BEFORE THE HOUSE COMMITTEE ON THE JUDICIARY
SUBCOMMITTEE ON COURTS, INTELLECTUAL PROPERTY AND THE INTERNET

FIRST SALE UNDER TITLE 17

TESTIMONY OF JONATHAN BAND
COUNSEL, OWNERS' RIGHTS INITIATIVE

JUNE 2, 2014

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The Owners' Rights Initiative (ORI) is an organization of over 20 companies and trade associations that have joined together to protect ownership rights in the United States.[1] We believe in the fundamental premise that **if you bought it, you own it**, and should have the right to sell, lend, or give away your personal property. ORI formed when the *Kirtsaeng v. Wiley* case was pending before the Supreme Court. We now are dedicated to preserving that holding, and making sure that it is not undermined in Congress, the executive branch, or in the courts. We also work to protect the principles of the first sale doctrine as technology continues to evolve, such as when software is incorporated into other products. Additionally, we try to prevent the misuse of IP law as a trade barrier that obstructs legitimate competition in other countries.

This testimony describes the importance of the first sale doctrine to the U.S. economy. Next, it explains why the international exhaustion rule adopted by the Supreme Court is sound policy. Finally, it identifies a problem that requires Congressional action: ensuring that consumers and resellers can transfer products that contain software.

Before diving into the details of copyright law, we want to stress that the first sale doctrine is the articulation of a basic feature of property rights. When you own a physical good, you have the right to dispose of it as you please. You can sell it, you can lend it,

[1] A list of ORI members can be found at http://ownersrightsinitiative.org/about/.

you can give it away. The fact that some aspect of the good is covered by a copyright owned by an author does not diminish your rights in the good. If I purchase a lawfully published copy of a novel written by Elmore Leonard, his estate owns the copyright in the novel, but I own the physical copy. Leonard's copyright prevents me from copying the novel, but it doesn't prevent me from selling my copy or giving it away. The first sale doctrine is what protects my property rights in my copy. Similarly, if I buy a North Face jacket with its distinctive logo, North Face's copyright in the logo doesn't prevent me from donating the jacket to the Salvation Army, or the Salvation Army from subsequently selling the jacket. And Coca-Cola's copyright in the design of the label on a can of Coca Cola does not prevent the owner of a hot dog stand outside of Yankee Stadium from reselling the cans of Coke that he buys at Costco.

The first sale doctrine works because it corresponds to consumers' expectations relating to their property. They understand that they can't copy the Elmore Leonard novel or make counterfeit copies of the North Face jacket or the Coca Cola can. At the same time, they fully expect to be able to sell or give away legitimate copies of these products. Whether the copies of the Leonard novel are printed in the United States or in Canada makes no difference to the consumer. He expects to be able to resell it regardless of where it was printed or purchased. Likewise, the owner of the North Face jacket expects to be able to give it to the Salvation Army, regardless of whether it is sewn in the United States or Malaysia.

The Supreme Court's decision in *Kirtsaeng* makes sense because it is consistent with consumer expectations. The purchaser's right to transfer the copy of the Turow novel, or the North Face Jacket, or the can of Coca Cola, should turn not on *where* the copy was made or where it was first sold, but on whether the copy was manufactured lawfully. Any other rule would be counterintuitive and impossible to implement. In today's global market, downstream sellers would have no way of knowing where a product was manufactured or originally sold.

I. The Importance of the First Sale Doctrine

Justice Breyer, writing for the U.S. Supreme Court in *Kirtsaeng v. John Wiley & Sons, Inc*., 133 S. Ct. 1351, 1363 (2013), stated that the first sale doctrine "is a common-law doctrine with an impeccable historic pedigree." He quoted a 17th century articulation of "the common law's refusal to permit restraints on the alienation of chattels," *id*., and observed that "a law that permits a copyright holder to control the resale or other disposition of a chattel once sold is similarly 'against Trade and Traffi[c], and bargaining and contracting.'" *Id*. Justice Breyer underscored "the importance of leaving buyers of goods free to compete with each other when reselling or otherwise disposing of these goods." *Id*. Competition, "including the freedom to resell, can work to the advantage of the consumer." *Id*.

The first sale doctrine operates at every level of our economy. It allows wholesalers to sell products covered by copyright, including products distributed in copyrighted packaging, to retailers without first securing distribution licenses from the manufacturers. The first sale doctrine likewise permits retailers to sell products to consumers without obtaining distribution licenses. Finally, the first sale doctrine permits consumers to rent or lend the products to other consumers, or to sell or give the products away when they no longer need them. The first sale doctrine reduces transaction costs and enables competition between sellers of new products as well as between new and used products. In *Kirtsaeng*, the Court recognized the importance of the first sale doctrine to libraries, used-book sellers, car dealers, technology companies, retailers, and consumers. The limitation on the distribution right provided by the first sale doctrine is critical to the functioning of our economy because the distribution right applies not only to products whose primary value is their protected expression, such as books, films, and sound recordings, but also to the protected expression in the packaging of all products.

II. International Exhaustion

A. *Kirtsaeng v. Wiley*

At issue in the *Kirtsaeng* case was how the first sale doctrine applied to goods purchased abroad. Section 106(3) of the Copyright Act grants the copyright owner the exclusive right "to distribute copies or phonorecords of the copyrighted work to the public by … lending."[2] However, the first sale doctrine, codified at section 109(a) of the Copyright Act, terminates the copyright owner's distribution right in a particular copy "lawfully made under this title" after the first sale of that copy.[3] In recent years, there had been extensive litigation over the meaning of the phrase "lawfully made under this title" in section 109(a). Rights holders generally argued that "lawfully made under this title" meant "lawfully made in the United States." This interpretation would allow the rights holder to prohibit some "parallel imports" or "gray market goods"—that is, the rights holder could prevent a third party from importing legal but less expensive foreign-made copies. Conceivably, this interpretation would also allow the rights holder to prohibit the resale of foreign-made goods sold initially in the United States with the rights holder's authorization.

[2] 17 U.S.C. § 106(3).
[3] 17 U.S.C. § 109(a).

On March 19, 2013, by a 6-3 majority, the Supreme Court rejected this interpretation.[4] In an opinion written by Justice Breyer, the Supreme Court found that "lawfully made under this title" meant manufactured in a manner that met the requirements of American copyright law, *e.g.*, manufactured with the permission of the rights holder. The Court reached this conclusion after a careful examination of the context of the words in Section 109(a), the common law history of the first sale doctrine, the legislative history of Section 109(a), and the Court's earlier decisions. In effect, the Court adopted an "international exhaustion" rule; the distribution right in a copy was exhausted after the first sale of that copy anywhere in the world.

B. The Correct Policy Going Forward

Now that the Supreme Court has issued its decision, there is no point in arguing over whether the Court properly interpreted the relevant statutory provisions, although we think it did. What matters going forward is whether the Court reached the right policy outcome, or should Congress intervene. We believe that the Court did reach the right policy outcome, and there is no reason for Congress to disturb it.

There are three basic policy choices: 1) the first sale doctrine should apply to all legal copies, regardless of where manufactured or sold (the Court's international exhaustion rule); 2) the first sale doctrine should apply only to legal copies sold in the United States with the rights holder's authorization (domestic exhaustion); or 3) the first sale doctrine should apply only to legal copies manufactured in the United States (the Second Circuit's rule in *Kirtsaeng*).

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[4] *Kirtsaeng v. John Wiley & Sons*, 133 S. Ct. 1351 (2013).

Option 3 makes absolutely no policy sense. Even the Second Circuit agreed that there was no logical reason to give foreign-made copies more protection that U.S.-made copies, as it would encourage the export of jobs. Also, this approach would grant rights holders too much control over the alienation of property, given the large amount of goods that are foreign-made and sold in the U.S. with the rights holder's authorization.

Thus, the real choice is between applying the first sale doctrine to all copies, regardless of where manufactured or sold (international exhaustion), or applying the first sale doctrine only to copies sold in the United States (domestic exhaustion).

The policy argument in favor of domestic exhaustion is that it permits rights holders to price discriminate by preventing arbitrage—to charge U.S. consumers higher prices than foreign, less wealthy, consumers. This in theory enables higher profit margins from U.S. sales while benefiting consumers in less developed countries.[5]

How does this benefit the U.S. economy? Rights holders claim that the additional production for foreign markets means more jobs in the United States. Additionally, the profits from the foreign sales would be reinvested here in the development of new products.

But this argument makes two enormous assumptions. First, it assumes that the copies are manufactured in the United States. But for many copyrighted products, this is not the case. Even if the underlying work was created in the United States, the manufacturing of copies occurs in other countries with lower labor costs. Thus, the jobs resulting from increased production aren't in the United States. A motion picture might

[5] However, in some less developed countries, media prices are actually higher in absolute terms than in the United States because the distributors sell only to wealthy, price-insensitive consumers.

be filmed in the United States, but the DVDs could be printed in Mexico.[6] So, the increased production of DVDs to keep up with foreign demand leads to more production jobs in Mexico, not the United States.

Second, this argument assumes that the rights holders are U.S. companies that will reinvest the profits in the United States. But again, in many instances, this isn't true.[7] Four of the six largest English language trade publishers, which sell 70% of the popular books in the U.S., are foreign owned. Four of the five largest science, technical, medical, and professional publishers are foreign owned. Two of the three major record labels are foreign owned. Omega, the plaintiff in the previous first sale case in the Supreme Court, is a Swiss company.[8] Pearson, which brought several cases against book importers, is a British company.

Indeed, Justice Ginsburg said in her dissent that "the Court embraces an international-exhaustion rule that could benefit U.S. consumers but would likely disadvantage *foreign* holders of U.S. copyrights." 133 S. Ct. at 1385 (emphasis supplied). It is hard to see how U.S. consumers paying higher prices to benefit foreign workers and corporations would benefit the U.S. economy. At the same time, the economic benefits of an international exhaustion rule—robust secondary markets resulting in lower prices—are obvious.

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[6] It should be noted that many motion pictures made by U.S. studios are actually filmed in whole or in part overseas. *See* J. Band and J. Gerafi, *Foreign Ownership of Firms in IP Intensive Industries* 15 (2013), available at http://infojustice.org/archives/28840. The leading special effects companies relied upon by U.S. studios are located in the UK, Canada, and New Zealand. *See* Richard Verrier, "California visual effects artists fight foreign film tax credits," *Los Angeles Times*, December 21, 2012, http://articles.latimes.com/2012/dec/21/business/la-fi-ct-visual-effects-protest-20121221.

[7] J. Band and J. Gerafi, *Foreign Ownership of Firms in IP Intensive Industries* (2013), available at http://infojustice.org/archives/28840.

[8] *Costco v. Omega*, 131 S. Ct. 565 (2010).

At a minimum, much more rigorous study would need to be performed to determine whether a domestic exhaustion rule would be a net positive or negative to the United States in light of our increasingly globalized economy. In the absence of compelling evidence of the benefit of shifting to a domestic exhaustion rule, the default position should be free trade unimpeded by government regulation. As Justice Breyer observed, "the 'first sale' doctrine is a common-law doctrine with an impeccable historic pedigree."133 S. Ct. at 1363. It is rooted in "the common law's refusal to permit restraints on the alienation of chattels." *Id*.

Further, there is no inherent right under copyright law to price discriminate and segment markets. As Justice Breyer noted, "the Constitution's language nowhere suggests that its limited exclusive right should include a right to divide markets or a concomitant right to charge different purchasers different prices for the same book, say to increase or to maximize gain.… We have found no precedent suggesting a legal preference for interpretations of copyright statutes that would provide for market divisions." *Id*. at 1371.

Moreover, there is a long history of copyright law, through the first sale doctrine, limiting a rights holder's ability to price discriminate and segment markets within the United States. If a rights holder should have the ability to force a U.S. consumer to pay a higher price for a book than a Mexican consumer, then why shouldn't a rights holder have the ability to force a consumer in New York or California to pay higher price for the book than a consumer in Mississippi or West Virginia? If arbitrage is bad in international markets, why is it acceptable in domestic markets?

In any event, even after *Kirtsaeng*, rights holders can still price discriminate and segment foreign markets—it just isn't quite as easy to do so. They can use contracts to prohibit foreign wholesalers from importing to the United States. They can restrict the number of copies distributed in any country to meet local demand. They can engage in modest product differentiation sufficient to discourage importation. In short, they can act exactly as every other business that cannot rely on copyright to enforce price discrimination.

Finally, a domestic exhaustion rule would create a minefield for charitable organizations such as Salvation Army or Hadassah that raise money by selling donated goods. These organizations would have no way of knowing if an item donated to them had first been sold in the United States with the manufacturer's authorization. Thus, they could potentially incur liability for selling a genuine product that had been imported by someone further up the supply chain without the manufacturer's permission.

III. Applying the First Sale Doctrine to Software Essential to the Operation of Hardware

Given the importance of the first sale doctrine, we support the Subcommittee's examination of how the doctrine could be applied to digital goods. While we understand the need to assess carefully the nuances involving digital goods, we believe that the concept of ownership and consumer expectations mean that stakeholders ultimately should work towards a solution that enshrines the first sale principle when discussing the rules of the road for the resale of digital goods.

At the same time, the Subcommittee should not overlook an aspect of "digital first sale" of concern to our members that affects a specific category of tangible goods: products that are distributed with software essential to their operation. Software, of course, is a digital technology. Even though the consumers buy the physical products, ranging from high-end servers to toasters, the manufacturers can claim that they are just licensing the software essential to the products' operation.[9] These licenses can contain a variety of restrictive terms that limit ownership rights by interfering with resale of the products, thereby harming the consumers that want to sell equipment they no longer want and the secondary market consumers that want to buy that equipment.[10] Often, these secondary market consumers are federal, state, and local government entities. ORI believes that manufacturers should not be permitted to use software licenses to interfere with the resale of products.

Manufacturers currently employ software licenses to place the following impediments on the alienability of physical products:

- **Prohibition on transfer.** Some license agreements provide that the software license is non-transferable. For example, the license for the software that comes installed on a NetApp product is not transferable. As a practical matter, NetApp gets paid twice for the right to use the same software: once by the original purchaser of the product, and a second time by the purchaser of the used product. Purchasers of Cisco equipment often find that it is cheaper to buy new equipment than pay the excessively high price for a license for the software essential to the operation of the used equipment.
- **Refusal to provide updates.** Some license agreements specify that routine updates such as security-patches will be provided only to the original licensee.

[9] The software often is pre-installed into the product by the manufacturer or the vendor. However, sometime the user must install the software provided by the manufacturers via the Internet or storage media such as DVDs.
[10] These licenses also interfere with the sale of unused products by resellers.

For example, Oracle refuses to supply routine updates to the purchasers of used hardware products containing essential Oracle software, unless they make an additional payment.

- **Bundling of maintenance contracts.** Some manufacturers will use control over the essential software as a means of forcing purchasers of used equipment to buy additional services from them. IBM, for example, will charge purchasers of used equipment a fee for software updates, but will provide the updates for free to purchasers that enter into maintenance agreements.[11]

The legal fiction on which these restrictive practices is based is that the essential software is licensed, not sold, to the purchaser of the hardware in which the software is installed. The manufacturers argue that because the purchaser is merely a licensee of the copy of the software, it does not have rights that normally accrue to the owner of a copy, such as the first sale doctrine or the right to make temporary internal copies necessary for the operation of a computer. *See* 17 U.S.C. §§ 109(a) and 117(a). The U.S. circuit courts are split on the validity of the manufacturers' argument. The Ninth Circuit has accepted this argument, *Vernor v. Autodesk*, 621 F.3d 1102 (9th Cir. 2010), while the Second Circuit has rejected it, *Krause v. Titleserv*, 402 F.3d 119 (2d Cir. 2005). Underlying this split concerning whether a person who acquires a copy of a computer program is an owner or a licensee of the copy is an even more profound split concerning preemption of contract terms inconsistent with the Copyright Act. Compare *Bowers v. Baystate Techs., Inc.,* 320 F.3d 1317 (Fed. Cir.), *cert. denied*, 539 U.S. 928 (2003)(holding that the

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[11] Here are links to examples of these restrictive licenses: Palo Alto Networks (https://www.paloaltonetworks.com/support/support-policies/secondary-market-policy.html); and EMC (http://www.emc.com/collateral/software/warranty-maintenance/h2483-sw-use-rights.pdf).

Copyright Act does not preempt contractual terms prohibiting actions permitted under fair use), with *Vault Corp. v. Quaid Software Ltd.,* 847 F.2d 255 (5th Cir. 1988)(holding that under the Supremacy Clause of the U.S. Constitution, contract terms prohibiting copyright exceptions are unenforceable).

Congress previously dealt with a similar issue in the context of software rental. In 1990, when Congress was considering amending the Copyright Act to prohibit the rental of software because it facilitated infringement by consumers, companies that rented cars and other equipment that contained software expressed concern that the amendment could prevent these rentals. Accordingly, Congress added an exception to the software rental prohibition that applies to "a computer program which is embodied in a machine or product and which cannot be copied during the ordinary operation or use of the machine or product." 17 U.S.C. § 109(b)(1)(B)(i).

Preserving the resale rights of consumers of physical products that contain software is important for reasons that go beyond the protecting the economic interests of these consumers and the secondary market consumers who would purchase these products. If the manufacturer refuses to provide to the secondary market consumer the security patches it provides to the original consumer, the security of the secondary consumer's computer system could be compromised. Such security patches typically are provided to the original consumer free of charge. In essence, the original purchase price entitles the consumer to receive security patches and other patches that fix bugs in the program.

Preserving a secondary market in these physical products is also important for the environment. If older products can be refurbished and resold, those products stay out of landfills. Moreover, the recycling of the older products reduces the need to mine raw materials and produce new components.

We recognize that the problem of restrictions placed on software essential to the operation of hardware implicates complex issues of legal theory at the intersection of Constitutional preemption, the Copyright Act, and contract law. Nonetheless, this is a very concrete practical problem of manufacturers attempting to leverage the copyright in a component into perpetual control over a much larger device. At present, primarily manufacturers of computer and telecommunications equipment misuse software license agreements to interfere with resale. Yet as more products are distributed with pre-installed software, such as cars and consumer appliances, this problem will become more widespread. We believe that this problem can be addressed by a relatively simple amendment to the Copyright Act.

IV. IP as a Trade Barrier

The International Trade Commission (ITC) recently issued a report, *Trade Barriers That U.S. Small and Medium-sized Enterprises Perceive As Affecting Exports to the European Union,* which identifies the European Union's use of trademark law as a trade barrier.[12] The purpose of the ITC's report is to catalogue trade barriers as a tool for the U.S. Trade Representative in conducting the Transatlantic Trade and Investment Partnership (TTIP) negotiations with the EU. The ITC report's list of EU trade barriers specifically includes "excessive rights of original trademark owner," and the EU's restrictive trademark regime is mentioned at several points. In particular, the report focuses on the use of trademark law to prevent the importation of genuine goods outside

[12] ORI testified at a hearing that was part of the inquiry that resulted in the report.

of authorized distribution channels. This harms U.S. businesses and individuals trying to sell used and new products in the EU. ORI commends the ITC for recognizing that "overprotecting intellectual property is as harmful as underprotecting it."[13]

[13] *White v. Samsung Electronics*, 989 F.2d 1512 (9^{th} Cir.)(Kozinski, J., dissenting), *cert. denied*, 113 S. Ct. 2443 (1993).