IP Exhaustion around the World: Differing Approaches and Consequences to the Reach of IP Protection beyond the First Sale

The Exhaustion Doctrine in the United States

NEW YORK STATE BAR ASSOCIATION
INTERNATIONAL LAW AND PRACTICE SECTION
FALL MEETING—2013
HANOI, VIETNAM

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I. Overview

Intellectual property rights are limited monopolies a government grants for the use or distribution of products that embody or use the intellectual property, whether a patented invention, a copyrighted work, or a brand name protected by a trademark. The value of the intellectual property right depends upon both the underlying demand for the products subject to the patent, copyright or trademark, and the ability of the rights holder to exploit the monopoly position.

One traditional means of maximizing returns on a monopoly position is to divide markets among different licensees by putting various restrictions on their use of the licensed intellectual property. These restrictions can be, for example, limited geographic territories, or limitations on the field of use or market segment. Patentees can use field of use restrictions in the biopharma industry, for example, to distinguish uses of an invention in the diagnostic, therapeutic and research markets, or in human and animal applications. Copyright owners may grant separate licenses for hard cover and soft cover books, for manufacture and sale in different countries or for different language editions. And trademark owners may choose to use different licensees for different goods sold under the brand.

Geographic limitations are common in licenses of all kinds of intellectual property. But the ability of a rights holder to put geographic restrictions on the sale or use of products is subject to a fundamental limitation. Once the rights holder or someone authorized by the rights holder has sold the product, the intellectual property right is considered exhausted, so the purchaser is free to resell or otherwise dispose of the product. This is called the *first sale doctrine* or the *exhaustion doctrine*.

II. The Geographic Scope of Exhaustion

Intellectual property rights are territorial. Historically, they have been recognized at the level of the individual country. At the same time, it has long been the case that a particular intellectual property right may be recognized in multiple jurisdictions, either virtually automatically as is the case with copyrights under the Berne Convention, or through exercise of rights under important international treaties such as the Paris Convention (concerning both patents and trademarks), the Madrid Protocol (concerning trademarks) or the Patent Cooperation Treaty (concerning patents). In addition, the European Union has expanded the territory of protection for intellectual property rights through the European Patent Convention, granting what is in essence a group of national patents in each member country, and the Community Trademark, granting a unitary trademark registration enforceable throughout the European Union.

The tension between national and international recognition of intellectual property rights is reflected in different applications of the exhaustion doctrine. There are three possible approaches:

(a) **National exhaustion**: An authorized sale within a country where rights are granted exhausts the right to control further disposition within that country.

(b) **Regional exhaustion**: An authorized sale within a country where rights are granted exhausts the right to control further disposition anywhere in the region where such country is located (such as the EU).

(c) **International exhaustion**: An authorized sale anywhere in the world exhausts the right to control further disposition.

III. Patent Exhaustion

In the United States, the exhaustion doctrine was first applied to patents in the case of *Adams v. Burke*, 84 U.S. 453 (1873). The plaintiff Adams had acquired all patent rights to an improved coffin lid except for the area within ten miles of the city of Boston, where the patent rights were retained by the coffin makers Lockhart & Seelye. Burke bought coffins from Lockhart & Seelye and used them in his undertaking business in Natick, lying 17 miles outside of Boston. Adams sued for patent infringement, but the Supreme Court held that a patentee who sells a patented article exhausts the patent monopoly. Having acquired the coffins from Lockhart & Seelye in Boston, Burke was free to transport them to Natick and use them there.

The exhaustion doctrine applies only if and to the extent the seller is authorized to make the sale under the patent. Where the seller's authority to sell is restricted to a particular field of use, the first sale cannot exhaust the patent holder's rights outside the licensed field of use. For example, in *General Talking Pictures v. Western Electric*, 304 U.S. 175 (1926), the owner of patents in vacuum tube amplifiers sold the amplifiers through its exclusive licensees for use in making talking picture equipment, but also sold amplifiers under nonexclusive licenses that were expressly limited to the making and selling of the patented amplifiers for other uses, such as radio broadcast reception. One of the nonexclusive licensees, the American Transformer Company, made the patented amplifiers and sold them to General Talking Pictures Corp., knowing that the purchaser would include them in talking picture equipment to be leased to theaters. Since the sale of the amplifiers was not included in the scope of the license, both the sale of the amplifiers by American Transformer and their use by General Talking Pictures infringed the amplifier patents.

Although field of use restrictions make it possible to segment the market for a patented product, it has long been clear that exhaustion bars a patent owner from simply breaking down the manufacturing process of a patented article to extract royalties at each level of production. In *United States v. Univis Lens Co.*, 316 U.S. 241 (1942), the patent owner, Univis Corporation, set up a licensing scheme under which it licensed the right to manufacture lens blanks to its affiliate Univis Lens Co., which could only sell the blanks to purchasers who had obtained a license from Univis Corporation to finish the lens blanks. The corporation offered three such licenses, one for wholesalers, one for finishing retailers and one for prescription retailers, who were subject to resale restrictions under the terms of their licenses. The Court struck down this scheme on the grounds that the patent rights in the lenses were exhausted by the first sale, since the lens blanks had no other use than to be ground and polished into finished lenses.

Despite *Univis*, patent holders were still able to impose after-sale restrictions on the use of patented products. For example, a manufacturer of nebulizers was able to enforce single-use restriction on its products as long as notice of the restriction was given to purchasers of the product. *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (Fed. Cir. 1992). Another tactic was to split inventions into discrete patents covering a product on one hand and the method of using the product on the other. This permitted the patent holder to charge downstream royalties, since the courts had held that exhaustion does not apply to method claims at all. *Bandag, Inc. v. Al Bolser's Tire Stores, Inc.*, 750 F.2d 903 (Fed. Cir. 1984).

The Supreme Court undermined the multi-tiered licensing models that these limits on the exhaustion doctrine enabled in *Quanta Computer, Inc. v LG Electronics, Inc.*, 533 U.S. 617

(2008). LG concerned certain product patents covering semiconductor chips and separate patents on the method of combining the patented semiconductors with other components to make personal computers. LG licensed Intel to manufacture and sell semiconductor chips under both the product and method patents, but Intel was not permitted to sublicense LG's method patent claims to third parties. Instead, Intel was required to notify its customers that the purchase of semiconductor chips did not include a license to make other products by combining the chips with a non-Intel product. The Supreme Court held that LG exhausted its patent claims by licensing Intel to sell the semiconductor chips, since the chips themselves embodied the essential features of the invention and had no reasonable use other than to be combined with other components to make finished products. Neither the fact that the other patents were based on method claims nor the requirement of notice to Intel's customers was sufficient to prevent the exhaustion of LG's patent claims.

Although *Quanta* extended the exhaustion doctrine with respect to domestic sales of patented products, it did not address the issue of the geographic scope of exhaustion. Based on the Supreme Court's decision in *Boesch v. Graff*, 133 U.S. 697 (1890), and later Federal Circuit decisions, the United States currently follows a rule of national exhaustion for patents. In *Boesch*, the defendant had acquired allegedly infringing lamp-burners from a German manufacturer who was exempted by statute from the restrictions of the corresponding German patent. The Court held that, even if the lamp-burners were non-infringing when acquired in Germany, the right to control the manufacture, use and sale of the lamp-burners in the United States was unaffected by the German law. The Federal Circuit cited *Boesch* in *Jazz Photo Corp. v International Trade Commission*, 264 F.3d 1094 (Fed. Cir. 2001). In that case, Fuji Photo Film Co. charged that Jazz Photo Corp. and others were infringing Fuji Photo's patents on its single-use camera by acquiring used cameras, opening them up, refurbishing them, and re-selling them. Some of the cameras that were refurbished were originally sold in the United States but some were sold abroad. The court found that the patents were exhausted with respect to cameras sold in the United States but not with respect to cameras sold abroad.

The Federal Circuit followed *Jazz Photo* in *Ninestar Tech. Co. v. ITC,* 667 F.3d 1373 (Fed. Cir. 2012), *cert. denied,* 133 S. Ct. 1656 (2013). That court expressly rejected the argument that *Quanta Computer* supported a change in the national exhaustion rule.

The Supreme Court's 2013 decision in *Kirtsaeng,* discussed below, establishing international exhaustion as the rule for goods protected by copyright, has called into question whether the United States will continue to follow a national exhaustion rule for patents. Although the first sale doctrine for copyrights is codified in the Copyright Act but the exhaustion doctrine for patents is based on case law, much of the reasoning in *Kirtsaeng* is drawn from common law analogies and could arguably apply to patents as well as copyrights. It will be up to the Supreme Court to address this issue in an appropriate case.

The Court conspicuously forewent an opportunity to consider the issue when, shortly after deciding *Kirtsaeng,* it denied certiorari in *Ninestar Technology.* Many expected the Court either to accept and decide the case or vacate the decision and remand for reconsideration in light of *Kirtsaeng.* Instead, the Court simply denied the petition. This could indicate that the Court views *Kirtsaeng* as limited to copyright law. Alternatively, the Court might simply not have considered *Ninestar Technologies* a suitable vehicle to address the issue. Some differences in the facts and some procedural complications would have made the case somewhat "messy."

Finally, during the past year, the Supreme Court has addressed the important issue of how patent exhaustion applies to self-replicating technologies, for example, patented seeds with beneficial genetic traits that can be purchased, planted and used to grow more seeds with the inherited trait. *Bowman v. Monsanto Co.,* 133 S. Ct. 1761 (2013). *Bowman* involved Monsanto's patented "Roundup Ready" soybean seeds, which are genetically resistant to Monsanto's herbicide Roundup. Monsanto sold the seeds to farmers coupled with a license agreement that, among other things, forbad the replanting of seed saved from the crop grown with the purchased seed.

To attempt to avoid the license restrictions and exploit the exhaustion doctrine, farmer Hugh Bowman did not merely replant his own saved seed. He purchased soybeans intended for food use that local farmers had sold to a local grain elevator, knowing that many of his neighbors planted the "Roudup Ready" seeds. He planted the purchased seed, sprayed it with Roundup to kill off any plants that were not "Roundup Ready," saved the seeds produced and replanted them. Bowman reasoned that because he was buying the seed from a purchaser remote from Monsanto, he could avoid the restrictions of the license agreement and claim exhaustion as a defense to infringement.

Monsanto sued for patent infringement. After losing below in the district court and on appeal, Bowman sought review by the Supreme Court. The Court, in a unanimous decision by Justice Kagan, firmly rejected Bowman's exhaustion defense. The Court reasoned that the exhaustion doctrine allows a purchaser to resell or use in any manner the purchased articles. It does not, however, allow the purchaser to make additional copies of the patented article. Because Bowman was using the seeds to make additional copies, not just using or selling them, he could not claim exhaustion. Bowman's argument that he was simply using the seeds the way farmers ordinarily use seeds was soundly rejected.

IV. Copyright Exhaustion

A copyright owner has the exclusive right by statute to control not only reproduction of the copyrighted work, but also its sale and distribution. 17 U.S.C. § 106(3). However, over 100 years ago, the Supreme Court applied the first sale doctrine to limit the copyright holder's right to control downstream distribution. *Bobbs-Merrill Co. v. Straus*, 210 U.S. 339 (1908). In that case the publisher, Bobbs-Merrill, inserted a notice in its books that any retail sale at a price under $1.00 would constitute an infringement of its copyright. Macy's department store disregarded the notice and sold the books for eighty-nine cents each, without the publisher's consent. The Court found no copyright infringement, holding that the exclusive statutory right of distribution applied only to the first sale of the copyrighted work. The first sale doctrine was subsequently codified in the Copyright Act of 1976, 17 U.S.C. § 109.

There are two significant issues with respect to copyright exhaustion. One relates to the application of the doctrine to copyrighted software and the other to the geographic scope of copyright exhaustion.

Software. Although it may seem to many that when one pays money to acquire a physical medium containing a copy of computer software the software has been "sold," in most cases, the software is actually "licensed" under a license agreement that contains restrictions on use, often including resale restrictions, and expressly provides that no ownership is transferred. The license may be a written document or merely a document that appears online and is quickly clicked through. Software owners seek to avoid the consequences of the first sale doctrine by nominally licensing rather than selling. However, if the nominal license is treated legally as a sale of a copy of the software for exhaustion purposes, then software owners will not be able to enforce restrictions on resale of copies of the software.

The Ninth Circuit's 2010 decision in *Vernor v. Autodesk, Inc.*, 621 F.3d 1102 (9th Cir. 2010), *cert. denied*, 132 S. Ct. 105 (2011), gave significant guidance concerning when a nominal license of software will be treated as such for copyright exhaustion purposes. In *Vernor,* the declaratory judgment plaintiff acquired authentic used copies of copyrighted computer software that had been manufactured by the defendant Autodesk and first acquired by an architectural firm. Vernor then put the copies up for sale on eBay. Autodesk sent Vernor copyright infringement notices under the Digital Millennium Copyright Act ("DMCA"), demanding that he cease the sale of the software. Vernor responded that the sales were lawful. Vernor's auctions were repeatedly interrupted, because eBay suspended the auctions upon receipt of Autodesk's DMCA notices, reinstating them only after Autodesk failed to respond to Vernor's counter-notices of lawful sale. The computer software was sold under a license agreement with restrictions on the use of the software, including a prohibition on renting, leasing, or transferring the software without Autodesk's consent.

Vernor sued Autodesk for a declaration that his online sales of the computer software were lawful. The issue was whether the original transfer of the copies of computer software acquired by the architecture firm from Autodesk was a "sale," rather than a mere transfer of possession pursuant to a license. If the transfer was a sale, then the architecture firm was a lawful owner of the copies and could resell them, just as the owner of a book may resell the book. As a subsequent lawful owner of the copies, Vernor would then have the right to use or resell the copies as he pleased. But if, as Autodesk argued, the transfer of the software was pursuant to a license, the first sale doctrine would not apply. The district court held that the transfer of the computer software from Autodesk to the architecture firm was a lawful first sale, which exhausted Autodesk's copyright, but the Ninth Circuit reversed on appeal, and the Supreme Court declined to review that decision.

Vernor established a three-factor test for determining whether software is licensed or sold for first sale doctrine purposes:

> We hold today that a software user is a licensee rather than an owner of a copy where the copyright owner (1) specifies that the user is granted a license; (2) significantly restricts the user's ability to transfer the software; and (3) imposes notable use restrictions.

621 F.3d at 1111. Note that under *Vernor* merely stating that the user is granted a license is not sufficient to avoid a first sale. There must also be significant restrictions on transfer and meaningful restrictions on use. The net result is that in most cases the software owner's invocation of a license will be respected for exhaustion purposes.

Geographic scope of exhaustion. The second important issue in copyright exhaustion is the geographic scope of the doctrine. The Copyright Act, itself, contains conflicting provisions and provides no meaningful guidance on the issue. On the one hand, Section 602(a) of the U.S. Copyright Act provides that:

> 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.

On the other hand, Section 109 provides that:

> 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.

If a copyright owner authorizes the copying and distribution of a protected work, a book for example, outside the United States, does a purchaser of a copy outside the United States infringe the copyright by subsequently reselling the copy in the United States? Section 602(a) would suggest yes. Section 109 would suggest no. The courts have been struggling with this issue for a long time and have finally produced a definitive answer. Crystalized to its essence, the issue turns on the meaning of "lawfully made under this title." If it means that the copy must be made in the U.S. to be considered made under the U.S. Copyright Act, then the first sale provision would not apply to foreign made copies. If not, then the first sale doctrine could trump Section 602(a).

In *Quality King Distribs., Inc. v. L'anza Research Int'l, Inc.*, 523 U.S. 135 (1998), the Supreme Court held that authorized foreign sales of copyrighted products that were manufactured in the United States exhausted the U.S. copyright in them. In dicta, the Court suggested that the statutory first sale doctrine would not apply in the case of copies manufactured abroad, even if manufactured with the copyright holder's authorization. In other words "lawfully made under this title" should be interpreted as "made in the United States" rather than "made without violation of the copyright holder's exclusive rights."

The Ninth Circuit followed that interpretation in *Omega S.A. v. Costco Wholesale Corp.*, 541 F.3d 982 (9th Cir. 2008). Omega manufactured watches in Switzerland and sold them worldwide using authorized distributors, dealers, and retailers. In 2003, Omega developed and registered the copyright in the "Omega Globe Design," consisting of three Greek "omega" symbols inside a circle, which Omega engraved as a design on the underside of its watches. After failed negotiations in which Costco sought to become an authorized Omega retailer, Costco purchased Omega brand watches engraved with the copyrighted design from a supplier who obtained them from third parties who had bought the watches from Omega's authorized distributors overseas. After Costco began selling the Omega watches at a substantial discount from Omega's suggested retail price, Omega sued Costco for copyright infringement. The Ninth Circuit ruled in favor of Omega, holding that the first sale doctrine was only available for imported goods that were manufactured in the U.S. The Supreme Court accepted the case for review, but the Ninth Circuit's decision was affirmed by an equally divided Court after Justice Kagan recused herself. 131 S. Ct. 565 (2010).[1]

The issue came before the Court again this year in *Kirtsaeng v. John Wiley & Sons Inc.*, 133 S. Ct. 1351 (2013), this time with all nine justices sitting. In a March 19, 2013 6-3 decision, the Court departed from its dicta in *Quality King* and held that the first sale doctrine does apply to the resale of copies lawfully made abroad. The case concerned the U.S. sale of college textbooks made for, and originally sold in, foreign markets. The often substantial price differential between the foreign and U.S. versions of the same textbook offered an arbitrage opportunity to resell the foreign versions to U.S. college students. Supap Kirtsaeng, a Thai student, exploited that opportunity. He purchased authorized versions of textbooks in Thailand and resold them in the U.S. to U.S. students for more than he paid but less than the students would have paid for the U.S. editions. John Wiley & Sons was not pleased, as this activity threatened its global market segmentation and price differentiation strategies. Wiley sued Kirtsaeng in the Southern District of New York and prevailed in the district court and on appeal to the Second Circuit, in a 2-1 decision.

The Supreme Court reversed in an opinion by Justice Breyer. The decision reasoned that the better reading of the "lawfully made under this title" language does not impose any

[1] Ultimately, Omega lost the case notwithstanding its appellate "victory." On remand, the district court granted summary judgment in favor of Costco, ruling that use of an insignificant copyright protected element for the purpose of restricting parallel importation constituted copyright misuse rendering the copyright unenforceable. *Omega SA. V. Costco Wholesale Corp.*, 2011 U.S. Dist LEXIS 155893 (E.D. Cal. Nov. 9, 2011).

geographical limitations and simply means made "in accordance with copyright law" of whatever jurisdiction. Arguments by Amici concerning the practical implications of limiting the first sale doctrine to goods manufactured in the U.S. were clearly also influential. Libraries, museums, technology companies and used book dealers argued that if the first sale doctrine were limited as Wiley urged their use of the millions of books and other goods printed or made abroad would be inhibited. They would need to locate the copyright owner and seek permission before making any further dispositions. (One wonders how they got along for so many years during the period of uncertainty.) The Court was also concerned that eliminating the first sale doctrine for foreign made goods would mean that even copies lawfully imported and sold in the U.S. with the copyright owner's permission could not thereafter be freely resold. This concern could, of course, be overcome by a rule providing that any first sale in the U.S. would invoke exhaustion no matter where the copy was made. However, the Court rejected such an approach, reasoning that the statute's language could not be reconciled with such a "half-geographical/half-nongeographical interpretation".

Even though the Copyright Act's first sale doctrine is statutory, in construing it the Court relied on the long common law history, in the U.S. and England, establishing exhaustion principles applicable to intellectual property. The Court reasoned that the statute was simply a codification of the common law, which had long recognized intellectual property exhaustion without geographical limitations. Some suggest that this reliance may support a future extension of the *Kirtsaeng* holding to patent law.

Justice Ginsburg, the author of the contrary dicta in *Quality King,* wrote the dissenting opinion. She urged that "lawfully made under this title" meant that the first sale doctrine was intended to apply only to goods made where U.S. copyright law applies, and that the ability of copyright owners to price discriminate internationally was economically important, should be preserved, and is what Congress intended. She also noted that in its trade negotiations the United States has consistently opposed principles of international exhaustion of intellectual property rights.

Kirtsaeng effectively establishes international copyright exhaustion as United States law. It remains to be seen whether that rule will also replace national exhaustion as the rule for U.S. patents.

V. Trademark Exhaustion

In the United States, trademark law has a dual purpose – protecting consumers from confusion in the marketplace and protecting producers from unfair competition in the form of confusingly similar marks. As the Supreme Court put it:

> In principle, trademark law, by preventing others from copying a source-identifying mark, . . . quickly and easily assures a potential customer that *this* item – the item with this mark – is made by the same producer as other similarly marked items that he or she liked (or disliked) in the past. At the same time, the law helps assure a producer that it (and not an imitating competitor) will reap the financial, reputation-related rewards associated with a desirable product.

Qualitex Co. v. Jacobson Prod. Co., Inc., 514 U.S. 159, 163-64 (1995). The right conferred by trademark law is therefore different from the explicit monopolies conferred by patent and copyright law. As long as the products are genuine and the consumer is not confused, there is no infringement. This means that in the absence of alteration, the first sale of trademarked goods exhausts the trademark owner's rights. As the Second Circuit has put it:

> As a general rule, trademark law does not reach the sale of genuine goods bearing a true mark even though the sale is not authorized by the mark owner. . . . Thus, a distributor who resells trademarked goods without change is not liable for trademark infringement.

Polymer Technology Corp. v. Mimran, 975 F.2d 58, 61-62 (2d Cir. 1992), *accord Tiffany (NJ) Inc. v. eBay, Inc.*, 600 F.3d 93, 103 (2d Cir. 2010). In other words, one need not be an "authorized" dealer or distributor to resell genuine trademarked goods lawfully whether or not they were manufactured in the United States or acquired in the United States. However, one may not lawfully misrepresent the status of "authorized" dealer.

In practice, the phrase "genuine goods bearing a true mark" raises serious issues. If a reseller modifies the goods before reselling them or fails to submit the goods to the trademark owner's quality control, the use of the trademark may constitute infringement. Similarly, the sale of unaltered trademarked goods may constitute infringement if the goods are somehow materially different from the goods authorized for sale under the mark in the U.S. For example, if the trademark owner or its licensee formulates or packages the goods intended for sale in other countries materially differently from those sold in the U.S. there will be no exhaustion and the goods cannot be sold into the U.S.

In the famous case of *Original Appalachian Artworks, Inc. v. Granada Electronics, Inc.*, 816 F.2d 68, 73 (2d Cir. 1987), the trademark owner sold Cabbage Patch Kids dolls in the United States with "birth certificates" and "adoption papers." It also licensed the sale of Cabbage Patch Kids dolls in Spain with birth certificates and adoption papers in Spanish. When dolls intended for the Spanish market were sold in the United States, the trademark owner brought an infringement suit. The Second Circuit held that even though the Spanish dolls were genuine in the sense that they were authorized by the trademark owner, the material differences between the dolls intended for the U.S. market and those intended for the Spanish market – primarily the Spanish language "birth certificate" and "adoption papers" – caused confusion among U.S. customers and constituted infringement.

Other circuits have adopted the same position with respect to materially different goods. See *Societe Des Produits Nestle, S.A. v. Casa Helvetica, Inc.*, 982 F.2d 633, 636 (1st Cir. 1992) (differences in quality control, formulation, packaging and price); *Iberia Foods Corp. v. Romeo*, 150 F.3d 298, 302-03 (3d Cir. 1998) (recognizing principle but finding differences not material); *Martin's Herend Imports, Inc. v. Diamond & Gem Trading USA, Co.*, 112 F.3d 1296, 1302 (5th Cir. 1997) (goods in styles and patterns not imported by the authorized U.S. importer); *Softman Prod. Co., LLC v. Adobe Systems, Inc.*, 171 F. Supp. 2d 1075, 1092 (C.D. Cal. 2001) ("The first sale doctrine does not apply . . . when an alleged infringer sells trademarked goods that are materially different than those sold by trademark owner." However, unbundling of software products sold bundled by the trademark owner not a material difference); *Davidoff & CIE, S.A. v. PLD Int'l Corp.*, 263 F.3d 1297, 1302 (11th Cir. 2001). The *Davidoff* case illustrates that even seemingly minor differences may be treated as material changes in the context of trademark infringement. The court held that the removal of batch codes from bottles of perfume was a sufficient alteration of the trademarked product to constitute a material difference.

The threshold of materiality for differences that will make them sufficient to override the general rule of exhaustion is, of course, not a bright line. At least one court has held that the threshold should be low – the existence of any difference . . . that consumers would likely consider to be relevant when purchasing a product – because, "[a]ny higher threshold would endanger a manufacturer's investment in product goodwill and unduly subject consumers to potential confusion by severing the tie between a manufacturer's protected mark and its associated bundle of traits." *Societe des Products Nestle, S.A. v. Casa Helvetia, Inc.*, 982 F.2d 633, 641 (1st Cir. 1992).

Failure to impose quality control that is required by the trademark owner can also result in goods being treated as non-genuine, preventing the application of the exhaustion doctrine to their resale. *El Greco Leather Prod. Co. v. Shoe World, Inc.*, 806 F.2d 392, 395 (2d Cir. 1986), *cert. denied*, 484 U.S. 817 (1987). This position has also been adopted in other Circuit courts. See *State of Idaho Potato Com'n v. G & T Terminal Packaging, Inc.*, 425 F.3d 708 (9th Cir. 2005) (holding that former licensee could not continue to use the IDAHO certification mark for his potatoes, despite the fact that his potatoes came from Idaho, because they did not go through the mark owner's quality control); *Shell Oil Co. v. Commercial Petroleum, Inc.*, 928 F.2d 104 (4th Cir. 1991) (finding that oil products without Shell's quality controls are "not truly genuine"); but *cf.*, *Iberia Foods Corp. v. Romeo*, 150 F.3d 298, 302-03 (3d Cir. 1998) (lack of quality control measures limited to inspection for self-evident defects does not make goods materially different).

The quality control analysis can also be used to support a finding of infringement when the reseller makes relatively minor changes to the product packaging. In *Zino Davidoff S.A. v. CVS Corp.*, 571 F.3d 238 (2d Cir. 2009), the court found that removal of the unique production codes, which enabled the manufacturer to detect counterfeits, determine date of manufacture and facilitate recall if necessary, from the trademarked goods' packaging interfered with the trademark owner's ability to exercise quality control over its products.

The genuine product analysis relates to the attributes of the product itself, not to those of the type of store in which it is sold. Even if a trademark holder wants its products sold only in high-end locations, it cannot prevent a subsequent sale of a product at a retail store on grounds that the item is not genuine because it was not intended for sale there. See *Polymer Technology Corp. v. Mimran*, 37 F.3d 74 (2d Cir. 1994) (Plaintiff "failed to offer any support for the proposition that the unauthorized sale of genuine products will constitute trademark infringement merely because the goods contain a label indicating that the goods were meant to be sold in another market . . .”).

Finally, the reseller may infringe the trademark owner’s rights even if the goods are genuine if it falsely suggests that it is related to or authorized by the trademark owner. See *Bandag, Inc. v. Al Bolster’s Tire Stores*, 750 F.2d 903 (Fed. Cir. 1984) (finding infringement for a telephone advertisement that used language that falsely indicated defendant was a franchisee). Here the consumer confusion is not about the goods themselves, but about the source of the goods.

VI. Gray Goods

In the international context, trademark exhaustion most frequently arises in the United States in connection with parallel importation or “gray goods.” Trademark owners usually desire to exclude gray goods to protect their authorized U.S. goods from competition. As noted above, where gray goods are substantially identical to the authorized U.S. goods except that the trademark owner did not intend for them to be sold in the U.S., their importation is difficult to stop.

A trademark owner wishing to enforce its unexhausted trademark rights against gray goods has basically two legal alternatives under U.S. law: (1) try to have the U.S. Customs and Border Patrol exclude the goods at entry, or (2) sue the importer for trademark infringement and unfair competition in court and obtain an injunction. If available, Customs enforcement is obviously the better route because the government does the work for the trademark owner and bears most of the cost, and because the goods are blocked at the border and so never enter the stream of commerce. However, Customs enforcement is not available to every trademark owner.

Two separate U.S. statutes authorize Customs to exclude goods based on their trademark – (1) Section 526 of the Tariff Act, 19 U.S.C. § 1526, and (2) Section 42 of the Lanham Act (the U.S. Trademark Act), 15 U.S.C. § 1124. These two sections work somewhat differently.

Section 526 of the Tariff Act prohibits the importation of goods manufactured abroad bearing a federally registered trademark owned by a U.S. citizen or a company organized in the U.S. where the owner has filed the Certificate of Registration with the Customs Service. On its face the statute seems to mean that trademark rights for U.S. citizen registrants are not exhausted by a first sale of goods manufactured outside the U.S. However, the Customs Service's interpretation of this section, which the U.S. Supreme Court upheld as reasonable in *K-Mart Corp. v. Cartier, Inc.*, 486 U.S. 218 (1988), is that if the U.S. owner is a corporate affiliate of the foreign manufacturer, then importation of genuine goods that source from the foreign manufacturer is not barred. Thus, in effect, the only genuine gray goods that this statute will bar are those manufactured abroad bearing the trademark of a U.S. citizen registrant, who has filed the Certificate of Registration with Customs, but not manufactured by an affiliate of the trademark owner, *e.g.*, manufactured by an unaffiliated licensee.

Section 42 of the Lanham Act works somewhat differently. It authorizes Customs to exclude goods that (a) bear a trademark that copies or simulates a federally registered trademark (on the Principal Register), or (b) bear a name which copies or simulates the name of any foreign manufacturer located in a country that by treaty, convention or law affords similar privileges to citizens of the U.S. As with § 526, the protection is invoked by filing the Certificate of Registration, or other information about the mark, with Customs. Section 42 applies not only to outright counterfeit goods, but also to trademarked goods that were authorized by the trademark owner, but are not "genuine" because they differ from the authorized U.S. goods in one or more of the material respects discussed above. Customs regulations contain the same "corporate affiliate" exception that applies to § 526. However, courts have questioned whether that exception is valid with respect to § 42. *E.g., Lever Bros. Co. v. United States*, 877 F.2d 101 (D.C. Cir. 1989). Accordingly, if a trademark owner cannot meet the requirements of § 526, § 42 may still be helpful.

A trademark owner pursuing private litigation against a gray goods importer, rather than Customs enforcement, has several statutes to choose from, including a court action under:

- Lanham Act § 32 forbidding infringement of registered trademarks;
- Lanham Act § 42, which in addition to authorizing Customs enforcement provides for a private right of action to prevent importation of infringing goods;
- Lanham Act § 43(a) forbidding "false designation of origin," including infringement of unregistered trademarks;

or an administrative proceeding before the United States International Trade Commission under:

- § 337 of the Tariff Act, 19 U.S.C. § 1337.

Under any of these statutes, "all roads lead to Rome" as one court put it (*Societe des Produits Nestle, S.A.*, 982 F.2d at 640), meaning that the trademark owner must demonstrate that the gray market goods to be excluded are materially different from the authorized goods in some respect.

VII. Practical Implications for Licensing

Changes in application of the exhaustion doctrine, such as *Kirtsaeng* wrought, upset established models of licensing, as the *Quanta* decision did for models that were based on the ability to charge separate royalties for sales of components and assembly operations. How these changes will affect licensing practices in different industries is still being worked out.

A. Open Questions.

1. *Can contractual limitations prevent exhaustion?*

In its decision in *Quanta*, the Supreme Court suggested that LG could have avoided exhaustion of its method patent by requiring that Intel sell the patented products only to licensees under LG's method patent. If the licensed rights are merely facets of a single invention, however, such limitations could constitute an antitrust violation as in the *Univis Lens* case.

2. *What will be the geographic scope of patent exhaustion?*

Will the *Kirtsaeng* result for copyrights be extended to patents. Pending further decisions by the Supreme Court, the answer is not clear.

B. Practical measures to avoid exhaustion

1. *Contractual restrictions*.

Include language that excludes prohibited conduct from the scope of the license grant, provided that the prohibitions do not raise antitrust concerns. If the behavior is not within the grant of the license, then the sale is not an authorized sale and the exhaustion doctrine will not apply to it.

2. *License rather than sell.*

The exhaustion doctrine is known as the first sale doctrine because it requires a sale. If the transaction can be structured so that the object of the license is never sold, there will be no exhaustion. For example, rather than selling copies of its software, a software vendor could sell its software as a service on the internet. Then its customers will never take title to any software media and the exhaustion doctrine will never apply.

3. *Product differentiation*.

If products intended for different markets can be differentiated in material ways, they can often be excluded even if a rule of international exhaustion would otherwise be applicable, as in the case of trademarked goods in the United States.

4. *Splitting up ownership of intellectual property geographically*.

If international exhaustion is ultimately based upon the identity of the rights holder, so that any sale is considered an authorized sale in any country where the rights holder has corresponding rights, then an effective geographic division of the international market could require that the rights be divided among separate entities. Retention of common control, however, could well defeat such a strategy by prompting a court to lump the entities together for purposes of exhaustion.

5. *Holding U.S. trademark registrations in U.S. corporations or entities.*

A non-U.S. trademark owner may be able to take advantage of § 526 of the Tariff Act to exclude gray market goods if its U.S. trademark registration is held in a business entity formed in a United States jurisdiction, rather than in the foreign parent. This could be accomplished by forming a special purpose entity in the U.S. to hold the trademark or contractually permitting the authorized U.S. importer and distributor to register the trademark (with suitable provisions to recover ownership in the event of termination).