS FOR LEGAL ANALYSIS

The fact pattern in *Costco* incorporates components from three economic models: patents, copyrights, and price discrimination. The standard versions of these models are analyzed below, with insight on what elements may be applicable to the *Costco* case as well as the models' limitations. These models also provide guidance to determine what the core issues in *Costco* are, and if the case is actually about copyright or if different issues are hiding beneath the guise of copyright infringement.

Patents

Intellectual property encompasses patents, copyrights, trademarks, and trade secrets. While intellectual property is intangible, it possesses many of the characteristics of a public good in that once it is created, it can be reused without diminishing its quantity.[43] As a result, public goods create increased benefit when more people have access to and use them. But with intellectual property, there are numerous costs, like research and development costs, involved in actually creating the good, or idea. Patents provide incentives to make the costs incurred in creating an idea worth the benefits because of the chance to have exclusive property rights. While patents help provide production incentives, they also create monopolists and monopoly prices, which prevents society from realizing the maximum benefit.

Application to Costco Facts

This model has some applicability to the *Costco* case in that it is a standard intellectual property issue. Copyrights, like patents, do provide a level of exclusive use. Once a company has a registered copyright, it prevents another organization from using a strikingly similar or easily confusable image. Copyrights are also intangible, and have the same type of public good properties in that a copyright can technically be reused without diminishing its quantity.

Unlike patents, a copyright holder does not have the same type of strong monopoly power that comes from preventing potential competitors from using a certain process or creating a particular good. A copyright does not prevent others from producing watches, they just cannot produce an "Omega" watch. But it is possible that there is some sort of monopoly effect that results from the value of the brand, which is indicated by the copyrighted logo. Even though the logo itself, by virtue of it being merely a design, is not a marketable product, it is critical when it

[43]Thomas J. Miceli, The Economic Approach to Law, Second Edition, (Stanford: Stanford University Press, 2009) , p. 180.

is affixed to a tangible good. In this case, that good is a watch. The logo acts as a signal to the consumer that they are purchasing an Omega watch, which is believed to be a high-quality luxury watch. With this brand recognition, a company can charge a sort of monopoly price because they are excluding other watch manufacturers from the same level of brand value. Another view of this concept is that they have essentially created a unique product, and since no other competitor can create an Omega watch without violating the copyright, Omega can charge a higher monopoly-like price on its watches. This also means that there are incentives to increase the value of the brand that is associated with the logo, which is analogous to the production incentives that result from patent protection.[44]

Another similarity comes from the intuition behind marginal cost. With a patent, the fixed costs that are involved come from research and development. With copyrights, this translates into the time to design the logo and receive registration. Yet after these fixed costs have been incurred, the marginal costs are virtually, if not actually, zero.[45] It is important to remember that in the Omega case, the production of the watches are not of concern, but the actual copyrighted logo. Since the marginal cost is the cost of producing each additional unit of output, once a design has been created, the cost of duplicating it is almost nonexistent. Thus, like with the patent model, there will also be declining average costs.

Limits of the Model

The obvious problem of applying this model is that it is specific to patents, which are not involved in *Costco*. Patents are primarily distinguishable because they apply to the invention or

[44] It is possible that one of Omega's problems with Costco selling its Seamaster Collection watches was that it could diminish the brand value. Costco has the connotation of being cheap, which contradicts the idea of luxury that Omega wants its watches to exemplify. The law, however, cannot provide any recourse for brand diminution. Not only would quantifying the harm and extent of the brand dilution be difficult, but it would open the door to a plethora of disputes.

[45] John F. Duffy, "The Marginal Cost Controversy in Intellectual Property," *The University of Chicago Law Review*, (Winter 2004), Vol. 71, Issue 1, p.37-56, <http://www.warsystems.hu/wp-content/uploads_bodo/Duffy-The%20 Marginal%20Cost%20Controversy%20in%20Intellectual%20Property.pdf> (accessed 6 April 2011).

discovery of any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement on something existing.[46] Copyrights, on the other hand, pertain to original works of authorship and forms of expression as opposed to subject matter. Patents have a life of twenty years, and give the patent holder the right to exclude others from making, using, offering for sale, or selling the invention in the United States or importing the invention into the United States.[47] A copyright provides the owner with the exclusive right to reproduce the copyrighted work, to prepare derivative works, to distribute copies, and to display the copyrighted work publicly. Since the types of protections and the objects being protected differ, the model does not fit copyright scenarios perfectly.

The predominant benefit of obtaining a patent is the ability to hold a monopoly for a period of time and earn monopoly profits. While it was previously argued that some type of monopoly pricing power could result from a strong brand value associated with a copyrighted logo, the clear differential with a patent is that its *intent* is to provide a monopoly. There are strong incentives to hold a patent because of the assurance that you will have pricing power and be able to eliminate direct competition. This certainty does not come with a copyright in the same way, meaning that the model is accounting for incentives that are not present in a copyright case.

Because a copyright is for an image and not a tangible product, producers will also not necessarily determine the level of output based on where marginal revenue equals marginal cost like with a patent. After all, a company does not sell copies of the logo, and it is unclear if the products stamped with the logo could be produced at an MR = MC level. It is possible that there will not be any monopoly profits or deadweight loss, and prices might not rise as greatly so as to

[46]"General Information Concerning Patents," United States Patent and Trademark Office, January 2010, <http://www.uspto.gov/patents/resources/general_info_concerning_patents.jsp#heading-2> (accessed 6 April 2011).
[47]Ibid.

cause such a drastic reduction in consumer surplus. Because of the uncertainty with the copyright's impact on the actual tangible good, this model cannot predict the pricing and output effects strongly. These prediction problems further suggest that the issues in *Costco* are not truly centered about intellectual property.

COPYRIGHT

Landes and Posner derive a model that is specific to copyrights and focuses on both the incentive and cost of expression effects of differing degrees of copyright protection. They assume that creators and copiers produce quality-adjusted copies that are perfect substitutes, demand is not subject to uncertainty, the cost of expression is the only fixed cost of an expressive work, and the marginal costs for creators are constant.[48] The model consists of the following:[49]

p = price of a copy
$q(p)$ = market demand for copies of a given work
x = number of copies produced by the creator
y = number of copies produced by the copier
c = creator's marginal cost per copy
e = cost of expression
z =level of copyright protection

From this, we can simplify to $q = x + y$. The level of copyright protection is constrained between the values of zero and one; $z = 0$ occurs when there is no copyright protection, and $z = 1$ represents absolute protection where no copy can be made without permission from the copyright holder. Landes and Posner also assume that copiers will produce duplicates up to the quantity where price equals marginal cost.

In the graphic representation, $D(q)$ is the overall market demand for copies, DD is the creator's derived demand for copies, MR_{DD} is the marginal revenue for derived demand, and

[48] William M. Landes and Richard A. Posner, The Economic Structure of Intellectual Property Law, (Cambridge: The Belknap Press of Harvard University Press, 2003), p. 71.
[49] Ibid.

$y = y(p,z^0)$ is the copiers' supply curve. The resulting shaded box, R^0, shows the gross profits (where Л = $(p - c)x - e(z)$) that the creator of an expressive work will earn.

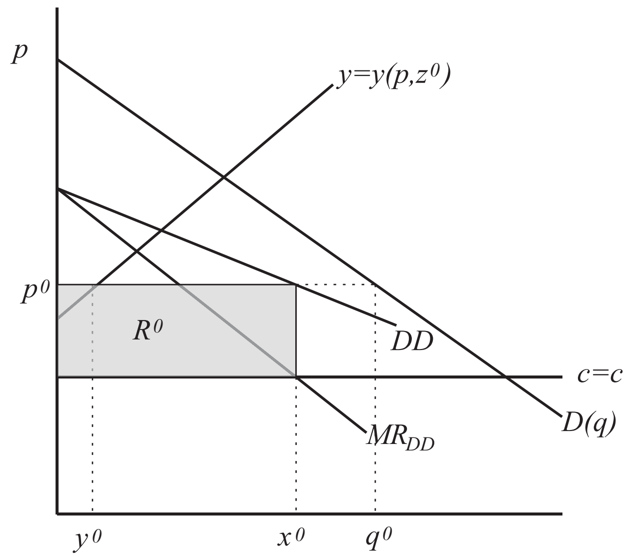

***Figure 1**: Landes and Posner's economic model for copyright.*

According to the explanation that Landes and Posner provide, "Some copyright protection is necessary to generate incentives to incur the costs of creating easily copied works. But too much protection can raise the costs of creation to a point at which current authors cannot cover their costs even though they have complete copyright protection for their own originality."[50] Changing the level of copyright protection has several impacts. First, as *z* increases, the price per copy rises and consequently the number of copies that are sold decreases, resulting in a larger deadweight loss. This movement also leads to an increase in the creator's gross profits and creates a producer surplus.

But the effect does not stop there—the impact is also felt on the market for new works. The total number of works created is denoted by *N*. Landes and Posner suggest that the number

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[50]William M. Landes and Richard A. Posner, The Economic Structure of Intellectual Property Law, (Cambridge: The Belknap Press of Harvard University Press, 2003), p. 74.

of works that an author creates will rise until the cost of expression of the marginal author equals the gross profit. Similarly, *N* will also rise as copyright protection increases, until it reaches the point where the cost of the marginal author's expression equals his or her return. Thus, the supply of works depends on both the amount of gross profits from selling copies (*R*) as well as the level of copyright protection, or $N = N(R,z)$. In the below figure, z^1 delineates increased copyright protection. Landes and Posner also emphasize that because they two effects can counteract one another, the net effect of increasing *z* on *N* is uncertain.

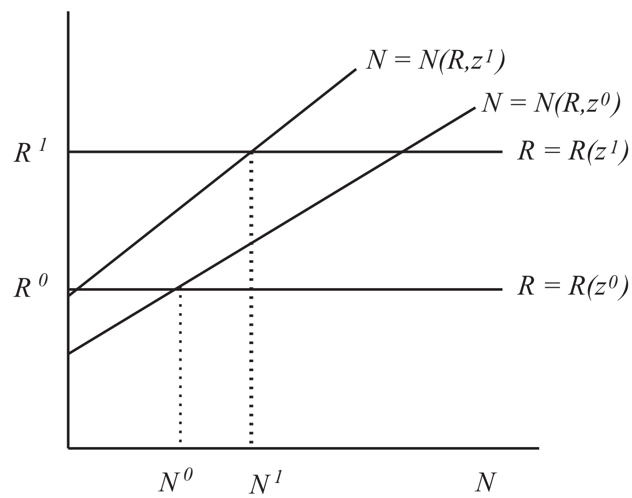

Figure 2: *The impact on the market for new works.*

Recall the earlier example where an increase in *z* led to greater prices, lower output, and higher gross profit. The rise in gross profits will decrease the supply of new works because creators can continue to sell their work at a high price and not have to invest in the costs of expression required to make a new product. Thus, producer surplus is actually decreased in the new works market.

Application to Costco Facts

The level of copyright protection, or *z*, in the Landes and Posner model is important for the *Costco* case. With the denunciation of the first sale doctrine for internationally-manufactured products, *z* essentially increases; by producing goods abroad, a company receives more copyright protection than they would if the goods were produced domestically. This is then also a de facto decrease in *z* for domestic producers because they obtain fewer rights from the same copyright process in comparison. In either circumstance, *z* is affected in some way.

Limits of the Model

A main problem with the model is that, while it is specific to copyright, it is also focused heavily on works like books and plays that can easily duplicated and be used. With Omega, the consumers are not purchasing the logo to use like they would buy a copyrighted text to read. Omega is in the business of making watches as opposed to expressive works; the market demand is not for copies like in the model. The incentives of continuing to create expressive works that the model represents are not the same for Omega as for an author. There is no benefit to Omega creating a new logo, just a new watch stamped with the existing logo. Thus, the market for new works that Landes and Posner derive is irrelevant as well.

While the Landes and Posner model explains how traditional copyright cases work, it provides little insight into how *Costco* should have been decided. This is puzzling; Omega sued Costco for copyright infringement, but the economic model for copyright does not apply to the facts of the case. Most importantly, this model makes it clear that while copyright infringement is the central legal debate, it is not actually the core issue of the case. If *Costco* was truly about copyright, then the Landes and Posner model should fit well. The reason that a standard copyright model is inapplicable is because a copyright claim is purely a means that Omega is using to stifle parallel importation so that it can continue to price discriminate.

PRICE DISCRIMINATION

Price discrimination is often a concern because it has properties of a monopoly where producers charge consumers different prices for the same good. Monopolies have the potential to create an inefficient allocation of resources, making price discrimination a poor process. There are three different types of price discrimination: first degree, second degree, and third degree. Under first degree price discrimination, which is also know as perfect discrimination, each unit of a good is sold at the consumer's reservation price. This effectively eliminates consumer surplus and redistributes it all to producer's surplus. Second degree price discrimination differs in that demand is divided into subgroups based on multiple consumers' reservation prices, and each block is charged approximately that price.

The final type is third degree price discrimination, which is present in the *Costco* case. With third degree price discrimination, consumers can be segmented into two or more groups, each of which has its own continuous demand function reflecting quantities sold to that group at alternative prices.[51] Often these divisions can be made based on differing price elasticities of demand; a group with a low price elasticity will be one segment, and a group with a high price elasticity will be another. Producers chose this strategy because it maximizes profits.

[51]F.M. Scherer and David Ross, Industrial Market Structure and Economic Performance, (Houghton Mifflin Company: Boston, 1990), p. 490.

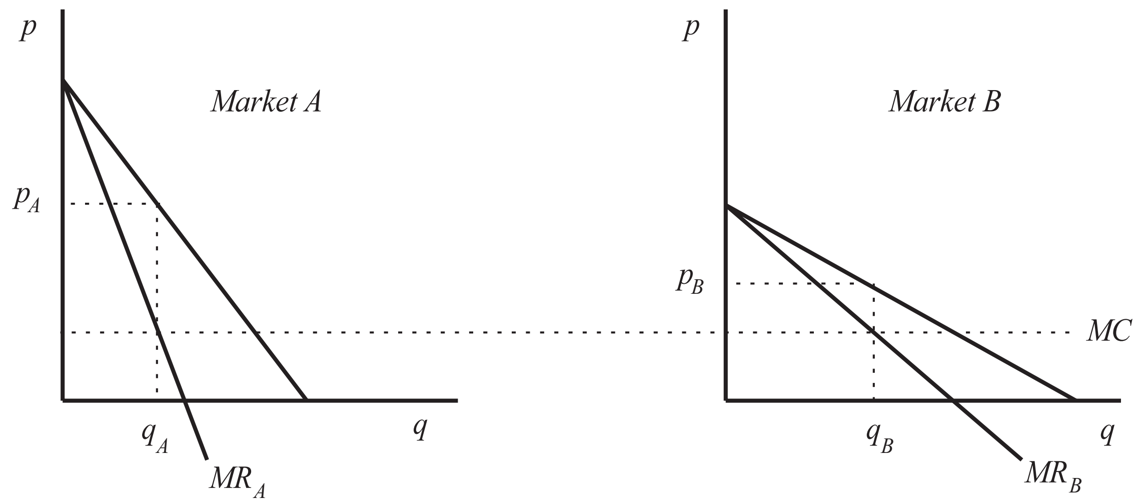

Figure 3*: The third degree price discrimination model.*

Figure 3 portrays the effect of third degree price discrimination. The graphs show the global market segmented into only two groups, Market A and Market B. Because the producer is manufacturing the same good in the same location, marginal cost will remain constant regardless of the market segment. In the distinct segments, however, there will be differing demand and marginal revenue curves depending on the local price elasticities for the product. The demand curve in Market A is very steep, indicating that the market's price elasticity is low. In contrast, Market B shows a flatter demand curve, which translates into a higher price elasticity. As the graphs show, despite the same marginal cost, the particular demand and therefore marginal revenue for the market alters prices. The price discriminating producer will charge higher prices in the less elastic Market A and lower prices in Market B to earn the greatest profits possible.

If there are factors that prevent a producer from segmenting the market either across the board or only for certain classes of consumers, producers will likely switch to a uniform price to maintain profits. Since markets were previously divided, this new uniform price may be higher than before for some segments. With uniform pricing, the aggregate demand function has two components that depend on if, at the new price, all markets are served.[52] If the uniform price rises to a certain point, the producer will drop certain high-elasticity markets from service because not enough consumers will purchase the goods at the raised price. Another result is that output is redistributed from low-demand markets to high-demand markets, which equates marginal valuations thereby increasing welfare, or the sum or producer and consumer surplus.[53] Profit will always be lower under a uniform pricing scheme since a producer cannot have the full benefits of monopoly power, but what matters is if this loss for producers is offset by gains in consumer surplus.

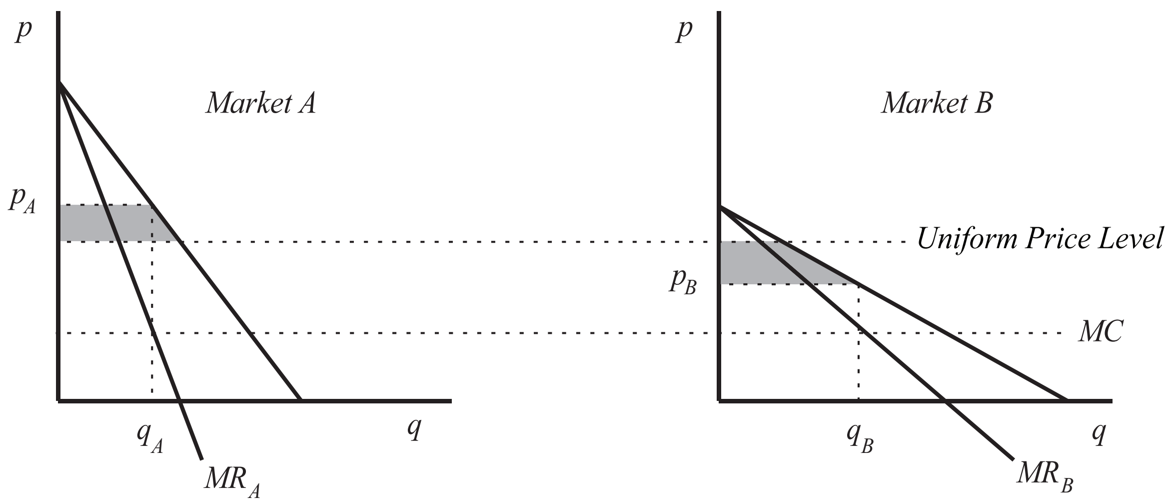

Figure 4*: The impact of moving from third degree price discrimination to a uniform price level across all markets.*

These effects are illustrated above in Figure 4. A uniform price will be lower than the discriminating price in Market A, but higher in Market B. The result is that consumer surplus is basically redistributed from the high-elasticity market to the low-elasticity market from a global

[52]David A. Malueg and Marius Schwartz, "Parallel Imports, Demand Dispersion, and International Price Discrimination," *Journal of International Economics*, (1994), Vol. 37, p. 167-195, ScienceDirect, <http://www.sciencedirect.com> (accessed 10 April 2011) p. 175.
[53]Ibid, p. 175.

perspective. Looking at an isolated market, the same effect could be described as shifting the surplus from consumers to producers. The shaded areas in Figure 4 reflect these changes; in Market A, the gray represents additional consumer surplus and it Market B it depicts lost consumer surplus.

Application to Costco Facts

In *Costco*, Omega used third degree price discrimination to divide consumers. Omega segmented the market based on country, charging consumers in some countries higher price than in other countries. This is likely because the United States had a lower price elasticity of demand for luxury watches, which will be explored further in Chapter 3. By preventing the first sale doctrine, the Supreme Court implicitly supported price discrimination between markets.

Limits of the Model

While perhaps not a true limitation, one aspect of the model that is not of concern in this case is the shift away from low-demand countries that would result from less of an ability to price discriminate. As the model demonstrates, when a company is unable to price discriminate, they will likely move to uniform pricing eventually and shift sales from low-demand countries to high-demand countries. The worry is that these markets will not be served and that this shifts welfare away from these countries. While this would be problematic for goods that are more of necessities, it does not matter for a product like the luxury watches in the *Costco* case.

ECONOMIC IMPACTS OF THE DECISION

HIGHER PRICES

Costco was able to sell the Omega watches at reduced prices to consumers because they purchased the watches abroad through parallel importation. Omega had segmented the market, charging higher prices in the United States and lower prices in other foreign markets. Often when this price discrimination occurs, wholesale importers and distributors will arbitrage goods to take advantage from the cheaper foreign prices.[54] If Costco was restricted from importing the discounted products, it would be required to buy the watches at the higher rate quoted to United States distributors, meaning that the higher prices would be passed along to the consumers. Furthermore, according to an amici curiae brief submitted by the Retail Industry Leaders Association, "Parallel importation also prevents manufacturers from maintaining price driven market segmentation by propping up prices domestically and depressing prices in foreign markets, in favor of global equilibrium pricing."[55] The overall effect would be constantly high prices for imported goods in the United States market.

PRODUCTION INCENTIVES

With the decision affirming the lower court's ruling in favor of Omega, additional protection was provided to goods that were manufactured abroad since they are not be subject to the first sale doctrine. This result provides a strong incentive for companies to move production abroad because they will be able to retain rights after a sale. Because of the *Costco* decision, "...companies can protect virtually anything by slapping a tiny, copyrighted logo on it and producing it overseas. As the owner of the copyright, they can dictate whether or not it's sold in the U.S. and under what terms."[56]

There are also minimal costs involved for companies making the incentive of greater protection even more attractive. Since the new first sale interpretation requires that only the

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[54] "Brief Amici Curiae of Retail Industry Leaders Association, et. al., in Support of the Petitioner," *Costco Wholesale Corporation v. Omega S.A,* 562 U.S. __ (2010), American Bar Association, <http://www.americanbar.org/content/dam/aba/publishing/preview/publiced_preview_briefs_pdfs_09_10_08_1423_PetitionerAmCu7RetailCos.authcheckdam.pdf > (accessed 22 March 2011).
[55] Ibid.
[56] Daniel Fisher, "*Costco v. Omega* is About Much More Than Cheap Watches," *Forbes*, 5 November 2010, <http://blogs.forbes.com/danielfisher/2010/11/05/costco-v-omega-is-about-much-more-than-cheap-watches/> (accessed 26 March 2011).

copyrighted portion of the product be manufactured abroad, companies can reap the advantages without incurring exorbitant relocation costs for entire production plants. Actually obtaining the copyright is inexpensive as well because it requires creating a simplistic—yet original, a very low threshold—design and registering it with the United States copyright office for a fee that is less that fifty dollars.[57] Barriers are minimal since this process does not require any prolonged research and development efforts and high proofs of novelty like for a patent. Creating a copyrightable logo could take just a matter of minutes.

The question regarding incentives to produce abroad was brought up in the Supreme Court oral argument when Justice Alito asked the counsel for the respondent: "Well, what is your answer to the argument that if 'lawfully made under this title' means basically made in the United States, that provides a great incentive to manufacture goods abroad and that can't possibly be what Congress intended?"[58] The attorney agreed.

AFTERMARKETS

Aftermarkets include segments such as video rentals, garage sales, used bookstores, and other rental or resale industries and transactions. All of these aftermarkets are currently legal. They also account for a substantial flow in the economy. Retail commerce in copyrighted works sold in the United States was $881 billion in 2009, movie rentals showed earnings of $9.5 billion in 2008, sales of used video games topped $2.4 billion in revenue in 2009, and currently the overall market for used goods is over $200 billion.[59] The reason that all these aftermarkets are

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[57]"Brief Amici Curiae of American Association of Law Libraries, et. al., in Support of the Petitioner," *Costco Wholesale Corporation v. Omega S.A,* 562 U.S. __ (2010), American Bar Association, <http://www.americanbar.org/content/dam/aba/publishing/preview/publiced_preview_briefs_pdfs_09_10_08_1423_PetitionerAmCu6NonProfitOrgs.authcheckdam.pdf> (accessed 26 March 2011) , p.14.

[58]"Oral Argument Transcript," *Costco Wholesale Corporation v. Omega S.A,* 562 U.S. __ (2010), 8 November 2010, <http://www.supremecourt.gov/oral_arguments/argument_transcripts/08-1423.pdf> (accessed 22 March 2011).

[59]"Brief for the Petitioner," *Costco Wholesale Corporation v. Omega S.A,* 562 U.S. __ (2010), American Bar Association, <http://www.americanbar.org/content/dam/aba/publishing/preview/publiced_preview_briefs_pdfs_09_10_08_1423_Petitioner.authcheckdam.pdf> (accessed 26 March 2011), p. 47.

able to exist is because of the first sale doctrine, since goods can be sold over and over again without control from the producer or prior owners.

Under *Costco*, however, copyright holders that manufacture their products abroad would be able to restrict rental, lease, and other lending-based industries.[60] These aftermarkets could be crippled. Moreover, the effects would extend beyond the aftermarkets and spill into primary markets. By preventing consumers and industries from having the ability to sell used goods or to rent out goods, one of the original incentives for buying is diminished and purchases of copyrighted goods in primary markets may decrease as well. Thus, the impacts infiltrate deep into numerous industries.

[60]"Brief for the Petitioner," *Costco Wholesale Corporation v. Omega S.A,* 562 U.S. __ (2010), American Bar Association, <http://www.americanbar.org/content/dam/aba/publishing/preview/publiced_preview_briefs_pdfs_09_10_08_1423_Petitioner.authcheckdam.pdf> (accessed 26 March 2011), p. 47.

CHAPTER 3

THE DECISION | WAS THE LAW WRONG?

The prior models revealed that *Costco* does not fit the criteria for a typical copyright case, but rather uses copyright law protections as a means to price discriminate and increase profits. Building upon this insight, it is possible to more closely apply the models and determine whether or not the ruling in *Costco* was the best decision from an economic standpoint, using domestic welfare as a metric. Moving beyond *Costco*, there is also the potential to use alternative decision-making paradigms based on economic frameworks in the future, including output-based rules and contracts.

A WELFARE-MAXIMIZING RULING

The standard base measure for determining the efficacy of outcomes is maximum economic welfare, or the sum of producer and consumer surplus. In cases of parallel imports, however, there is much debate over focusing on national welfare versus global welfare. Welfare resulting from parallel imports is essentially zero-sum; when welfare improves for some markets, it decreases welfare in others. As a result, national welfare may increase or decrease for a country, but global welfare may remain unchanged or may move in the opposite direction.

The best economic decision regarding welfare then depends on the role of the Supreme Court. Of course, the textbook answer from any introductory American government course teaching checks and balances will be that the duty of the Supreme Court, as part of the judicial branch, is to interpret the law. A melodramatic response might indicate that the role of the Supreme Court is to uphold justice. But beyond that, the real question that is important for the *Costco* case is determining what class of persons that the Supreme Court is responsible for protecting. It seems that on a pure binary level, by virtue of being in the United States and a tool for recourse predominantly for United States citizens, the Supreme Court should weigh the interests of United States consumers and producers greater than those of international consumers and producers. This is not to say that the Supreme Court should turn a blind eye to the repercussions that may result elsewhere, but concern for these issues should not be a fundamental guiding force. Essentially, in welfare terms, if the Supreme Court used an economic framework for decision-making the focus should be on maximizing domestic welfare as opposed to global welfare.

With this in mind, the best ruling from an economic standpoint would be to maximize welfare in the United States. The *Costco* case does not do this. To determine if welfare is greater or lower in a world with the third degree price discrimination that is allowed under *Costco*, it is necessary to look at the elasticity of demand. Consumers in low-elasticity markets will be adversely affected by price discrimination because, since a low elasticity means that demand is not as sensitive to price changes, they will face higher prices for goods. On the converse, consumers in high-elasticity markets, where demand is very responsive to price changes, will pay lower prices. While specific data on the current price elasticity for luxury watches is limited, older studies shed light on the elasticity properties of watches in the United States. In a 2001 study, Carbaugh found the price elasticity of watches to be 0.4.[61] Similarly, de Vries determined that the price elasticity of jeweled watches was 1.04 using a scale that ranged from 0-21.1 to compare 176 commodities imported into the United States.[62] With insight from both of these studies as well as knowing how luxury goods generally act, it is a fair assumption that Omega watches have a low price elasticity of demand in the United States. In fact, this is likely why Omega price discriminates and charges higher prices for its watches in the United States compared to other markets. Thus, segmented-market pricing lowers welfare in the United States.

A ruling favoring Costco instead of Omega would have allowed for parallel importation of goods manufactured abroad because of the viability of the first sale doctrine. Consumers in the United States would be able to obtain the watches at lower prices, increasing consumer surplus. Even if Omega eventually adopted a uniform price because of the fear of parallel importation, since the United States was already in a high-price market, the uniform price would probably be lower. This would cause an increase in consumer surplus in the United States, but also a decrease in producer surplus. If we were looking at global welfare, the decrease in producer surplus may offset the increase in consumer surplus and leave total welfare unchanged or affected only marginally. But the producer surplus reduction is not represented in a domestic welfare calculation because the manufacturer is based abroad. From a domestic perspective, surplus has

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[61]"*Estimating the Impact of Trade Policy Changes on the Price of Imported Products and on Trade in such Product,"* The International Commercial Diplomacy Project, <http://www.commercialdiplomacy.org/manuals/manual_economic2.htm> (accessed 9 April 2011).
[62]Barend A. de Vries, "Price Elasticities of Demand for Individual Commodities Imported into the United States," *Staff Papers - International Monetary Fund*, (1950), Vol. 1, p. 397-419, JSTOR, <http://www.jstor.org/stable/3866193> (accessed 9 April 2011).

only increased, as has total welfare.[63] The first sale doctrine and parallel importation allows high-elasticity markets to reclaim some of the consumer surplus that was lost due to price discrimination while still enabling producers to segment markets.

Another constrain to account for with respect to welfare is actual output. If output overall increases, it is possible that both producer and consumer surplus, and thereby total welfare, can rise. According to Malueg and Schwartz (1994), when demand dispersion is large enough welfare is actually higher under discrimination than under uniform pricing.[64] But if total output is no higher under price discrimination than with uniform pricing, welfare will be lower in a discrimination situation because it does not equate marginal valuations.[65] To make the best economic decision, the Supreme Court should have asked if the price discrimination resulted in an overall increase in sales; worldwide, did more people have access to this good because they were able to price discriminate? While the exact answer to this question is unknown, given that Omega watches are a luxury good and are still expensive even in its low-price markets, it is unlikely that output due to price discrimination would be significantly higher than under uniform pricing. Furthermore, Malueg and Schwartz also argue that, provided that demand is linear, if under uniform pricing the monopolist drops no markets, uniform pricing yields higher welfare than discrimination.[66] Again, because luxury goods are already priced high compared to other goods, it does not follow that a uniform price would cause Omega to drop any markets. Welfare is worse under discrimination.

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[63] It is possible that a counter effect decreasing surplus some could occur if Omega has shareholders that are based in the United States and if the inability to price discriminate hurts the value of their shares.

[64] David A. Malueg and Marius Schwartz, "Parallel Imports, Demand Dispersion, and International Price Discrimination," *Journal of International Economics*, (1994), Vol. 37, p. 167-195, ScienceDirect, <http://www.sciencedirect.com> (accessed 9 April 2011), p. 175.

[65] Ibid.

[66] Ibid.

In sum, the *Costco* ruling favoring Omega and hindering parallel importation through the denunciation of the first sale doctrine for goods manufactured abroad was not economically sound because it does not maximize welfare. More importantly, Supreme Court decisions set a precedent. And while the 4-4 ruling does not have true precedential value because of the failure to reach a majority opinion, it still implicitly affirms the lower court's ruling. The nature of Supreme Court decisions lets this ruling be applied in the future and creates a broad impact, meaning that welfare is not decreased just in this particular case but will be reduced in numerous other situations that rest upon this decision.

CREATING AN GOOD-BASED TEST

One of the problems with why many of the models were not an exact fit for the *Costco* case is because they applied to different types of goods. Intellectual property is a wide category, and even within its subdivisions of patents, trademarks, and copyrights there are further distinctions to make. Copyrights cover books, music, and in *Costco*, goods; patents encompass computer chips and pharmaceuticals. And these are an extremely minimal sample of the diversity that is covered. Landes and Posner appear to recognize this constraint as well, suggesting the following as a way to determine the appropriate amount of protection to provide for intellectual property:

> Ideally, in deciding how broad or narrow an intellectual property right to recognize, one would want to classify different forms of intellectual property according to the output likely to be produced with and without the recognition of such a right and grant such recognition only to those forms in which output would be seriously suboptimal without it. So in areas of intellectual property where fixed costs were low or other incentives besides the prospect of royalty income were

> present in force, intellectual property protection would be slight or would even be withheld altogether.[67]

This particular idea involves not judicial review, but the original determination of whether or not to grant an intellectual property right and, if so, how much. This is an interesting consideration on its own, but it also helps establish a framework for legal analysis. Specifically, it advocates classifying intellectual property on a different basis and not just whether it is a patent, trademark, or copyright. Intellectual property should be divided based on the level of output that is produced as a result of obtaining the property right.

With respect to the first sale doctrine and parallel importation, an output-based rule could apply as well. The third degree price discrimination model showed that price discrimination is good if it results in greater quantities of goods being sold, but it is not beneficial if reduces quantity sold or does not impact quantity. Preventing the first sale doctrine also enables third degree price discrimination to exist. But since price discrimination only maximizes welfare under certain conditions, it follows that the first sale doctrine should also be allowed as a defense when certain conditions exist. Based on the model, price discrimination should be encouraged when overall output would rise if the producer had the ability to discriminate. The corollary would be that in these scenarios, the first sale doctrine should not apply because it would lead to lesser output and a decrease in welfare. When price discrimination has no affect on output, the first sale doctrine should be allowed because it increases consumer surplus and maximizes overall welfare.

Therefore, instead of creating a uniform rule that, provided that a good is affixed with a copyrighted symbol, the first sale doctrine does not apply to goods manufactured abroad, a case-

[67]William M. Landes and Richard A. Posner, The Economic Structure of Intellectual Property Law, (Cambridge: The Belknap Press of Harvard University Press, 2003), p. 24.

by-case rule that depends on how output would be impacted under different pricing scenarios is better. Producers have the chance for monopoly profits if price discrimination would enable them to increase output and reach more markets, but are restricted when price discrimination does not alter output and only eliminates consumer surplus in the push for profits.

THE POTENTIAL FOR CONTRACTS

If a case-by-case model is unappealing, another potential alternative would be to use contracts. In the Supreme Court oral argument, Justice Sotomayor set up the framework for this possibility and asked, "Why don't we let contract law control the violations of any agreements with foreigners with respect to manufacturing and distribution?"[68] Essentially, when manufacturers sell their goods they could contract with the buyers that they would not be allowed to resell the goods either at all, or not to an unauthorized distributor. Another term could be to let purchasers resell goods, but within a price range that the manufacturer sets. This type of condition would avoid the real problem that Omega had in the *Costco* case, which was that Costco was selling the watches too cheaply.

The first sale doctrine would not need to be invoked in these cases because any subsequent sale would be considered a breach of contract and contract law remedies could apply. Contracts would become the standard rule for any producer that wishes to limit distribution to designated markets. As the counsel for the petitioner explained during oral argument, "If the only issue were one of contract, there would be no need for § 602(a)(1) because there would be no need to create a copyright remedy where contractual remedies are sufficient; that is, in

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[68]"Oral Argument Transcript," *Costco Wholesale Corporation v. Omega S.A,* 562 U.S. __ (2010), 8 November 2010, <http://www.supremecourt.gov/oral_arguments/argument_transcripts/08-1423.pdf> (accessed 13 April 2011), p. 46.

circumstances where there is privity between the U.S. copyright owner or the U.S. copyright owner's direct party and the foreign copyright owner."[69]

While a contract model may work theoretically, it is not necessarily possible. The counsel for the respondent argued that doing so would not be practical because many of the people would not be in privity of contract with the United States copyright owner. This method may make sense for the first several resale transactions that involve corporate distributors or middlemen contracting with the producers. The problem arises with the later transactions performed at the personal level, like selling goods on eBay or at garage sales. It is not plausible for manufacturers to contract with parties at such a minute level, and without doing so, there would be no privity of contract thereby preventing enforcement of any remedies. While contracting parties could be protected, these other end users may still be vulnerable to copyright claims.

To avoid the problem of being outside of privity of contract, it would be necessary to also make the first sale doctrine applicable to all goods, including those that are manufactured abroad. The first sale doctrine then acts as a penalty default rule which a manufacturer has the option to contract around, but it also forces the manufacturer to reveal critical information to the other contracting party, namely its desire to restrict certain subsequent sales.[70] This shifts the burden of enforcing a limitation on sales to the manufacturer who must take an action, instead of giving any company with a copyright an overarching ability to exercise protection whenever it will benefit them. Manufacturers benefit by being able to retain a degree of control over additional sales, but this also allows any average consumer that does not enter into a contract to be free

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[69]"Oral Argument Transcript," *Costco Wholesale Corporation v. Omega S.A,* 562 U.S. __ (2010), 8 November 2010, <http://www.supremecourt.gov/oral_arguments/argument_transcripts/08-1423.pdf> (accessed 13 April 2011), p. 26.
[70]Justin Yedor, "Lacking Swiss Precision: The First-Sale Doctrine in *Costco v. Omega*," *Duke Journal of Law & Public Policy Sidebar*, (2011), Vol. 6, p. 126-141, <http://www.law.duke.edu/journals/djclpp/index.php?action =downloadarticle&id=196> (accessed 23 March 2011).

from the threat of a copyright infringement lawsuit. Because the contract terms would vary among parties, the impacts on aggregate domestic welfare are ambiguous. But because buyers would have leverage against producers that need to move output and may prefer contracts to the first sale doctrine, domestic buyers could feasibly purchase goods more cheaply than under price discrimination.

CONCLUSIONS

WHY A WATCH MATTERS

Supreme Court decisions create precedent. This is why judicial decision-making must be so deliberative, so that the full potential impacts of a ruling can be explored and so that unintended consequences can be minimized. A person may wonder why he or she should care about the sale of a watch. The answer is because of the precedential power of court decisions, and how the opinion can be applied in other, perhaps very different, situations. The *Costco* decision is important because the implications extend far beyond watches. As the prior analysis has demonstrated, Omega's rationale for suing Costco stemmed from the desire to continue price discriminating instead of a real copyright infringement claim. Copyright was merely masking Omega's true intentions, yet the courts' rulings throughout the life of *Costco* explicitly created case law regarding copyright law. Legally classified as a copyright case, there is a threat that *Costco* will be applied to future cases and lead to rulings that are at odds with what would be the best decision for an actual copyright case, such as book duplication or music distribution.

One significant impact of the decision would be on libraries, which are possible because of the first sale doctrine. Because after the initial sale the copyright holder loses the ability to control the good, libraries are able to lend books again and again. But over 200 million legally acquired books in over 9,200 public libraries across the United States have foreign publishers, and many books that have publishers based in the United States were manufactured internationally.[71] Moreover, it is difficult to determine where a text was actually produced unless it explicitly states the printing location in the book. Under the *Costco* interpretation, lending these books would no longer be protected under the first sale doctrine and foreign manufacturers could assert their copyright holder privileges to sue. Libraries are forced to weigh the benefits of providing global works against the risk of liability in a pricey copyright infringement lawsuit.

Even though some works may still be safe under different protections like fair use, implied license, and educational purpose, it is not certain that these defenses would be strong enough, especially considering their efficacy would depend upon the whims of changing courts. In its amicus brief, the American Library Association noted, "While most copyright owners probably would not sue a library for lending a lawfully acquired copy of a foreign printed book, libraries will not engage in conduct that is technically unlawful just because there is a low probability of litigation."[72] Moreover, there is still the fear that a lawsuit could materialize. Libraries are then boxed into knowingly breaking the law if they do not remove books published abroad, risking a lawsuit for lending out a book, or undertaking an almost impossible task to determine the origin of every book in their collections.

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[71]"Brief Amici Curiae of American Library Association, et. al., in Support of the Petitioner," *Costco Wholesale Corporation v. Omega S.A,* 562 U.S. __ (2010), American Bar Association, <http://www.americanbar.org/content/dam/aba/publishing/preview/publiced_preview_briefs_pdfs_09_10_08_1423_PetitionerAmCu3LibraryAssns.authcheckdam.pdf> (accessed 25 March 2011), p. 4.
[72]Ibid, p. 23.

The problems are paramount when physical goods exist, but they are intensified with digital media. A case easily analogous to the libraries situation is online and digital texts. With developments in technology and the trends of personal reading devices and tablets such as the Kindle, iPad, and Nook, more books are becoming digitized and uses of electronic books are increasing. And libraries are realizing that they can take advantage of e-readers and do not need to only operate with physical books. On April 20, 2011, Amazon reversed its policy and made it possible to borrow and read e-books from over 11,000 public libraries on the Kindle—a service that the Nook and Sony Reader already offered.[73] The New York Public Library saw a thirty-six percent increase it the use of its e-books between 2010 and 2011, showcasing the prevalence of electronic works.[74]

Another prime source of online literature is Google Books. In collaboration with several universities across the world, Google scanned over 15 million books and made either all of or excerpts of the books available on the web.[75] Scanning books is technically copying them. If the copyright holder did not give the scanner permission to duplicate the book, then it could be considered infringement. Google maintained that its actions to create the world's largest online library were legal under the fair use doctrine. Furthermore, Google wanted to have the ability to freely digitize orphaned works, or writings that are still under copyright but where their authors or copyright holders cannot be found. Full text was only available for books that had given Google permission to replicate them or for books where the copyright had already expired. Nonetheless, the Authors Guild and the American Association of Publishers sued. The parties

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[73] Julie Bosman, "Kindle Users to Be Able to Borrow Library E-Books," *The New York Times*, 20 April 2011, <http://www.nytimes.com/2011/04/21/technology/21amazon.html?ref=technology> (accessed 21 April 2011).
[74] Ibid.
[75]Clair Cane Miller, "Book Ruling Cuts Options for Google," *The New York Times*, 23 March 2011, <http://www.nytimes.com/2011/03/24/business/media/24google.html?_r=1&adxnnl=1&src=tptw&adxnnlx=1300978889-+uZtk/cv0+Hyu/5zLQCHZQ> (accessed 14 April 2011).

ultimately reached a settlement, where Google would pay $125 million, be allowed to continue scanning books, and also offer entire texts for sale on the site. Authors that did not want their books in the database would have to contact Google and opt out.[76] Despite the settlement, Judge Denny Chin rejected the agreement in a New York federal district court in March 2011.

Many people, including Judge Chin, have argued that the issues in the Google Books case have grown so complex and because they are likely to arise in the future with other digitized publications, it is time for Congress to debate the matter and enact legislation as opposed to relying on the courts.[77] While Google's case focused heavily on orphan works and the fair use doctrine, it seems that if litigation continues, the first sale doctrine will arise as well. Regardless, the Google Books case will thrust questions over copyright to Congress. And in its broad copyright inquiry, *Costco* will inevitably come up. It might then have been the Supreme Court's intention to release such a minimalist statement on *Costco*, so that the legislative branch would not be forced to clash with the judicial branch and potentially denounce and invalidate the court's ruling. When Congress assesses the current nature of copyright and what laws will be best to adapt to the future, the same economic theories discussed throughout this paper can provide guidance.

The importance of this decision is that the repercussions do not only apply to consumerism, but also extend deeper into the foundations of democracy. There is a societal benefit to the existence of physical and online libraries because of their ability to freely provide books from across the world for anyone to access. We want to support the free flow of information just as much as the free flow of goods. Access to information helps develop a

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[76]Jerry Brito, "Explaining the Google Books Case Saga," *Time Magazine*, 23 March 2011, <http://techland.time.com/2011/03/23/explaining-the-google-books-case-saga/> (accessed 14 April 2011).

[77]William McGeveran, "Does the Google Books Settlement Set the Stage for a Congressional Intervention?" *Capital New York*, 4 April 2011, <http://www.capitalnewyork.com/article/culture/2011/04/1742995/does-google-books-settlement-set-stage-congressional-intervention> (accessed 14 April 2011).

knowledgeable citizenry, which is essential to informed decision making. It is imperative that we balance copyright protections for creators of expressive works with the inherent societal benefit of providing access to these works to the public. The degree of copyright protection should be reasonable, and not an overarching power to have absolute control of a product infinitely. Without doing so, the foundations for the free exchange of ideas crumble.

This case is certainly not about copyright in the traditional sense. Rather, as one of the petitioner briefs argued, "Omega is merely attempting to improperly leverage copyright law to use a minor, practically invisible logo to obtain absolute control over the disposal of a high value product."[78] The economic analysis throughout this paper showed how this practice is rarely efficient or welfare maximizing in general, and especially not in the case at hand. *Costco* is by no mean the stopping point of the copyright debate. Congress's solution should not only afford property rights, but also fully assess the economic implications of its actions and consider the aforementioned economic theories when crafting new policy.

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[78] "Brief Amici Curiae of American Association of Law Libraries, et. al., in Support of the Petitioner," *Costco Wholesale Corporation v. Omega S.A,* 562 U.S. __ (2010), American Bar Association, <http://www.americanbar.org/content/dam/aba/publishing/preview/publiced_preview_briefs_pdfs_09_10_08_1423_PetitionerAmCu6NonProfitOrgs.authcheckdam.pdf> (accessed 26 March 2011).

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APPENDIX A

17 U.S.C. § 602. Infringing importation or exportation of copies or phonorecords

(a) Infringing Importation or Exportation.—

(1) Importation.—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.section 501.

(2) Importation or exportation of infringing items.—Importation into the United States or exportation from the United States, without the authority of the owner of copyright under this title, of copies or phonorecords, the making of which either constituted an infringement of copyright, or which would have constituted an infringement of copyright if this title had been applicable, is an infringement of the exclusive right to distribute copies or phonorecords under section 106, actionable under sections 501 and 506.

(3) Exceptions.—This subsection does not apply to—

(A) importation or exportation of copies or phonorecords under the authority or for the use of the Government of the United States or of any State or political subdivision of a State, but not including copies or phonorecords for use in schools, or copies of any audiovisual work imported for

purposes other than archival use;

(B) importation or exportation, for the private use of the importer or exporter and not for distribution, by any person with respect to no more than one copy or phonorecord of any one work at any one time, or by any person arriving from outside the United States or departing from the

United States with respect to copies or phonorecords forming part of such person's personal baggage; or

(C) importation by or for an organization operated for scholarly, educational,

or religious purposes and not for private gain, with respect to no more than one copy of an audiovisual work solely for its archival purposes, and no more than five copies or phonorecords of any other work for its library lending or archival purposes, unless the importation of such copies

or phonorecords is part of an activity consisting of systematic reproduction or distribution, engaged in by such organization in violation of the provisions of section 108(g)(2).

APPENDIX B

§ 109. Limitations on exclusive rights: Effect of transfer of particular copy or phonorecord

(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. Notwithstanding the preceding sentence, copies or phonorecords of works subject to restored copyright under section 104A that are manufactured before the date of restoration of copyright or, with respect to reliance parties, before publication or service of notice under section 104A(e), may be sold or otherwise disposed of without the authorization of the owner of the restored copyright for purposes of direct or indirect commercial advantage only during the 12-month period beginning on —

(1) the date of the publication in the Federal Register of the notice of intent filed with the Copyright Office under section 104A(d)(2)(A), or

(2) the date of the receipt of actual notice served under section 104A(d)(2)(B),whichever occurs first.