

# The First-Sale Doctrine in International Intellectual Property Law: Trade in Copyright Related Entertainment Products

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*The first-sale doctrine is a mechanism by which producers coordinate the international distribution of copyright related entertainment products and is the source of much litigation against unauthorised traders in copyright product. This article presents an economic analysis of copyright and the evolution of international intellectual property law. The objective is to highlight a contentious issue in international law; namely, the timing of the exhaustion of the right of first sale, and how this impacts upon trade in entertainment products, particularly sound recordings. The article demonstrates that international conventions, such as TRIPS, do not mandate the adoption of national exhaustion.*

## Introduction

This article investigates the economics of copyright and the international dimensions of trade in entertainment products, focusing on sound recordings. Record companies, and multinational entertainment (MNE) companies more generally, have utilised copyright law and the first-sale doctrine to assist in the international coordination of territory (country) specific distribution, pricing and marketing strategies. To be successful these strategies must be backed by laws that prevent the establishment of unauthorised distribution channels, whereby legitimate copyright product is redirected from low-price to high-price markets. Parallel trade accounts for a significant and growing proportion of world trade in patent, trademark and copyright products, estimated to be in excess of \$10 billion in North America alone.<sup>1</sup> This article is organised as follows. The second section presents an economic analysis of intellectual property (IP) rights, followed by an investigation of the evolution of international IP law in the third. This lays the foundation for the review of the first-sale doctrine in international

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law and the controversy surrounding the exhaustion of copyright. This analysis enables us to ascertain the legal obligation, with respect to copyright exhaustion, imposed by membership of various international copyright conventions, including TRIPS. A final section concludes.

### Intellectual Property Rights

Intellectual property may be defined as the expression of an idea or concept as a consequence of an individual's creative endeavour. There are two main branches of intellectual property: industrial property (including trademarks, patents and industrial designs), and copyright (relating to literary and artistic works). IPR law typically grants creators a bundle of exclusive rights. These amount to economic rights that enable the commercial exploitation of copyright product and are designed to encourage and reward creative effort. This encourages technological progress by enabling creators to derive financial rewards from their creations.

Intellectual property displays the public good characteristics of non-excludability and non-rivalry. Non-excludability refers to the difficulty faced by a creator in preventing unauthorised use. Non-rivalry means that the use of the creation by one person does not prevent use by another. Additional users neither reduce the quantity or the quality of the good. An obvious example of non-rivalry is the distribution of literary or musical works using the Internet where an infinite number of copies can be reproduced at close to zero cost. It may be conceptually useful to consider copyrightable creative works as 'information goods' in which the creative work is fixed to an information carrier,<sup>2</sup> for example, a musical work fixed to a sound recording (CD or cassette). While rivalry and exclusivity exist for individual copies of a CD, the musical work itself can be separated from the original carrier and fixed to another. It is this separation and duplication that gives rise to the public good characteristics of the sound recording, and intellectual property more generally.

The public good nature of intellectual property, combined with high establishment costs and low reproduction costs, encourages imitation. Imitation of this kind is referred to as *free riding*: individuals waiting to copy the creation rather than engaging in creative endeavour themselves. The unauthorised commercial reproduction and distribution of intellectual product is referred to as *piracy*. A deceptive trademark or design used to 'pass-off' an item as an original authorised product is typically referred to as *counterfeit* product.

Granting exclusive rights to creators of intellectual property provides the market power to commercially exploit the work and thereby provides the economic incentive for the creation/production of intellectual property.

Exclusive economic (monopoly) rights to the intellectual property helps to eliminate free riding. Unfettered piracy would drive down the price of the creative work to the marginal cost of reproduction rendering it commercially unprofitable. Without the opportunity to exploit commercially the intellectual property, creators may be unwilling to allocate resources to creative activities. This would lead to *market failure*, the underproduction of intellectual property. The protection of IPR via copyright law prevents free riding and encourages the production of creative works.

A conflicting consequence of exclusivity, however, is a restriction in the dissemination of the intellectual property that reduces consumption levels. Dissemination increases consumption and thereby increases consumer welfare. Minimal rights for creators will encourage dissemination and enhance consumer welfare. This increased welfare has the consequential cost of reducing economic returns to copyright owners and thereby discourages creative endeavour. The static consumer welfare gains resulting from increased dissemination may therefore be at the cost of foregone dynamic gains resulting from decreased creative activity.

Numerous attempts have been made to construct economic models that identify the optimal level of protection, portraying copyright law as a means of achieving an efficient allocation of resources. While useful in helping to conceptualise the key issues confronting regulators, these models provide little hope of identifying the optimal level of protection. The information constraints are simply too restrictive. For example, Landes and Posner<sup>3</sup> depict the supply of creative works ( $q$ ) as a function of price ( $p$ ) and a hypothetical index of copyright protection ( $z$ ):

$$q = q(p, z) \quad (1)$$

Following this procedure we can modify equation (1) to depict the consumption of creative works ( $c$ ) as a function of  $p$  and  $z$  as follows:

$$C = c(p, z) \quad (2)$$

The higher (lower) are  $z$  and  $p$ , the lower (higher) is  $c$  and the higher (lower) is  $q$ . That is, consumption is inversely related to copyright product price and the level of protection, while the supply of copyright product is directly related to copyright product price and the level of protection. The higher the value of  $z$ , the higher the market power enjoyed by creators, and thereby the higher the ensuing market price. The objective is to set  $z$  at a level that will maximise national welfare ( $w$ ),

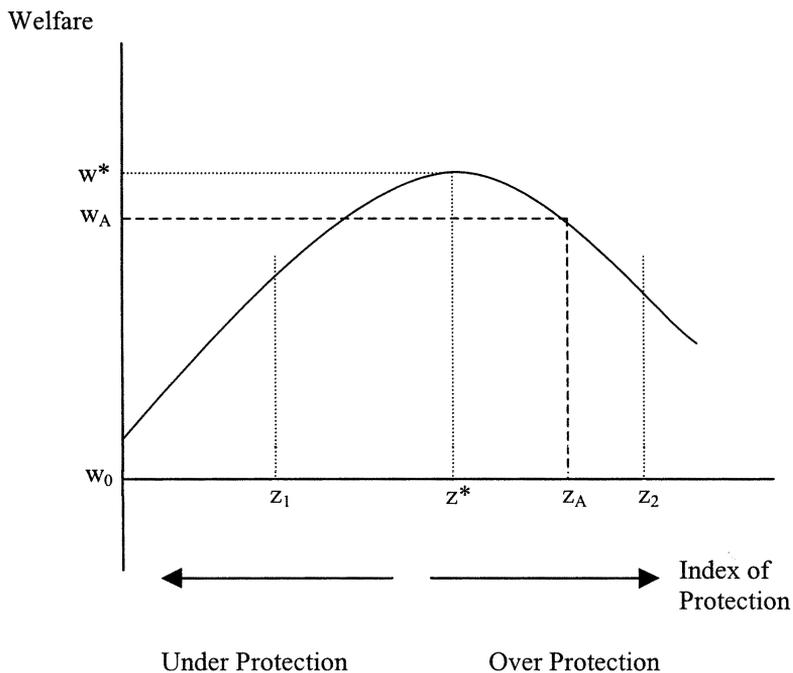
$$w = w[c(p, z), q(p, z)] \quad (3)$$

Equation (3) depicts national welfare as a function of both consumption and production of copyright product, which in turn are a function of the level of protection and price.

The key issue is how the level of protection,  $z$ , ... is set along several dimensions. In general, the modern law of copyright makes intelligent estimates (about the level, breadth and duration of protection).

The challenge for policy makers is to set the appropriate level of market power in a way that balances the interests of both producers and consumers. The socially optimal outcome would be one in which the creator and/or producer is rewarded for their endeavour with a (normal) profit, while maximising consumption subject to the constraint of profitable commercial application. This trade-off can be illustrated in a diagram measuring the theoretical level of national welfare against varying levels of intellectual property right protection, as presented in Figure 1.

FIGURE 1  
THE WELFARE-PROTECTION TRADE-OFF



At low levels of protection ( $z1$ ), creative works will be under-produced because unrestricted competition at the commercial application stage will result in significant levels of piracy. As the level of protection rises, the production of creative works increases, thereby increasing consumption and social welfare. Increased protection will enable creators to charge a higher price and this will lower dissemination. Thus, while social welfare rises as we move towards the optimal level of protection, this rise disguises a shift in the distribution of income from consumers to producers of creative works. This redistribution continues as the level of protection rises. Beyond some theoretical optimal level of protection, depicted as  $z^*$  in Figure 1, the market power of copyright owners is so high that the costs of reduced dissemination exceed the benefits derived from the production of additional creative works.

In a sense, setting the level of copyright protection is an attempt at balancing two welfare losses and gains. Increasing protection raises prices and induces an increase in the production of copyright product. This reduces welfare losses resulting from piracy and underproduction while at the same time excluding potential consumers and thereby lowering consumer welfare. In reality, the information constraints are so severe that setting the optimal level of copyright protection is problematic. Referring to the first order maximisation problem derived from a model for optimal copyright protection, Koboldt states that it is obvious that:

the determination of the optimal level of copyright protection is a difficult task and requires lawmakers to possess complete information about the production technologies and demand structures. (p.147)

Clearly, policy makers do not, and will never have complete information. Setting the optimal regulatory regime is made even more difficult by the several dimensions of copyright protection, including the breadth, level and duration of coverage, and the nature and severity of the penalties for IP infringement. For this reason, the politics of competing interests often take precedence over economic cost-benefit analysis in setting the regulatory framework, without any clear notion of net social gain.

legal interest-balancing leads to no unique solutions, only acceptable bargaining outcomes. The law can more easily recognize the existence of competing interest than measure relative costs and benefits. Even more to the point, interest balancing embodies no clear notion of net social gain.<sup>4</sup> (p.92)

While there may be little hope that economic analysis can resolve the question of the appropriate scope of IPR protection it can nonetheless make an important contribution to our comprehension of the multidimensional

nature of copyright law and the challenges faced by policy makers in attempting to set the optimal level and nature of protection. More precisely, economic analysis can, at the margin, investigate and measure the likely distributional consequences of different levels of copyright protection for producers and consumers of copyright product and on overall social welfare. Critical to this determination is the level of concentration of ownership within various entertainment markets and the prevailing degree of competition. Overprotection and the ensuing market power can result in anti-competitive conduct that lowers economic efficiency. In the context of international trade in entertainment product, the inclusion of a distribution right, in which the creator of a copyright product can control its distribution beyond the point of first sale, may introduce one such distortion. In the following section we investigate the evolution of international IP law, as a preview to considering the first-sale doctrine.

### **Evolution of International IPR Conventions**

The importance of intellectual property in generating wealth for both individuals and nations has led to concerted efforts at international level to create a legal and institutional framework to foster the recognition and protection of intellectual property. In 1886 ten nations established the International Union for the Protection of Literary and Artistic Works by signing the Berne Convention for the Protection of Literary and Artistic Works (1886), the latest revision taking place in Paris and producing the Berne Convention for the Protection of Literary and Artistic Works Paris Act of July 24, 1971 (as amended on 28 September 1979). The primary purpose of this convention was to provide foreigners with protection equal to that enjoyed by local residents in member countries. The Berne Convention rests on three basic principles:

- **National Treatment:** copyright owners must be given protection in member countries equal to that granted to their own nationals.
- **Automatic Protection:** protection is not conditional on any formality, such as registration (as is the case with a trademark, for example).
- **Independence of Protection:** that protection granted is independent of the existence of protection in the country of origin.

The Berne Convention provides protection for literary, dramatic, musical and artistic works. Sound recordings and broadcasts were covered by the inclusion of a category 'subject matter other than works'. The Berne Convention sets minimum standards of protection relating to the 'economic rights' of creators. These exclusive rights include the right of:

- Translation (Article 8)
- Reproduction (Article 9)
- Public Performance and Communication (Article 11)
- Broadcasting (Article 11)
- Adapting, Altering and other Alternations (Article 12)

The general rule in relation to minimum duration of protection is the expiration of the 50th year after the author's death. The Convention also provides for certain 'moral rights' which bestow the right to claim authorship and the right to object to any modification or mutilation of the work that is detrimental to the author's reputation. In recognition of the welfare-reducing effects of excessive market power, a number of exemptions to the bundle of exclusive rights are specified. Known as *fair dealing*, this includes the recording or reproduction of works for private use, research or study, criticism or review and reporting of news. As at 15 October 2000, the Berne convention had 147 member states (countries).

Efforts at protecting music copyright at the international level have not been limited to the Berne Convention. The establishment of the International Federation of the Phonographic Industry (IFPI) in 1933, today representing some 1,700 record producers in over 70 countries, was designed to focus efforts on enforcing intellectual property rights for the music industry and to help thwart the growth in international music piracy. The IFPI's goal is to secure effective legislation to protect intellectual property rights and to ensure adequate enforcement of that legislation.

Creating an international organization such as the IFPI was seen as a means of establishing specific audio copyright legislation where it did not exist, and at the same time harmonizing legislation so that piracy and parallel imports were illegal.<sup>5</sup>

To help achieve this goal the IFPI negotiated the establishment of the International Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organisations, otherwise known as the Rome Convention (1961), which unlike the Berne Convention was specific to copyright in musical works, and designed to improve protection for artists and record companies. Specifically, the Rome Convention grants:

1. performers exclusive rights to the communication of their live performance to the public, the fixation of their live performance (for example, as a sound recording) and the reproduction of such a fixation;
2. producers of phonograms (sound recordings) the right to authorise or prohibit the direct or indirect reproduction of their phonograms;

3. broadcasters the right to authorise or prohibit the rebroadcasting of their broadcast, the fixation and reproduction of any fixation of their broadcast.

Burke asserts that the specificity of the Rome Convention discouraged membership, which by 1970 amounted to only 11 countries. As at 15 October 2000 the Rome convention had 67 member states. Notably, as many as 30 members signed only recently (during the 1990s) and the USA, a major exporter of music product, is not a signatory.

In light of this failure and the need to continually upgrade and improve international protection in the face of new challenges to the protection of copyright, the IFPI negotiated the introduction of the Geneva Convention for the Protection of Producers of Phonograms Against Unauthorised Duplication of their Phonograms (1971). This convention was less onerous on member countries compared with the Rome Convention and was therefore more successful in attracting membership. By 15 October 2000 membership numbered 63 states and included the United Kingdom and the USA. The main aim of the Geneva Convention was to combat the growth of piracy, particularly international piracy, where large quantities of pirate sound recordings were being distributed all over the world. International piracy increased as a consequence of technological developments, namely the shift from vinyl to audiocassette as the main sound carrier and the development of hardware technology (such as the twin audiocassette deck). These technological advances reduced the cost of duplicating sound recordings and thereby stimulated music piracy. To address this the Geneva Convention expressly prohibits:

1. the making of duplicates without consent of the producer,
2. the importation of such duplicates,
3. the distribution of such duplicates to the public.

The Berne, Rome and Geneva conventions are all implemented by an agency of the United Nations (UN), namely the World Intellectual Property Organisation (WIPO). Despite the comprehensiveness of these existing treaties, many developing nations have yet to become signatories to these international agreements, and some that did, failed to effectively enforce domestic IPR laws. As net importers of intellectual property, developing nations choosing to ignore the adoption and implementation of IPR laws are able to free ride on the creative efforts of foreigners in developed countries.

it is in the narrow national interest of technology and entertainment importing countries not to pay much attention to IPR protection,

because this way they might be able to acquire IPR goods at a cheaper price through imitation or copying.<sup>6</sup>

Technological progress has made copying of entertainment goods, such as sound recordings and video games, a fairly simple and inexpensive process. The next wave of sound carrier technology was the compact disc and digital quality audio. CD-writers (or 'CD-burners' as they are often described) provide the opportunity to produce perfect reproductions (or clones) of the original sound recording. With the continuing reluctance of many countries to enforce IPR regulations, developed countries, led by the USA and the European Union (EU) pushed for the adoption of a new international treaty. The forum chosen was not WIPO but the Uruguay Round of the General Agreement on Tariffs and Trade (GATT), now the World Trade Organisation (WTO). This new treaty was the Agreement on Trade-Related Aspects of Intellectual Property Rights, Including Trade in Counterfeit Goods (TRIPS), which came into effect in 1995. Developing countries were induced to join TRIPS in return for the relaxation of controls over textile and agricultural imports by developed countries. This was a strategic move designed to extend membership to an international IPR convention, and importantly, one that is backed by the power of the WTO to enforce the law and impose penalties on rogue nations.

The TRIPS Agreement is the most comprehensive multilateral agreement on intellectual property thus far and covers copyright, trademarks, geographical indications (country of origin), patents, industrial designs, designs of integrated circuits and trade secrets. In relation to copyright, the TRIPS Agreement obliges members to comply with the main provisions of the Berne, Paris, Geneva and Rome Conventions. One advantage of negotiating an IPR agreement within the WTO is that it automatically extends coverage to all WTO member countries, some of which were not signatories to the WIPO conventions. In this way TRIPS is expected to help curb the growth in international piracy. The three main features of the TRIPS Agreement require:

1. a set of minimum standards to be provided by each member,
2. members to establish a set of domestic procedures and remedies for the enforcement of IPR,
3. disputes to be subject to WTO settlement procedures.

It is this last element that makes the TRIPS agreement different from all preceding IPR conventions. TRIPS departs from earlier IPR treaties in that disputes between members will be subject to WTO settlement procedures, where a WTO panel can impose trade sanctions on countries in violation of

the TRIPS agreement. By comparison, WIPO was considered to be a toothless tiger because of the absence of any effective enforcement powers.

There is an expectation among the net exporters of intellectual property that TRIPS will bring about the international harmonisation of IPR laws. Samuelson<sup>7</sup> suggests this is both difficult and undesirable because:

national intellectual property laws are (especially copyright laws) often intertwined with cultural values and policies that are deeply connected to national identity. (p.97)

She expresses concern over the *commodification* of artistic and literary works and suggests that the dominant values of free trade may bring about a homogenised global culture. With WTO settlement procedures in place to deal with disputes over IPR infringements, the cultural argument for intervention may well be deemed protectionist and subject to challenge. This potential loss of national autonomy and control over domestic cultural activities is of concern to many. Weinstock<sup>8</sup> presents a model of copyright law in a framework of democracy rather than a mere item of international trade. He notes that:

recent years have seen a dramatic move to reconceptualize copyright in terms of international trade. TRIPS epitomized that move. It aims to ratchet up worldwide copyright protection and enforcement in order to remove barriers to copyright industry exports. (p.218)

There are few industries that do not rely on IPR protection of one form or another, be it copyright, industrial design, or trade marks. The phenomenon of globalisation is an inescapable process that is integrating markets and economies. Music is a global industry and the development of harmonised international IPR regulation is inevitable and will come at the cost of national legislative, and perhaps cultural, autonomy.

Notwithstanding these developments, WIPO remains an important international body in the protection of IPR and is collaborating with the WTO on these matters. Two treaties were recently negotiated within WIPO in 1996, the WIPO Performances and Phonograms Treaty (WPPT) and the WIPO Copyright Treaty (WCT). These treaties are designed to update rights in the context of new digital and Internet technologies. The WCT requires signatories to comply with the main provisions of the Berne Convention and deals specifically with computer software and databases. The WPPT, on the other hand, deals with the IPR of performers (actors, singers, musicians, etc.) and producers of phonograms. It was introduced in recognition of the need to provide adequate solutions to the challenges of economic and technological developments, and in particular, the impact of the development of information and communication technologies, particularly

the Internet, on the production and use of performances and phonograms. Article 10, the 'Right of Making Available of Fixed Performances' and Article 14 the 'Right of Making Available of Phonograms' provide performers and producers with

the exclusive right of authorizing the making available to the public of their performances fixed in phonograms, by wire or wireless means, in such a way that members of the public may access them from a place and at a time individually chosen by them. (WPPT)

The right of 'making available' is clearly designed to cover on-demand communication of copyright material via the Internet. In the next section we investigate one of the more controversial aspects of copyright protection: the exhaustion of copyright and parallel trade.

### **Distribution Right and the Principle of Exhaustion**

Copyright law in most countries bestows a bundle of rights on creators, including the right to make copies available to the public. This amounts to a right of *first sale* or distribution. However, copyright law generally provides that the distribution right is *exhausted* with respect to a particular copy, after the copyright owner or his/her licensee has sold that copy. The principle of exhaustion means that the purchaser of the copyright product can subsequently re-sell the product without the consent of the copyright owner. It is for this reason that it is also referred to, principally in legal literature, as the *first-sale doctrine*.

The principle of exhaustion lies at the heart of a contentious and unresolved issue in international law; whether or not the copyright owner should control distribution beyond the first sale. Under the principle of *international exhaustion* (sometimes referred to as 'universality') the exclusive right to distribute a work is extinguished after the first sale of a particular copy anywhere in the world. The rationale behind this is that the copyright owner, having sold the product, has obtained the benefit of exclusive commercial exploitation rights bestowed by IPR law and should no longer control its distribution beyond the first sale. Under the principle of *national exhaustion* (or 'territoriality'), however, the exclusive right to distribute survives until the first sale of a particular copy within a specific nation. The sale of a copyright product in one country does not extinguish the right of first sale for that same copy in a second country.

The adoption of national exhaustion amounts to granting an *importation right* in which only the copyright owner or their licensed agent can legally import copies of a copyright product for distribution to the public. In effect, this amounts to a prohibition on parallel imports. Parallel imports refers to

copyright product manufactured within a specific territorial jurisdiction by the owner of the copyright or their authorised licensee, which is then imported for re-sale into another territorial jurisdiction by someone other than that territory's copyright licence holder.

The importation right enables copyright owners to partition the global market into national segments, setting price according to the price elasticity of demand in each segment, and thereby extracting monopoly profits.<sup>9</sup> In this context, it has been argued, that parallel imports provide effective competition to authorised distribution channels, thereby breaking this anti-competitive strategy. Proponents of the importation right argue that parallel import restrictions are expected to bolster the protection of copyright for the owner or licensee within a specific territorial jurisdiction and remove distortions arising from rivalry between licensees operating in different (national) territories. The latter argument amounts to the utilisation of government intervention (IPR law) to assist copyright owners in governing the vertical distribution of copyright products.<sup>10</sup>

Copyright owners have also employed technological and contractual measures to combat parallel imports, with limited success. In the motion picture industry, for example, film studios and major DVD hardware manufacturers agreed on a regional coding system in which discs encoded for the USA (region 1) would not play on hardware sold in Europe (region 2). A regional coding system is also employed by the Sony Corporation on its playstation video game consoles and software. Technological measures of this nature are relatively easy to circumvent utilising modified players, inserting chips that effectively convert the hardware into multi-zone players. Indeed, some hardware manufacturers openly market multi-zone DVD players, also capable of playing Video CDs (a pirate film format particularly popular in Asia) and MP3 audio files, a popular format for the digital distribution of free and pirate sound recordings over the Internet. The film industry responded with regional enhanced coding on some discs, rendering them unplayable on modified players. However, these measures provide only temporary relief as circumvention technologies (both hardware and software) quickly negate promised benefits to copyright owners and their territorial distributors.

The contractual approach to inhibiting parallel trade has, likewise, had limited success. Contractual arrangements may, for example, bestow exclusive territorial rights but limit or indeed prohibit exports into other territories. For the copyright owner, this facilitates the global coordination of product release timing and pricing strategies, and limits cross-territorial competition between authorised licensees and/or distributors. However, since manufacturers typically sell to distributors, which in turn sell to retailers, there are numerous points along the product distribution chain at

which product can be diverted from low-price to high-price markets. Copyright owners have only indirect and therefore limited control over third parties along the distribution chain. It is for this reason that contractual arrangements need to be backed by copyright laws that bestow an importation right to effectively restrict parallel trade.

As a major copyright exporting country, the USA (encouraged by a large and powerful copyright industry lobby), has been particularly vigilant in maintaining (if not strengthening) importation rights embodied within national copyright laws. For example, in 1997 the US Trade Representative threatened to initiate proceedings against Australia in the WTO if it proceeded with the planned amendment to the Copyright Act 1968 that would allow parallel importation of sound recordings. This implied that Australia would be in breach of its international obligations with respect to the TRIPS Agreement. In the following section we review international IPR law to evaluate the merit of this argument.

### **International IPR Law and the Exhaustion of Copyright**

There are essentially two sets of international laws with respect to IPR, those managed by the World Intellectual Property Association (WIPO) and more recently, those embodied in the TRIPS Agreement of the WTO. An IPR owner's exclusive right to make the product available for sale is incorporated in the Berne Convention, Rome Convention, and Geneva Convention, as outlined above. Disputes arising between convention member countries can be brought before the International Court of Justice.

Distribution is a key right identified in the WCT and WPPT. The WPPT defines the right of distribution in Article 12 (paragraph (1)):

Producers of phonograms shall enjoy the exclusive right of authorizing the making available to the public of the original and copies of their phonograms through sale or other transfer of ownership.

Importantly, Paragraph 2 of Article 8 explicitly avoids determination with respect to the timing of the exhaustion of this right.

Nothing in this Treaty shall affect the freedom of the Contracting Parties to determine the conditions, if any, under which the exhaustion of the right in Paragraph (1) applies after the first sale or other transfer of ownership of the original or a copy of the phonogram with the authorization of the producer of the phonogram.

The text of WCT (Article 6) is identical except that it refers to the making available of 'literary and artistic works' rather than phonograms. In other

words, members of both conventions are free to determine the timing of the exhaustion of the right of distribution and adopt the principle of national or international exhaustion as they see fit.

Negotiations within the WTO, as evidenced in the text of the TRIPS Agreement, have also left the controversial issue of the importation right to individual national regulators. Article 6 of TRIPS deals with the issue of exhaustion in the following way.

For the purposes of dispute settlement under this Agreement, subject to the provisions of Articles 3 and 4, nothing in this Agreement shall be used to address the issue of the exhaustion of intellectual property rights. (Part I: General Provisions and Basic Principles)

Unable to agree on whether the principle of national or international exhaustion should prevail, negotiators agreed to disagree and this question was left to individual member states to determine at a national level. Patented products would seem to be an exception to this rule as indicated in Article 28, which confers the following exclusive rights:

where the subject matter of a patent is a product, to prevent third parties not having his consent from the acts of: making, using, offering for sale, selling, or importing (footnote) for these purposes the product;

This would seem to suggest that patent owners have exclusive importation rights and that member states are unable to adopt international exhaustion with respect to patents. However, the footnote specific to the importation right states that the rights conferred are subject to Article 6. This seemingly contrary indication might be explained by Article 28, which prohibits importation, or any other act specified therein, by third parties 'without the owner's consent'. The making available or distribution of the patent product in a member country would suggest consent and thereby enable third parties to import and distribute copies first sold overseas.

The issue of the exhaustion of copyright has implications for the nature of the bundle of exclusive rights and market power bestowed on copyright owners, and thereby on the distribution of income between consumers and producers of copyright product. Moreover, in an international context it can impact upon the distribution of income and welfare among nations via its impact on domestic prices and trade flows. This would seem to have been recognised during the negotiations of the TRIPS agreement. Specifically, Article 7 states that IPR laws should promote technological innovation, transfer and dissemination:

to the mutual advantage of producers and users of technological knowledge and in a manner conducive to social and economic welfare, and to balance rights and obligations.

This statement would seem to provide support for a policy of selective international exhaustion by product class, as espoused by Donnelly.<sup>11</sup> That is, either national or international exhaustion should be adopted for specific classes of products (for example, sound recordings, motion pictures or video games) where it can be demonstrated that the adopted position 'balances rights and obligations' in a way that maximises social and private efficiency. Indeed, Article 8 of TRIPS makes it clear that WTO members have the right to adopt national rules and policies to prevent restrictive practices by IPR owners.

Appropriate measures ... may be needed to prevent abuse of IPR by holders or the resort to practices, which unreasonably restrain trade or adversely affect the international transfer of technology.

In specific product classes the exploitation of an importation right embodied in the principle of national exhaustion may be deemed to 'unreasonably restrain trade' and be detrimental to the national welfare of a member state. Specifically, an importation right may enable copyright owners and their licensees to extract monopoly profits from a specific territory at the expense of domestic consumers. Indeed, the potential for certain types of licensing arrangements to be anti-competitive was recognised within Section 8 of TRIPS which explicitly deals with 'Control of Anti-Competitive Practices and Contractual Licences'. Article 40 enables member states to adopt appropriate measures to prevent anti-competitive practices. Parallel import prohibitions have been described, in some quarters, as anti-competitive and the adoption of the principle of international exhaustion for the purpose of removing price discrimination and/or collusive conduct by monopoly IPR rights holders is consistent with this section of the TRIPS Agreement. It would seem that under international law neither the WTO or WIPO treaties prescribe either national or international exhaustion with respect to the distribution right. This is supported by a range of literature on this legal issue, to which we now turn.

In an investigation of patent rights under WTO laws, Bronckers<sup>12</sup> seeks to answer the legal question of whether the WTO obliges or prohibits member countries from adopting international exhaustion. In doing so he deliberately ignores the economic issues and welfare implications relating to the timing of the exhaustion of the distribution right. In a review of the negotiating history of the TRIPS Agreement, Bronckers points out that the primary objective for developed countries was to improve the effectiveness

of IPR protection in developing country markets. Moreover, the dispute resolution mechanisms of the WTO would provide the necessary vehicle for the effective implementation of enforcement measures against offending member countries. This was something that was lacking in the WIPO treaties. Under the dispute settlement mechanism of the WTO, a member country can initiate the establishment of a tribunal to adjudicate alleged violations by another member country. Importantly, WTO and TRIPS now provide for cross-sectoral retaliation. If a member country infringes on copyright, then the aggrieved national government can impose a punitive tariff on another product, say clothing. Under the old GATT framework, the country imposing the tariff would have been in violation of the GATT, see Nimmer.<sup>13</sup> Bronckers points out that, as disputes between parallel importers and copyright owners or licensees often occur in the same country, WTO and TRIPS are unable to assist in settling what are essentially domestic disputes.

On the issue of the exhaustion of the distribution right, Bronckers contends that TRIPS was not intended to rule on the issue of exhaustion of IPR and that any creative interpretation to the contrary could not be used to impose restrictions on member countries with respect to their ability to rule independently on this issue. Citing a ruling by the WTO Appellate Body (to which a member state can appeal if unsatisfied with the decision of the tribunal) Bronckers demonstrates that in the context of ambiguity the less onerous meaning (in terms of obligations and sovereignty of members) is to be preferred to the more onerous:

Accordingly, from a WTO perspective, the discussion of the proper policy to be followed by individual Member States on the exhaustion of patent rights is entirely open. The WTO members must reconcile their views on policy, rather than on law, where the exhaustion of rights is concerned. Thus, if policy-wise it made sense to negotiate different rules on exhaustion for patent rights than for trademark rights, then there is nothing in WTO law that would prohibit this.

This conclusion is consistent with the policy options suggested by Donnelly (note 14) regarding the adoption of selective international exhaustion by product class, based on the economic costs and benefits unique to a specific product. Donnelly presents an excellent review of the legal precedent (judicial rulings) with respect to parallel imports and the exhaustion of rights in the US, Japan and EU, highlighting the somewhat complex and confusing legal environment within which traders are operating:

The current state of the exhaustion of rights principle internationally is uncertain and ambiguous and the practical results of the fractured

state of the law probably makes little sense to commercial traders ...  
The move towards the intellectual harmonization of intellectual property laws is clear and growing.

However, attempts at international harmonisation to date, as evidenced by the TRIPS Agreement, have proved difficult. Donnelly concludes that harmonisation of laws is necessary and considers four harmonisation models: *international exhaustion*, *national exhaustion*, *selective international exhaustion by product class*, and *rule of reason exhaustion*. National exhaustion, he argues, is inconsistent with the fundamental principle of international harmonisation and the harmonisation of rules within free-trade areas such as the EU and NAFTA. International exhaustion would seem to be the simplest model but, given the diverging views of numerous national governments on this issue, is not at present feasible. For this reason, Donnelly suggests that the remaining two models are achievable and consistent with present international IPR laws. *Selective international exhaustion by product class* is a hybrid model of national and international exhaustion:

Such a position has been investigated by the Japanese Ministry of International Trade and Industry. One option considered was to authorize parallel trade of products such as compact discs and watches but bar parallel imports of products such as industrial machinery and electrical goods.

The advantage of this model is that it provides the flexibility for policy to respond to the specific circumstances prevailing in a particular product market rather than apply either national or international exhaustion universally. This approach is consistent with Article 6 of TRIPS whereby each government is free to determine policy with respect to IPR law (patent, trademark, copyright etc.) in each product class (sound recording, business software, motion pictures etc.)

The *Rule of Reason Exhaustion Model* sets international exhaustion as the default, with the possibility of an IPR holder making a case that the IPR has not been exhausted by the first sale in another territory. Donnelly states:

The strength of such a model of harmonization is its ability to accommodate many interests. On the one hand, it has as the default rule international exhaustion which is both theoretically appealing and most vigorously promotes free trade and movement of goods. On the other hand, it affords intellectual property owners – acting through their government if necessary – the ability to prevent the exhaustion of their IP rights when circumstances warrant it in light of the policies of intellectual property rights and free trade in goods and services.

However, as Donnelly points out, genuine harmonisation would require consistent rulings in determining the validity of exemptions to the rule. This ambiguity is likely to result in considerable disputation. In practical terms I do not believe there to be a significant difference between the proposed hybrid models. In either case, a policy review committee would need to be established in which each product class would be examined and the economic, commercial and welfare implications considered. Representations and submissions would be sought from all interested parties after which, balancing the costs and benefits, a position would be reached regarding the exhaustion of IPR and parallel imports.

In the rule of reason model, this process would be initiated by the IPR owner or their territorial agent. In the alternate hybrid model, the process would be initiated by government, which would conduct a policy review over a period of time, investigating each product class sequentially. The latter was the approach taken by the Australian government on the issue of the exhaustion of IPR and parallel imports, which first ruled on books, then sound recordings, and more recently passed the Copyright Amendment (Parallel Imports) Bill 2002, which will effectively adopt the principle of international exhaustion on all copyright products.<sup>14</sup> As a net-importer of copyright product, it is not in Australia's national interest to overprotect intellectual property. See Figure 1 for the welfare-protection trade-off and the redistribution of income from consumers to producers as the breadth and depth of the range of exclusive rights is extended. In the Australian governments' estimation (and a view held by the Australian Competition and Consumer Commission (ACCC)), a prohibition on parallel imports would lower national welfare, since the benefits to (largely foreign) copyright owners would be smaller relative to the losses imposed on consumers as a result of higher domestic prices. The adoption of international exhaustion could be depicted by a movement from  $zA$  (see Figure 1) toward  $z^*$  raising national welfare from  $wA$  to  $w^*$ . In an action initiated by the ACCC, the Australian Federal Court found a number of MNE record companies guilty of breaches of the Trade Practices Act 1974, resulting from conduct designed to stifle parallel trade by, among other things, threatening to withdraw supply to music retailers engaging in parallel importing. The breaches were symptomatic of unwillingness by foreign copyright owners (acting through domestic subsidiaries) to accept intra-brand competition brought about by amendments to copyright law permitting parallel importation. Strategies to retain copyright owner control over vertical distribution included attempts to block both parallel exports and parallel imports.<sup>15</sup>

In an investigation of the cultural dimensions of the TRIPS Agreement, Samuelson (note 7) contends that the objective of the developed countries

was to bring IPR within the dispute resolution framework of the WTO. This would ensure that national governments enact and implement laws that prohibit piracy and counterfeit. Samuelson expresses concern over the use of TRIPS as a means of harmonising IPR laws if it leads to further international acceptance of the 'freedom imperialism' already embodied in the WTO. She contends that the artistic and cultural nature of many copyright products may provide justification for specific national laws that protect products that are deemed to be of national cultural significance.

substantial harmonization of national intellectual property laws may be difficult to achieve unless one wished to bring about a homogenized global culture of mediocrity in which commodification and free trade are dominant values.

The potential distortion of economic activity and resources resulting from the importation right, a form of non-transparent trade barrier, clearly warrants further investigation to determine its relevance in the contemporary trading environment. Indeed, while copyright has historically been defined on a territorial basis, there are two contemporary developments that will render these practices obsolete in the near future. The first development is the integration of the global market and the continuing establishment and extension of free trade areas. A good example of the latter is the EU 'Rental Directive', which allows individuals or companies to purchase and import copyright goods from any EU member country, irrespective of the territorial jurisdiction of the copyright licence holder from which they are purchased. That is, the EU applies a notion of *community exhaustion*. No doubt contractual arrangements between copyright owners and licensees within the EU are adapting to this changing regulatory environment. This would add some credence to the argument that the conflict between the territorial licence holder and the parallel importer is a contractual problem between the copyright owner and the licensee. Secondly, changes in digital technology and the Internet provide for the direct sale of copyright material to consumers in other territorial jurisdictions, while on-line delivery of digital quality sound recordings will challenge traditional means of promoting and distributing sound recordings.

Exclusive territorial licences mean that, in practice, parallel importation is severely restricted. This provides the copyright holder, often the local subsidiary of an MNE, with exclusive importation and distribution rights. This exclusivity may impact upon the structure of the domestic market, influence prices and quantity traded and cause a redistribution of income between copyright owners and consumers and between foreigners and local citizens. We now review related literature investigating the economics of

parallel imports generally with a view to developing a theoretical model of parallel imports with respect to sound recordings.

Having established that there is no legal impediment to the adoption of international exhaustion, we now examine the economic literature on the phenomenon of parallel imports and the issue of national versus international exhaustion. An investigation of the economic costs and benefits of parallel imports should enable us to determine whether or not, policy wise, international exhaustion is superior to national exhaustion.

### Summary and Conclusions

Copyright law is an essential safeguard for creators and producers of entertainment products. However, there is considerable controversy surrounding the nature of the bundle of exclusive privileges bestowed by these statutory rights. International IP law does not mandate the adoption of national exhaustion with respect to copyright products. As such, individual national governments are free to adopt national or international exhaustion and can do so across all product classes or selectively, considering the unique characteristics of the specific market to which it is applied. This is an important aspect of international trade law that will impact upon the distribution of entertainment products, and the ensuing market prices, the distribution of income between consumers and owners of copyright product, and on economic efficiency. The adoption of international exhaustion will enable the establishment of competing distribution channels for entertainment products. Whether this raises or lowers economic efficiency is a somewhat complex question, the answer to which depends on the unique market characteristics of the entertainment product in question. Accordingly, the Australian approach of selective international exhaustion, after a detailed analysis of the specific product market, seems a sensible approach.

### NOTES

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